

Australian Energy Market Commission

DRAFT REPORT

Review of Compensation Arrangements following an Administered Price, Market Price Cap or Market Floor Price

29 November 2012

REVIEW

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two principal functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

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Abbreviations

1 Executive Summary

The Australian Energy Market Commission (AEMC) has initiated this review into the arrangements for compensation following an administered price, market price cap or market floor price.

These arrangements allow participants to claim compensation if they have incurred a loss due to the application of administered pricing.¹ The circumstances under which this type of compensation can be claimed are relatively uncommon; since market start, only one claim has been made.

The draft recommendations in this report are designed to improve the frameworks which govern these compensation provisions, in order to promote more efficient market outcomes. These frameworks must balance the protection of consumers from sustained high prices against the maintenance of effective price signals to market participants. Maintaining this balance is important in promoting efficient investment in and operation of electricity services.

This review focusses on the operation and effectiveness of the current compensation arrangements in clauses 3.14.6 and 3.15.10 of the National Electricity rules (the rules or NER).

The key objectives of this review are:

- to align the structure and design of the compensation provisions with the objectives of paying compensation;
- to provide the market with a clear set of indicators as to when compensation is appropriate;
- to develop transparent mechanisms which facilitate the recovery of the costs of compensation on an equitable basis; and
- to remove any ambiguities and improve the general effectiveness, transparency and consistency of the compensation frameworks.

Our draft recommendations are:

- **Purpose of compensation:** We recommend that the clauses describing the purpose of compensation be amended, to clarify that the primary purpose is to maintain incentives for participants to supply energy during an administered pricing period.
- **Eligibility to claim compensation - who should be eligible:** We recommend that scheduled generators, scheduled load and scheduled network service providers should remain eligible to claim compensation. However, a clear case cannot be made for ancillary service providers to remain eligible to claim compensation.
- **Eligibility to claim compensation - eligibility criteria and market suspension:** We have developed new eligibility criteria based on market conditions. Participants will become eligible to claim compensation once the spot price has

¹ In this case, administered pricing refers to the application of the administered price cap, the market price cap, the market floor price or the administered floor price.

been actively capped by the administered price cap (or administered floor price) and remain eligible until the end of the trading day. Participants may only claim for any net losses incurred due to operating during the eligibility period. We also recommend that any reference to market suspension be removed from the eligibility criteria.

- **The AEMC's assessment process:** We have proposed a number of changes to the processes followed by the AEMC in the assessment of compensation claims. Firstly, we recommend that the AEMC should publish advice to inform the market of the commencement of a compensation claim. Secondly, we recommend that the AEMC should have some discretion to extend the time to complete assessment of a claim, in certain circumstances. The AEMC should also have some discretion to appoint a varying sized expert panel, depending on the complexity of individual compensation claims.
- **Public consultation process:** We recommend that a public consultation process is only likely to add value to the assessment of a compensation claim where the claim is for opportunity costs. No public consultation process is considered necessary for direct cost claims.
- **Recovery of compensation costs:** We have developed an approach which clarifies the process for recovery of the costs of compensation. This process recovers the cost of compensation from market customers in proportion to their total energy consumption during the compensation eligibility period.
- **Retailer pass through of costs:** We consider that existing processes do not impede retailers from passing through the costs of compensation to their end use customers. However, we welcome more detailed stakeholder comment on this issue.

In developing these recommendations, we have sought to balance simplicity of approach against the potential of various changes to promote improved efficiency. We consider that a transparent and easily applied approach will provide improved certainty and should help deliver more efficient operational and investment decisions in the long run.

We have focussed on those areas where we consider amendments to the existing arrangements are most likely to provide real benefits for consumers. In doing so, some new issues have arisen which were not explicitly identified in the issues paper. These new issues relate to the eligibility of other participants to claim compensation.

Given that these issues were not explicitly identified in the issues paper, and allowing for the Christmas period, we have allowed a longer period than the normal six weeks for the development of stakeholder submissions.

We welcome comments from all interested stakeholders.

Submissions to this review close on 24 January 2013.

2 Background

The AEMC has initiated this review into the arrangements for determining and paying compensation following an administered price cap (APC), administered floor price, market price cap or market floor price, under section 45 of the National Electricity Law (NEL).²

2.1 Context of the review

Currently, NER clause 3.14.6 of the rules sets out the framework for participants to claim compensation due to the application of an APC, administered floor price, market price cap or market floor price. The AEMC is required to determine whether compensation is payable and, if so, the amount of compensation to be awarded.

In 2010, Synergen Power Pty Ltd (Synergen) made a claim for compensation for its Snuggery and Port Lincoln units in South Australia. Synergen was the first participant to lodge a claim for compensation under the clause 3.14.6 provisions.

During the AEMC's assessment of the Synergen claim, a number of issues within clause 3.14.6 were identified. These issues related to:

- the situations in which parties may be eligible to apply for compensation;
- the roles of the AEMC and the three member expert panel;
- the AEMC's power to disclose information subject to a claim of confidentiality; and
- a lack of flexibility in the timing to process the compensation claim.

In its final decision on the Synergen Power compensation claim published in September 2010, the Commission discussed its intention to undertake a review of the arrangements for determining compensation under clause 3.14.6 of the rules. We also identified that clause 3.15.10 of the rules, which describes the arrangements for the recovery of the cost of compensation, should be reviewed.

2.2 Objectives of this review

The objectives of this review are:

- to align the structure and design of the compensation provisions with the objectives of paying compensation;
- to provide the market with a clear set of indicators as to when compensation is appropriate;
- to develop transparent mechanisms which facilitate the recovery of the costs of compensation on an equitable basis; and
- to remove any ambiguities and improve the general effectiveness, transparency and consistency of the compensation frameworks.

² Under section 45 of the NEL, the AEMC may conduct a review into the operation and effectiveness of the rules.

In conducting any review under the NEL, the AEMC is required to have regard to the National Electricity Objective (NEO), which is as follows:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to-

- (a) price, quality, safety, reliability and security of supply of electricity;
and
- (b) the reliability, safety and security of the national electricity system.”

Amendments to the compensation provisions may contribute to the achievement of the NEO in several ways, including by:

- providing incentives on participants to maintain a reliable supply of electricity;
- helping to maintain efficient price signals for investment in electricity facilities and services;
- providing increased regulatory certainty for participants regarding the eligibility for compensation and the general operation of the compensation provisions under clauses 3.14.6 and 3.15.10, which is likely to contribute to efficient decisions regarding operation and use of electricity services; and
- improving the efficiency of the process for assessing compensation claims and recovering compensation costs from market customers.

2.3 Consultation process

The recommendations contained in this draft report are likely to have important implications for stakeholders including generators, retailers, market customers, scheduled network service providers and AEMO. All interested stakeholders are therefore encouraged to make submissions to this draft report.

After consideration of submissions to this draft report, we intend to publish a final report. In accordance with section 45(4) of the NEL, a copy of the final report will be provided to the Standing Council on Resources and Energy (SCER). We intend to include a draft version of a rule change request with the final report.

At this stage, we intend to publish the final report in the first half of 2013.

2.4 Links to other relevant reviews

There are several AEMC rule changes and other processes which are relevant to the issues considered in this review. Stakeholders may find these documents useful to consider in conjunction with this draft report. These reports are available at www.aemc.gov.au and include:

- AEMC 2011, *Application and Operation of Administered Price Periods*, Rule Determination, 10 November 2011, Sydney;
- AEMC 2011, *Compensation Guidelines under clause 3.14.6 of the National Electricity rules*, Final Decision on Amended Guidelines, 17 February 2011, Sydney;

- AEMC, 2010, *Compensation claim from Synergen Power Pty Ltd*, Final Decision, 8 September 2010, Sydney;
- AEMC 2009, *Establishment of Guidelines for the determination of Compensation Following the Application of the Administered Price Cap, Market Price Cap, Market Floor Price or Administered Floor Price*, Final Decision, 30 June 2009, Sydney; and
- AEMC 2008, *Compensation Arrangements Under Administered Pricing*, Rule Determination, 18 December 2008, Sydney.

2.5 How to make a submission

The closing date for submissions to this Draft Report is 24 January 2013.

Submissions should quote project number “EPR0026” and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission

PO Box A2449

Sydney South NSW 1235

2.6 Structure of this report

The remainder of this draft report is structured as follows:

- Chapter 3 provides an overview of the current compensation arrangements;
- Chapter 4 sets out our draft recommendations regarding the purpose of compensation;
- Chapter 5 sets out our draft recommendations regarding the AEMC's assessment processes, including the public consultation process;
- Chapter 6 sets out our draft recommendations for the eligibility of scheduled generators to claim compensation;
- Chapter 7 sets out our draft recommendations regarding the eligibility of other classes of participant to claim compensation;
- Chapter 8 sets out our draft recommendations for the recovery of the costs of compensation; and
- Chapter 9 provides an overview of the next stages of the report and further processes once this review is complete.

3 Overview of the current compensation provisions

The compensation provisions are a component of the broader market price cap / cumulative price threshold / administered price period / APC framework. This framework is designed to protect consumers from extended periods of high prices, while maintaining incentives for participants to supply energy and continue to invest in the provision of energy services.

Below, we step through some of the key aspects of this framework, as well as examining the current compensation provisions in more detail.

3.1 The market price cap / cumulative price threshold / administered price cap / compensation framework

The National Energy Market (NEM) is a gross, energy-only market. The volatility of spot prices for both energy and ancillary services is therefore an important aspect of market design and operation. The ability of prices to move from $-\$1,000/\text{MWh}$ up to $\$12,900/\text{MWh}$ allows generators and other market participants to earn a reasonable return on assets and recover fixed costs, providing a signal for investment.

However, this volatility also creates risk for parties who participate in the wholesale market. A persistently high spot price can lead to participant financial distress and, in extreme cases, may impact the stability of the wider market.

While the management of risk by individual market participants is an essential and unavoidable aspect of participating in the NEM, the rules contain a number of mechanisms designed to help manage risks to individual market participants and systemic market wide risks.

The design of this area of the NEM has undergone several changes since its creation in 1996. Currently, the rules contain several mechanisms that together make up an overall package for managing the risks posed by periods of sustained high prices:

- a spot market price cap and a market floor price;
- a rolling cumulative price threshold that applies over a seven day period.
- an administered price period, which applies in the region where the cumulative price threshold was reached; and
- a compensation mechanism for eligible parties who have incurred losses due to the application of the APC.

The market price cap is currently set at $\$12,900/\text{MWh}$ and the market floor price is $-\$1000/\text{MWh}$.

The cumulative price threshold works by calculating the cumulative sum of the spot prices in a region across a rolling seven day period. If this total exceeds the cumulative price threshold (currently set at $\$193,900$), an administered price period commences.

During an administered price period, the spot price in the region is effectively collared between the APC of $\$300/\text{MWh}$ and the administered floor price of $-\$300/\text{MWh}$. Although AEMO continues to calculate a dispatch price and dispatch the market based

on this price, the spot price cannot exceed the limits of the APC and administered floor price for the entirety of the administered price period.

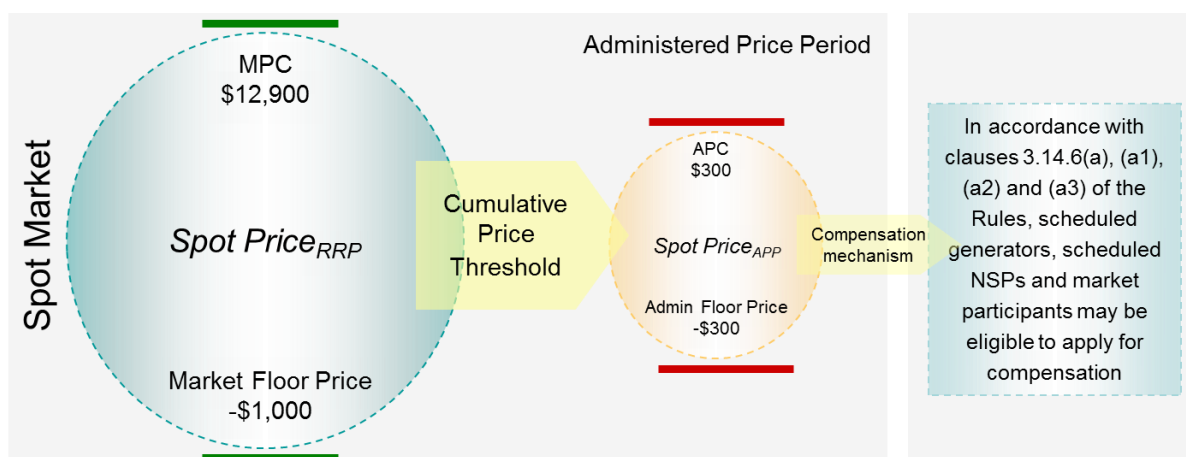
The administered pricing period continues until such time as the rolling seven day cumulative price drops back below \$193,000. The administered price period ceases at the end of the trading day in which the price drops below the cumulative price threshold.

The application of the APC during an administered pricing period may cause some participants to incur a loss. This may occur where the participant's direct or opportunity costs are in excess of \$300/MWh. While there are not many of these participants with costs in excess of \$300/MWh, the potential for them to incur a loss may create a disincentive to supply energy during an administered price period, or may weaken investment signals. This may have negative consequences for the reliability of supply of electricity services.

Accordingly, clause 3.14.6 allows for these participants to claim compensation for direct and opportunity costs. This compensation is administered by the AEMC.

The market price cap/cumulative price threshold/APC/compensation mechanism is illustrated in figure 3.1.

Figure 3.1 Market price cap / cumulative price threshold / APC mechanism



3.2 Participants eligible to apply for compensation

Clauses 3.14.6(a), (a1), (a2) and (a3) of the rules specify the types of market participant that are currently eligible to apply for compensation. These clauses also specify the specific circumstances in which each of these participant types are eligible to claim. The table below summarises the current provisions.

Table 3.1 Eligible participants

Relevant NER clause	Claimant type	Specific circumstances	Eligible to apply for compensation
Clause 3.14.6(a)	Scheduled Generator	Application of an APC during either an administered price period or market suspension	If resultant spot price payable is less than the price specified in the dispatch offer for a trading interval
Clause 3.14.6(a1)	Scheduled Network Service Provider	Application of an APC, the market price cap, the market floor price or an administered floor price	If resultant revenue receivable is less than the minimum requirement specified by the network dispatch offer for a trading interval
Clause 3.14.6(a2)	Market Participant (in respect of a scheduled load)	Application of an administered floor price during either an administered price period or market suspension	If resultant spot price is greater than the price specified in the dispatch bid for trading interval
Clause 3.14.6(a3)	Market Participant (in respect of an ancillary service generating unit or ancillary service load)	Application of an APC	If resultant ancillary service price is less than the price specified in the relevant market ancillary service offer for a dispatch interval

Importantly, the provisions setting out the circumstances in which a market participant may be eligible to apply for compensation operate separately to the process of determining whether that participant will actually receive compensation. That is, being eligible to apply for compensation does not necessarily mean that any compensation will be awarded.

3.3 Process for determining compensation

Clause 3.14.6 of the rules also requires the AEMC to determine whether compensation is payable, and if so, the amount of compensation payable, to any eligible participant.

The key areas covered by clause 3.14.6 relate to:

- the circumstances in which certain parties are eligible to apply for compensation;
- the preparation of compensation guidelines³ by the AEMC to support the operation of clause 3.14.6 which must:
 - identify the objectives of paying compensation as those set out under clause 3.14.6(c)(1);

³ AEMC 2011, Amended Guidelines, *Compensation Guidelines under clause 3.14.6 of the National Electricity rules*, 17 February 2011, Sydney

- require that the amount of compensation be based on costs directly incurred by the claimant and the value of any opportunities forgone;
- outline the methodology to be used to calculate the amount of compensation payable; and
- set out the information that AEMO and the claimant are required to provide;
- the roles and responsibilities of the AEMC in determining whether compensation should be paid and the amount of compensation payable, including:
 - a requirement on the AEMC to establish a three member expert panel (the panel) to provide advice to the AEMC on the claim; and
- the roles and responsibilities of the panel in providing advice to the AEMC.

3.4 Consultation and confidentiality

The process for determining compensation under the current rules arrangements involves a public consultation process. The AEMC must publish the a draft report from the panel, as well as its own draft report, and invite comment from stakeholders on these reports.⁴

In order to facilitate public consultation on a claim, the AEMC must publish all information provided by claimants or people making submissions, subject to any claims of confidentiality in respect of that information.

Chapter 4 of the compensation guidelines sets out how the Commission will deal with confidential information contained in claims or submissions. In summary, when performing its functions under clause 3.14.6 of the rules, the AEMC is required to take all reasonable measures to protect from unauthorised use or disclosure, information given to it in confidence.

Accordingly, if a claimant or person making a submission provides information to the AEMC and some or all of that information is clearly marked as confidential, the AEMC cannot publish the confidential information. In such a case, the AEMC will publish any non-confidential information contained in the claim or submission and include a note to the effect that confidential information has been omitted from the published information. These confidentiality requirements and the implications for consultation are discussed further in section 5.3.3.

⁴ NER clause 3.14.6(I)(3).

4 Purpose of compensation

4.1 Issues with the current arrangements

Compensation is designed to address the risk that application of the APC may reduce participant incentives to invest in plant and supply energy during an administered price period. This may occur if the APC actively caps the spot price in a region, causing dispatched participants to incur a loss.

These objectives are currently contained in clause 3.14.6 (c) of the rules. Specifically, the AEMC is required to:

- “(1) identify the objectives of the payment of compensation under this clause as being to maintain the incentive for:
- (i) *Scheduled Generators, Scheduled Network Service Providers* and other *Market Participants* to invest in *plant* that provides services during peak periods; and
 - (ii) *Market Participants* to supply *energy* and other services during an *administered price period*”

A key issue with the existing arrangements is their relative ambiguity as to the primary purpose of the payment of compensation. Specifically, clause 3.14.6(c) is not clear as to whether the payment of compensation is itself intended to contribute to investment signals at the margin, or whether it is intended to simply maintain existing investment signals sent through earlier periods of high prices.

Stakeholder submissions to the issues paper identified this as a key issue. AGL highlighted that there is an apparent conflict between the investment aspect of the clause and the fact that the compensation provisions themselves only allow for the recovery of direct and opportunity costs, rather than capital costs.⁵

International Power considered that the compensation mechanisms should allow for some recovery of capital costs, potentially in the form of a pro-rated annual capital charge as faced by a peaking generator.⁶ However, AGL stated that such an approach would be inappropriate, arguing that the purpose of the administered price period mechanism was primarily to limit participant risk exposure rather than allowing for recovery of capital costs.⁷ TRUenergy considered that the primary objective of the compensation provisions should be to maintain the incentive to invest in plant that provides services during peak periods.⁸

4.2 Recommendation

We consider that the primary purpose of the payment of compensation is to maintain incentives to supply energy and other services during an administered price period.

⁵ AGL, issues paper submission, p.2.

⁶ International power, issues paper submission, p.2.

⁷ AGL, issues paper submission, p.3.

⁸ TRUenergy, issues paper submission, p.3.

The secondary purpose of the payment of compensation is to reduce the likelihood that the capping of the spot price by the APC will materially weaken or erode the investment signals sent through the normal function of the market.

Our draft recommendation is that the rules clauses which establish the purpose of compensation should be amended accordingly.

4.3 Commission's considerations

Maintaining an incentive to supply energy during an administered price period is central to the purpose of the payment of compensation. An administered price period generally occurs following periods of high market stress where the supply demand balance may be tight. Encouraging generators to continue to supply energy in such market circumstances is particularly important, in order to promote the ongoing reliable supply of electricity to customers.

In contrast, the compensation provisions are not themselves designed to send an investment signal. In the NEM, this role is served by the occurrence of sustained high prices during the normal function of the market. The market price cap and cumulative price threshold are set at levels which are designed to send adequate investment signals, while protecting consumers from an inefficient extension of these high prices.

If the application of the APC actively limits spot prices and causes a participant to incur a loss, this may upset the balance between provision of investment signals and the protection of consumers from sustained high prices. Compensation addresses this potential imbalance by reducing the likelihood of investment signals being materially weakened or reduced by the action of the APC.

We consider that retaining some reference to investment signals in the purpose clause is important. While it may be argued that maintenance of incentives to supply energy is sufficient to address any weakening of investment signals, the retention of references to investment clarifies the appropriate role of compensation within the market price cap / cumulative price threshold / APC mechanism. This also provides market participants with some guidance as to how the AEMC and the panel are likely to approach the assessment of individual compensation claims.

5 AEMC compensation claim assessment process and public consultation

5.1 Issues with the current arrangements

Currently, the AEMC is responsible for the assessment of claims for compensation. Clause 3.14.6 of the rules sets out the AEMC's framework for claim assessment. This includes the process for establishing an panel and the timeframes for completion of its assessment. This clause also sets out the AEMC's public consultation framework when assessing a claim.

Once a formal notice of intent to claim has been received from a compensation claimant, clause 3.14.6 requires the AEMC to establish a three member advisory panel. The AEMC is required to publish the panel's draft report and a draft report setting out its initial findings. It must invite submissions on these reports and include consideration of these submissions in its final report. These events must occur within a specific timeframe which is described in NER clauses 3.14.6(g) through (n).

The current structure of this timeframe is relatively inflexible and may not always be optimal. For example, there is no time allowed at commencement of the process for gathering necessary information, nor any requirement to notify the market that a compensation claim has been received. There is also no capacity to extend the assessment process if necessary. The current arrangements also mandate a minimum size of the panel and do not allow for the engagement of a smaller sized panel for less complex claims.

In regards to the consultative process, the current arrangements do not consider the varying degree of benefit associated with engaging in a public consultation process for different types of compensation claims. The AEMC's confidentiality obligations may also affect our capacity to engage in the kind of consultation process currently envisaged by the rules.

In the issues paper, we asked stakeholders to comment on whether the AEMC remained the most appropriate organisation to assess clause 3.14.6 compensation claims, given the limits imposed by our confidentiality obligations. Various stakeholders commented on this issue. International Power stated that the kind of information provided by a claimant to facilitate assessment of its claim is commercially sensitive and should therefore be considered confidential. International Power considered that the AEMC's confidentiality obligations did not conflict with the role of assessing compensation claims.⁹

TRUenergy stated that the AEMC's confidentiality obligations may impede effective public consultation and recommended consideration of AEMO as a more appropriate body to administer compensation claims.¹⁰ AGL suggested that if the process for determining compensation could be made consistent with the process for determining

⁹ International power, issues paper submission, p.4.

¹⁰ TRUenergy, issues paper submission, p.5.

directions compensation under NER clause 3.15.7, the role of assessing these claims could be passed to AEMO.¹¹

Stakeholders also commented on the broader questions of the AEMC's assessment processes and timing. International Power suggested that the AEMC should have the capacity to engage a varying sized panel depending on the size of a claim, while TRUenergy suggested that the size of the panel appointed should reflect the value of the compensation claim.¹² AGL suggested that if the process for determination of compensation could be more clearly defined in the rules and made a "mechanical" process, then there may be no need for the appointment of a panel.¹³

International Power, AGL and TRUenergy all considered that the AEMC should be required to notify the market when a compensation claim has been received.¹⁴ While TRUenergy supported some flexibility in the timing of compensation claim assessments, it noted that the priority should be on the rapid resolution of compensation claims. AGL considered that claims should be processed promptly and did not support increased flexibility.¹⁵

5.2 Recommendations

Consultation claim assessment process

We consider that the AEMC remains the appropriate organisation to administer the assessment of compensation claims under clause 3.14.6.

However, we propose a number of amendments to the timeframe and process for assessment of compensation claims. These amendments are designed to promote a more efficient claim assessment process:

- on receipt of a compensation claim, the AEMC should publish advice on its website advising the market of commencement of the assessment process, containing relevant information about the nature of the claim;
- once the AEMC and the panel have received sufficient information from the claimant to begin formal assessment, the AEMC should publish further advice on its website of the formal commencement of the claim;
- the AEMC should have the option of extending the time period for assessment of individual compensation claims, in specific circumstances; and
- the AEMC should have the option of appointing a varying sized panel, depending on the complexity of individual compensation claims.

11 AGL, issues paper submission, p.8.

12 International power, issues paper submission, p.5; TRUenergy, issues paper submission, p.5.

13 AGL, issues paper submission, p.8.

14 International power, issues paper submission, p.5; TRUenergy, issues paper submission, p.5; AGL, issues paper submission, p.9.

15 TRUenergy, issues paper submission, p.6; AGL, issues paper submission, p.9.

Public consultation process

We consider that a mandatory public consultation process is unlikely to add significant value to the assessment of compensation claims. However, there may be benefit in a public consultation process in specific circumstances.

Accordingly, we propose the introduction of a limited public consultation process:

- For compensation claims which include only direct costs, we consider there is unlikely to be any benefit associated with a public consultation process. Accordingly, following receipt of a compensation claim for direct costs and publication of all relevant advice, the AEMC should proceed directly to publication of the panel's report and a report setting out our findings.
- For compensation claims which include opportunity costs, we consider there are likely to be benefits in publicly consulting on the proposed methodology for assessment of opportunity costs. Following receipt of a compensation claim for opportunity costs and publication of all relevant advice, the AEMC should publish:
 - the proposed methodology for assessment of opportunity costs as provided by the claimant;
 - a draft report from the panel; and
 - an AEMC draft report containing its own draft methodology developed in consultation with the panel.

Stakeholder comments on these documents should be factored into the AEMC's development of the final opportunity cost methodology, which it will publish as part of its final report, along with a final report from the panel.

5.3 Commission's considerations

5.3.1 Appropriate organisation to administer the compensation provisions

In the issues paper, we discussed the way in which the AEMC's confidentiality obligations may affect our ability to undertake effective public consultation.¹⁶ In light of this issue, we asked stakeholders whether it might be appropriate for another organisation with different confidentiality obligations to administer the assessment of compensation claims.

We consider that the AEMC remains the most appropriate organisation to administer the clause 3.14.6 compensation provisions. The AEMC possesses some experience and capacity for discretionary decision making necessary to fulfil this role.

Assessment of compensation claims is likely to require a degree of discretionary decision making. Other compensation provisions in the rules generally include

¹⁶ Further discussion of the AEMC's confidentiality obligations and related issues is contained in chapter 5 of the issues paper.

formulae or processes which define how compensation is calculated and awarded.¹⁷ In contrast, clause 3.14.6 compensation claims will be based around assessment of the different cost profiles of individual claimants and the specific market conditions underpinning each claim. These factors will vary between claims and cannot be explicitly quantified in formulae or defined processes.

A degree of discretionary decision making is also necessary given the substantial complexity associated with different compensation claims. This complexity is likely to depend on whether direct costs, opportunity costs, or a mixture of both types of costs are claimed. While the extent of direct cost claims are likely to be reasonably defined, this may not be the case for opportunity costs.¹⁸ By their nature, opportunity costs reflect the value of the next best utilisation of the claimant's resources. Calculation of this value is likely to consider many factors or utilise complex analytical processes. The claim amount itself may also be a significant amount and therefore contentious, requiring a degree of careful oversight and management.¹⁹

In addition to these known uncertainties, the progression of new compensation claims has the potential to expose new issues. For example, during the Synergen compensation claim, a number of previously unidentified issues were raised, including interpretation of the rules eligibility criteria and issues relating to confidentiality of information, necessitating this review. Given that only one clause 3.14.6 compensation claim has been progressed since NEM commencement, a risk remains that other unidentified issues may be identified in future claims.

Given these factors, we consider that the AEMC remains the most appropriate organisation to administer the clause 3.14.6 compensation provisions. The need for a decision maker with the capacity to exercise a degree of discretion aligns with our existing responsibilities of rule analysis and market development. The AEMC also possesses experience relevant to assessment of compensation claims, having undertaken the only claim assessment to date in the NEM as well as development of the guidelines and this review. As discussed in section 5.3.3 below, we also consider that the AEMC's confidentiality obligations do not pose a real impediment to our capacity to undertake effective assessment of compensation claims.

5.3.2 Amendments to the compensation claim assessment process

A transparent process for the assessment of compensation is consistent with efficient market design. Accordingly, the existing compensation provisions include a process and timeframe for the completion of the assessment of compensation claims. The current assessment timeframe is outlined in clauses 3.14.6(g) through (q).

¹⁷ For example, see clause 3.15.7 of the rules which defines the process for calculation of payments to directed participants.

¹⁸ Noting that no opportunity cost claim has to date been received by the AEMC.

¹⁹ The potential size of opportunity cost claims was identified as a risk by the Commission in the final determination of the 2008 *Compensation arrangements under administered pricing* rule change. The Commission considered that the extent of this risk was commensurate with the maintenance of desirable supply incentives.

While the prescriptive nature of the existing assessment process and timeframe provides the market with a degree of certainty, we consider that there are a number of areas where there is scope for improvement.

Firstly, while strict requirements are placed on the AEMC in terms of when it must publish draft and final reports, there is no requirement for an initial notification to the market that a claim has been received. Given the defined nature of the existing formal assessment process, it is likely that some time will be spent before formal commencement, gathering all necessary information to assess the claim. This could mean the first the market hears of a compensation claim is when the AEMC publishes its draft reports, which may be some time after the original claim was received.

Accordingly, we recommend that following receipt of a claim for compensation, the AEMC should be required to publish advice, on its website, that a claim has been received. This advice will include all relevant details of the claim, including the name of the claimant, the units for which compensation is being claimed and the time period in which compensable costs were incurred. We consider that this information is essential to the progression of the claim and should not be claimed as confidential by the compensation claimant.

Following this, the AEMC and the panel will assess the initial information provided by the claimant and will determine if additional information is required.²⁰

Once the AEMC and the panel are satisfied that the claimant has provided sufficient information to allow the claim to be assessed, the AEMC will commence formal assessment of the claim. The AEMC will publish further advice on its website of the formal commencement of the assessment process. This advice will include indicative dates for completion of the claim assessment process.

Secondly, the existing compensation assessment process requires the AEMC to establish a three member panel to advise its assessment. The costs of appointing this panel can be substantial; during the Synergen claim, the total cost of the three member panel was a significant fraction of the total amount awarded to Synergen. We consider that less complex claims may not warrant appointment of a full three member panel.

Accordingly, we recommend that the AEMC be given discretion to appoint a varying sized panel, depending on the complexity of the claim.

Lastly, it is possible that new or more complex issues may be identified during assessment of a compensation claim, or that the AEMC may face a material change in circumstances. In both cases, we consider that the existing strict timeframes in the rules may impede the AEMC's ability to undertake adequate assessment of compensation claims. Accordingly, we recommend that the AEMC be given the discretion to extend the timeframes for assessment of a compensation claim.

²⁰ Experience during the Synergen claim indicates that some time may elapse between initial receipt of the claim and commencement of the formal assessment process. This reflects the fact that the AEMC and the panel must gather sufficient information from the claimant in order to undertake an effective assessment, prior to commencement of the formal process. The time taken to complete this process will depend upon how quickly the claimant provides all information requested by the AEMC and the panel, in accordance with the compensation guidelines.

The discretion for the AEMC to extend assessment timeframes would be dependent upon criteria listed in the rules, such as the emergence of issues of sufficient complexity or a material change in circumstances. In this situation, the AEMC would publish advice on its website setting out the reasons for its extension of the timeframe, addressing the issues identified above and defining the new timeframe for delivery of its assessment.

5.3.3 Public consultation process

During assessment of the Synergen compensation claim, it became apparent that certain obligations placed on the AEMC may influence our capacity to undertake public consultation during assessment of a compensation claim. The *Australian Energy Market Commission Establishment Act 2004 (SA)* requires the AEMC to protect any information provided in confidence by a compensation claimant. This effectively prevents the AEMC from publishing any information marked as confidential, regardless of whether or not the AEMC agrees whether this information is confidential. This may restrict the ability of the AEMC to undertake the kind of public consultation process currently envisioned in the rules.

However, the extent to which this is actually an issue depends on the relative benefit of public consultation during the compensation process. This benefit will vary depending on what information is subject to consultation. We consider that while there is little benefit associated with public scrutiny of the direct costs incurred by a claimant, public consultation can add significant value in the assessment of opportunity cost claims.

Public consultation for direct cost claims

For most of the AEMC's statutory responsibilities, there are clear benefits associated with the inclusion of a public consultation process. In the case of a rule change proposal, public consultation allows for an enhanced examination of the costs and benefits associated with the rule change. A similar situation holds for market reviews.

For compensation claim assessments, the benefits associated with public consultation are less obvious. This reflects the fact that compensation claim assessments are focussed around the detailed verification of operational data and related costs, rather than a broader assessment of market outcomes.

For example, during the Synergen compensation claim, much of the information provided to the panel described operating and maintenance costs, such as price, volume and delivery dates of fuel as well as labour and maintenance expenditure. The panel assessed this information and where necessary, verified it by seeking additional supporting documentation, such as invoices and receipts.

Third parties are unlikely to be able to add real value in the assessment of these kinds of costs. While the claimant's contracted fuel or labour prices may be considered "too high" or "too low", such third party opinions are subjective and based on incomplete information. They add no material value to the process of verifying the total costs actually incurred by the claimant and the final compensation amount to be awarded. However, such detailed and specific information describing a firm's variable

operational and maintenance costs are central to competitiveness and are likely to be considered commercial in confidence.

There does not appear to be a strong case for public scrutiny of the detailed cost information provided by a compensation claimant. Accordingly, we consider that compensation claims for direct costs only should not be subject to a public consultation process, as the only information provided by the claimant will be related to their specific costs and spot market revenues. This means that when assessing a claim for direct costs, the AEMC would not publish a draft report but would instead proceed directly to the publication of the panel's report and its own report.

Our proposed approach allows a time period of sixty days between publication of the notice of formal commencement of assessment and publication of the final report.

Public consultation regarding methodologies to determine opportunity costs

When conducting an assessment of a compensation claim for opportunity costs, it will be necessary to develop a methodology for the determination of opportunity costs. Given that opportunity cost claimants are likely to face very different cost structures, the methodological approach to the determination of opportunity costs will necessarily be undertaken on a bespoke basis. Section 10.3.2.2 of the compensation guidelines set out the principles for selecting a valuation methodology to determine opportunity costs. The guidelines place the burden of responsibility for developing this methodology on the claimant.

We consider that there are likely to be benefits associated with undertaking a public consultation process in regards to such opportunity cost methodologies. While this consultation may not include numbers representing the specific costs incurred (if this information is claimed as confidential), it will allow stakeholders to review and comment on the mechanism used to determine these costs. For example, if a methodology were to involve modelling of projected generator costs and market prices, the form of the modelling would be made public and opened for consultation.

In order for this consultation to be effective, it will be necessary for an opportunity cost claimant to provide the AEMC with a proposed methodology.²¹ This proposed methodology should be suitable for publication and public consultation. The AEMC will consider this proposed methodology and, in consultation with the panel, develop a draft methodology.

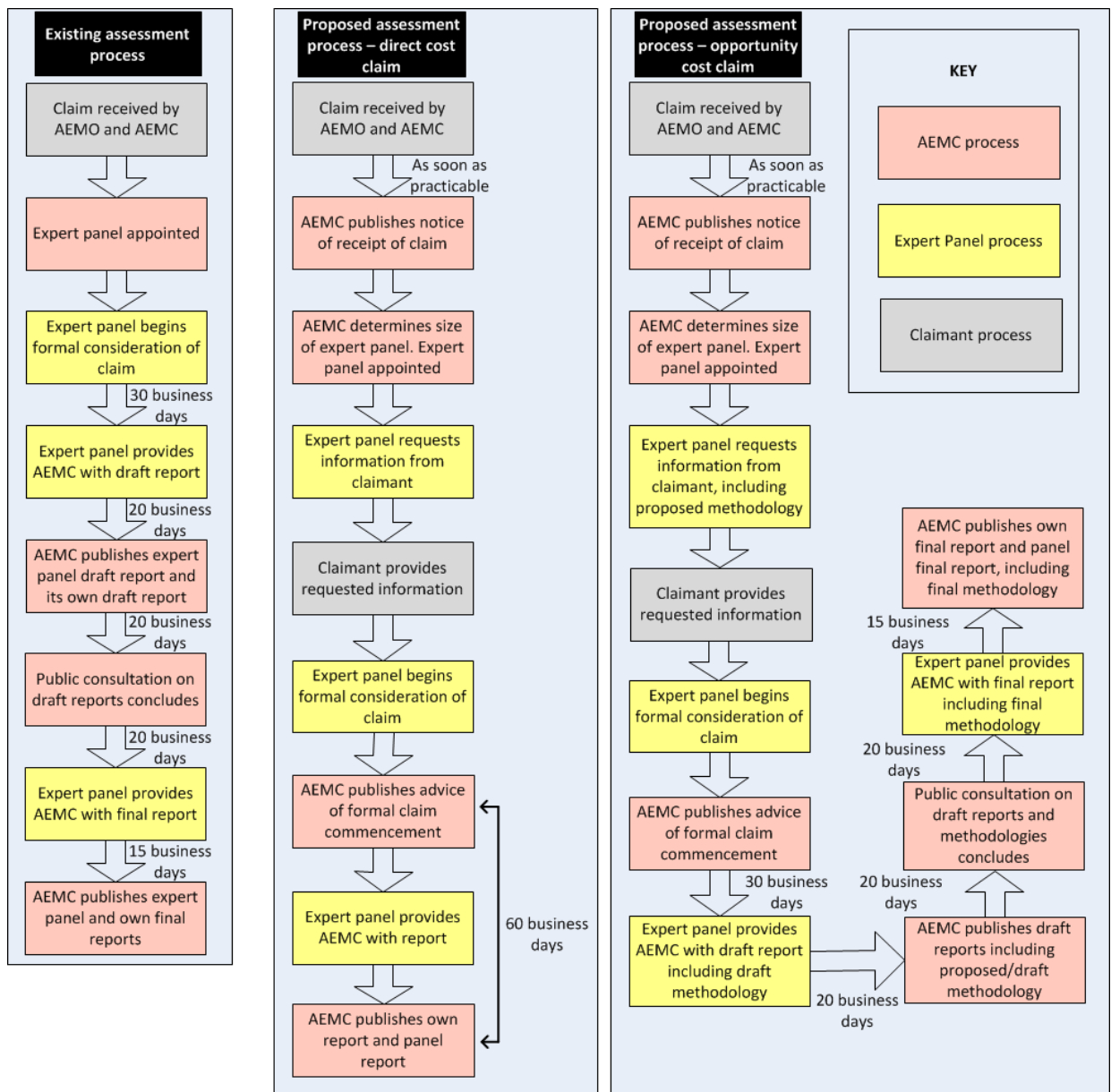
The proponent's proposed methodology, the AEMC's draft methodology, the panel's draft report and the AEMC's draft report will be published and opened for public consultation. However, as required by the AEMC's confidentiality obligations, any information marked as confidential by the claimant will be redacted from these documents.

²¹ The current compensation guidelines require an opportunity cost claimant to provide the information, models and analysis to support their claim. AEMC, *Compensation Guidelines under Clause 3.14.6 of the National Electricity Rules*, Australian Energy Market Commission, 17 February 2011, Sydney, p.17.

We consider that a time period which broadly reflects the existing arrangements is appropriate for assessment of opportunity cost claims. Our proposed approach therefore allows 105 days between publication of advice of formal commencement and the publication of the final reports.

An overview of the proposed revisions to the compensation cost assessment process is presented in figure 5.1 below.

Figure 5.1 Claim assessment process



6 Eligibility for scheduled generators to claim compensation

6.1 Issues with the current arrangements

Eligibility criteria describe the market conditions when compensation may be warranted. These criteria, in combination with the purpose clause described above, provide the market with guidance to inform participant operational decisions.

A set of eligibility criteria have been included in the clause 3.14.6 compensation arrangements since the first version of the national electricity code. In that time, the form of the criteria have not changed significantly. The existing criteria relate to scheduled generators, scheduled network service providers, market participants who have submitted dispatch bids in respect of scheduled loads as well as ancillary service loads and generating units.

The current eligibility criteria are defined as follows:²²

- A scheduled generator is eligible to claim compensation “...in respect of *generating units* if, due to the application of an *administered price cap* during either an *administered price period* or *market suspension*, the resultant *spot price* payable in respect of the *dispatched generating units* in any *trading interval* is less than the price specified in their *dispatch offer* for that *trading interval*.”
- A scheduled network service provider is eligible to claim compensation “...in respect of a *scheduled network service* if, due to the application of an *administered price cap*, the *market price cap*, the *market floor price* or an *administered floor price*, the resultant revenue receivable in respect of *dispatched network services* in any *trading interval* is less than the minimum requirement specified by its *network dispatch offer* for that *trading interval*.”
- A market participant is eligible to claim compensation “...in respect of a *scheduled load* if, due to the application of an *administered floor price* during either an *administered price period* or *market suspension*, the resultant *spot price* in any *trading interval* is greater than the price specified in the *dispatch bid* for that *trading interval*.”
- A market participant is eligible to claim compensation in respect of an ancillary service generating unit or an ancillary service load “...if, due to the application of an *administered price cap*, the resultant *ancillary service price* for that *ancillary service generating unit* or *ancillary service load* in any *dispatch interval* is less than the price specified in the relevant *market ancillary service offer*.”

Each of these different types of participant is currently eligible to claim compensation under varying circumstances. For example, eligibility for scheduled load to claim is based around the application of the administered floor price, while scheduled network service providers are eligible to claim due to the application of the APC, market price cap, market floor price or administered floor price. The implications of these different criteria are assessed in chapter seven.

²² NER clauses (a), (a1), (a2) and (a3) respectively.

It is worth noting that eligibility to claim compensation does not automatically mean that a claimant will be awarded any compensation. That is, under the existing arrangements, the eligibility criteria are separate to the process whereby the actual amount of compensation is determined. The primary purpose of the eligibility criteria is therefore to provide the market with an indication as to when compensation may be appropriate.

The current criteria contain a number of ambiguities which reduce their effectiveness in this role. These ambiguities centre around the fact that the current criteria are based on the difference between spot prices and dispatch offers.

At a more fundamental level, it is also unclear whether eligibility to claim compensation should necessarily apply to all of the different types of market participant who are currently included in the eligibility criteria.

In this chapter, we consider the problems associated with the general structure of the current eligibility criteria. We then examine the structure of eligibility criteria for scheduled generators. In the next chapter, we consider the broader question of whether other classes of market participant should remain eligible to claim compensation.

Use of the term dispatch offer

During assessment of the Synergen compensation claim, it became apparent that the meaning and correct interpretation of the existing eligibility criteria are somewhat ambiguous. This ambiguity relates to the fact that the existing criteria refer to the difference between the spot price and a claimant's dispatch offer. The principle behind these clauses is that if a participant is dispatched at a price which is less than the price it originally offered, it may incur a loss and should be eligible to claim compensation for that loss.²³

Synergen argued that they were eligible to claim compensation based on the fact that their "original" dispatch offer had capacity located in price bands greater than the spot price.²⁴ During the period of dispatch, Synergen had rebid this capacity into lower price bands.²⁵ Other stakeholders stated that Synergen should not be eligible to claim compensation for those trading intervals when they had rebid capacity, as they had rebid capacity into price bands which were lower than the spot price.²⁶

In its final decision, the AEMC agreed with Synergen. Specifically, we considered that the correct interpretation of the eligibility criteria referred to the difference between prices included in the original dispatch offer and the spot price, regardless of any rebids

²³ Under the current criteria, the situation where market price is less than dispatch offer applies to scheduled generators and ancillary service providers. The current criteria for scheduled network service providers refer to the difference between revenue received and the minimum network dispatch offer, while for scheduled loads the criteria refers to the difference between spot price under an administered floor price and the participant's dispatch bid.

²⁴ Synergen Power, *Submission of Particulars of Claim*, August 2009.

²⁵ When rebidding capacity, a participant moves its capacity between different price bands. However, these price bands themselves cannot be changed. The rebidding provisions are outlined in NER clause 3.8.22.

²⁶ AGL, submission to Synergen Power compensation claim, pp.4-7

of capacity between these price bands.²⁷ However, we also noted that this was a very broad interpretation of the term dispatch offer. As such, it may not provide much limitation on the capacity of participants to claim for compensation.

Consideration of this issue reveals further ambiguity associated with use of the term dispatch offer. The existing criteria refer to the difference between the price specified in dispatch offers and the spot price. However, as there are ten prices included in every dispatch offer, the “price specified in the dispatch offer” could be interpreted to refer to any of these ten prices.

Accordingly, the current eligibility criteria could be interpreted to mean that any participant who includes a price in their dispatch offer which is higher than the spot price would be eligible to claim compensation. Given that most participants include a price band at the market price cap and market floor price in every dispatch offer, these participants may consider themselves eligible to claim compensation. This perceived eligibility may hold, regardless of whether there is any capacity actually included in the dispatch offer at that price.

Given this issue, we do not consider that the existing criteria provide the market with effective guidance as to which participants should be able to claim compensation, nor the market conditions where compensation may be appropriate

The existing eligibility criteria also contain no reference to the fact that participants may only claim compensation for direct and opportunity costs. However, whether or not a participant has actually incurred a net loss in opportunity or direct costs is a key factor which determines whether compensation is awarded. We consider that the eligibility criteria should refer explicitly to participants who have incurred net losses in direct or opportunity costs following the application of the APC.

Various stakeholders commented on the appropriate form of eligibility criteria in submissions to the issues paper. International Power suggested that eligibility should reflect the situation where the spot price varied from the dispatch price. International Power stated that in this situation, a participant's dispatch target would have been different if the actual dispatch price had reflected the spot price capped at \$300. International Power also highlighted that references to "the dispatch price" are generally ineffective, given that the dispatch offer consists of ten separate price bands and that prices themselves are modified by loss factors.²⁸

International Power also highlighted the importance of rebidding of capacity by generators to avoid cycling of units. International Power stated that avoiding cycling of units can reduce total operating costs as well as minimise reliability risks. The design of the eligibility criteria should be structured in a way which reflects these market benefits and should allow participants to rebid capacity and remain eligible to claim.²⁹

²⁷ AEMC, *Final Decision: Compensation claim from Synergen Power Pty Ltd*, Australian Energy Market Commission, 8 September 2010, Sydney, p.11.

²⁸ International Power, issues paper submission, p.4.

²⁹ International Power, issues paper submission, p.6.

TRUenergy supported International Power's arguments, stating that the security and reliability benefits associated with rebidding outweighed any negative efficiency impacts.³⁰

AGL disagreed with International Power and TRUenergy's position. AGL stated that allowing participants to rebid capacity and remain eligible to claim compensation reduced the competitive discipline faced by such participants and would ultimately result in higher costs for consumers. They argued that there was no clear evidence of a heightened reliability risk during an administered price period and that allowing units to rebid and remain eligible disadvantaged more reliable units.³¹

6.2 Recommendation

The Commission considers that the existing eligibility criteria are largely ineffective. The existing focus on the difference between dispatch offers and spot prices fails to provide effective guidance to the market as to when compensation is appropriate.

We recommend that the existing eligibility criteria be replaced with a new approach. As discussed in chapter 4, the primary purpose of compensation is to maintain incentives on participants to supply energy during an administered price period. We therefore consider that the payment of compensation to participants becomes appropriate from the point in time where it is most likely to promote the continued supply of energy during an administered price period.

Our proposed eligibility criteria define a "compensation eligibility period" (the eligibility period). This eligibility period commences at the point in time when the APC first actively caps the price in a region. We consider that it is from this point in time that the application of the APC may cause participants to incur a loss and therefore reduce their incentives to supply energy. The eligibility period continues from the first trading interval in a trading day in which the APC actively caps the spot price in a dispatch interval, until the final dispatch interval of the final trading interval of the trading day.

During an eligibility period, a participant whose total costs exceed total revenue received from the spot market may claim compensation. These costs are limited to direct costs or opportunity costs, as defined in the compensation guidelines. Effectively, the participant may claim compensation if it has incurred a net loss during an eligibility period, after factoring in total revenue received from the spot market during that eligibility period.

6.3 Commission's considerations

6.3.1 Principles of scheduled generator eligibility

The primary focus of this chapter is on eligibility criteria for scheduled generators. To date, the only claim for compensation was received from a generator and we consider it likely that most future claims will also be from generators.

³⁰ TRUenergy, issues paper submission, p.4.

³¹ AGL, issues paper submission, pp.3-6.

We consider there is a clear risk that scheduled generators may incur a loss due to the application of the APC. Furthermore, we consider that the market benefits associated with allowing scheduled generators to claim compensation outweigh any inefficiencies or the potential for perverse outcomes. We therefore consider that it is appropriate that scheduled generators, as a class of market participant, should generally remain eligible to claim compensation.

Generators may incur a loss when the APC has actively limited the spot price and therefore available spot price revenue. Generators will suffer a loss if they are dispatched during this period but incur direct and opportunity costs in excess of their total spot price revenue.

However, the extent to which generators will actually incur such losses is limited by the fact that most generators do not have direct or opportunity costs in excess of the level of the APC. This was a key consideration of the Commission when it determined the level of the APC in 2008.³² In practice, the types of generator most likely to incur a net loss due to the application of the APC are those with very high operating costs (such as a liquid fuelled super peaking unit), or a generator with clear opportunity costs (such as a generator with very limited fuel resources).

The likelihood of such generators incurring a loss will also be based on whether or not the generator is dispatched when the APC is capping the spot price. As discussed above, it is at this point in time that the availability of compensation will help maintain incentives on participants to supply energy, in order to provide consumers with a reliable supply of electricity.

Given these considerations, it is appropriate that the eligibility criteria for generators are targeted towards addressing the risk of high cost generators incurring a loss due to the application of the APC. Furthermore, the criteria should recognise the temporal dimensions of when this risk may arise.

The Commission's proposed eligibility criteria for scheduled generators are therefore based around the following principles:

- During an administered price period, a dispatched generator in a region becomes eligible to claim compensation once the spot price in that region has been capped at the level of the APC. This is the trigger for commencement of the compensation eligibility period.
- The compensation eligibility period continues until the end of the trading day. At this point the "APC trigger" is reset and generators do not become eligible until the APC has again capped the price in the relevant region.
- A dispatched generator is only eligible if it has incurred total direct costs and/or opportunity costs in the eligibility period that exceed its total spot market revenue received during the eligibility period.

³² AEMC, *Determination of Schedule for the Administered Price Cap*, 20 May 2008, p.vii.

6.3.2 Parameters of the eligibility criteria

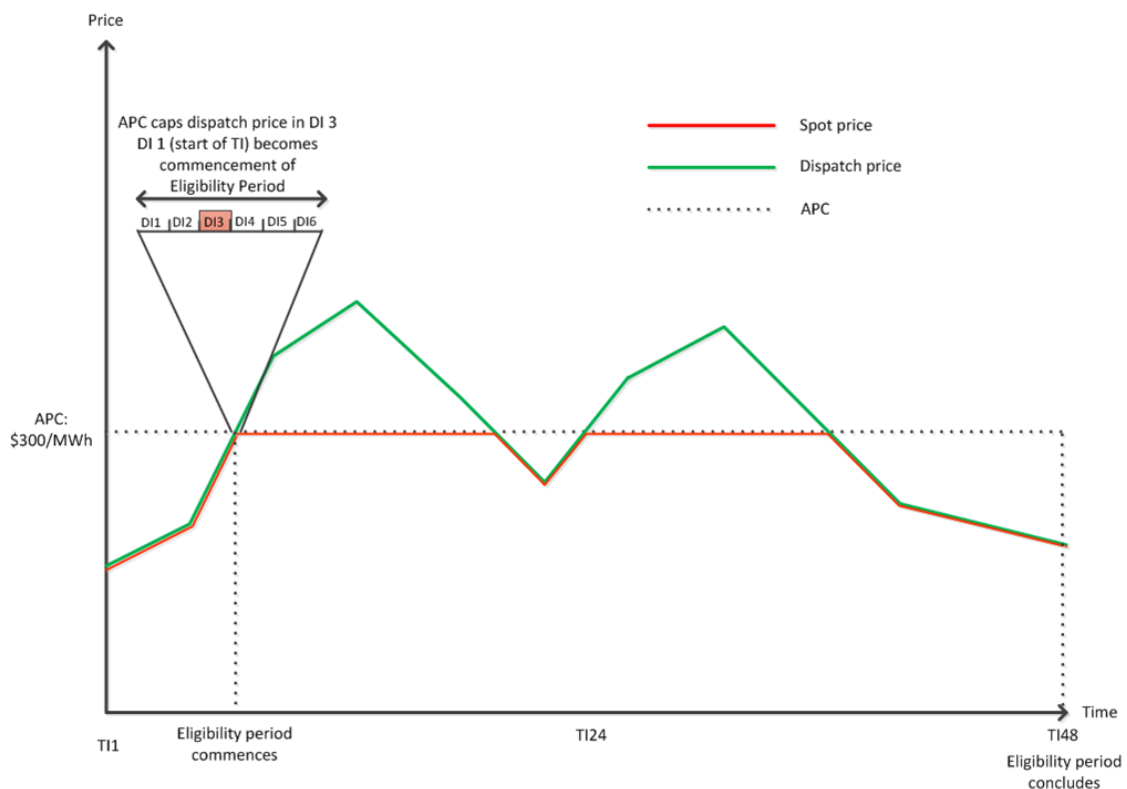
Commencement of the eligibility period

There are a very specific set of market conditions which may result in generators incurring a loss during an administered price period. These conditions define the point in time where the payment of compensation will help maintain the incentive to supply electricity. The Commission considers that an appropriate indication of when these conditions arise is the point in time when the APC first actively caps the spot price to \$300/MWh in a region.³³

Specifically, the "APC trigger" for commencement of compensation eligibility occurs when a dispatch interval price is first capped at the level of the APC. Following this, the start of the trading interval in which the dispatch price was capped at the level of the APC becomes the commencement point of the eligibility period.

As shown in the example in figure 6.1, the APC actively caps the dispatch price in dispatch interval three (DI3). Accordingly, the beginning of the trading interval in which that dispatch interval was located is the commencement of the eligibility period.

Figure 6.1 Commencement and conclusion of eligibility period



Importantly, once the eligibility period has commenced, eligibility continues regardless of whether the spot price drops below the level of the APC. For example, as figure 6.1 demonstrates, once the eligibility period has commenced, generators remain eligible to claim compensation even when the spot price drops below \$300/MWh around TI 24. The rationale for allowing this outcome is discussed in further detail below.

³³ Note that the dispatch price continues to be set according to generator offers.

Definition of costs that can be claimed through compensation

Our proposed eligibility criteria reiterate that compensation can only be claimed for direct and opportunity costs. As discussed above, only a small subset of generators are likely to incur direct and opportunity costs greater than \$300/MWh and therefore face potential disincentives due to the capping of the spot price by the APC.

Explicit inclusion of direct and opportunity costs in the eligibility criteria represents an improvement on the existing arrangements by providing clarity as to what types of costs can be claimed. This will provide the market with more effective guidance as to what type of generators should be eligible to claim compensation.³⁴

Definition of extent of eligibility period and recovery of net losses

The proposed criteria clearly define the commencement and the conclusion of the eligibility period. Once the eligibility period has commenced, it continues to the conclusion of the trading day, at which point the initial trigger is reset. This means that parties will not become eligible to claim compensation again until such time as the price is again actively limited by the APC.

A reset function emphasises that availability of compensation should reflect the market conditions which exist on a particular day; eligibility for compensation should not reoccur until it is clear that the underlying market conditions which justify it have reoccurred.

The proposed criteria also restrict the total claimable amount to the difference between the total direct and/or opportunity costs incurred by the generator during the eligibility period and the total spot market revenue earned during that period.

Rationale for structure of proposed eligibility criteria – cycling and rebidding

A key issue identified in the Synergen claim and which in part led to the commencement of this review is the question of whether peaking generators should remain eligible for compensation if they have rebid capacity into lower price bands.

Providing generators with some ability to rebid capacity and remain eligible may be a positive outcome. While there are potential costs and some risks associated with this behaviour, these are outweighed by the overall market benefit.

The proposed eligibility criteria have been designed with these benefits in mind. The criteria provide generators with some leeway to operate their units in an efficient manner by rebidding capacity. This allows for improved operational efficiency and will also reduce market reliability risks.

The nature of the costs and benefits associated with allowing rebidding are discussed later in this paper. First, however, it is useful to describe how rebidding is used by

³⁴ As discussed above, under the current eligibility criteria any generator is eligible to claim compensation, provided it has included a price band in its dispatch offer which is greater than the spot price in a trading interval. However, the amount that most generators are actually able to claim under the current arrangements is zero, if their direct and opportunity costs do not exceed spot market revenues.

generators to avoid cycling of units and the consequences or limitations associated with unit cycling.

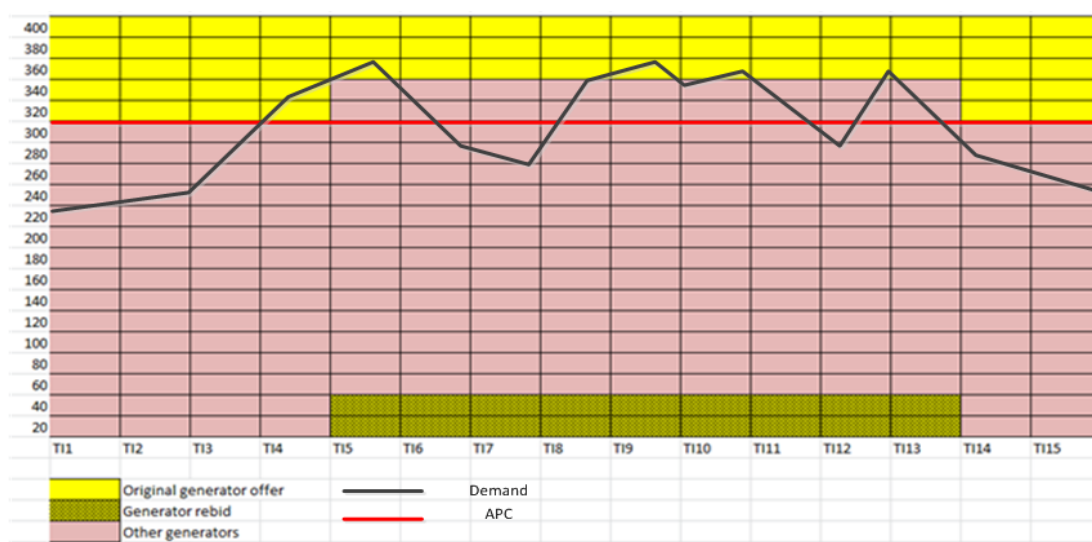
Rebidding strategies and the dispatch process

Rebidding of capacity from higher to lower price bands is used by peaking generators in part to maximise the likelihood of a consistent and smooth pattern of dispatch and to avoid multiple stop/start operation of peaking units. This stop/start pattern of operation, known as “cycling”, can occur as the market dispatch curve passes through then falls back below a generator’s minimum offer, resulting in the unit being ordered to switch on and then off by the NEM dispatch engine.

Figure 6.2, a stylised version of the merit order under an administered price period, provides an example of rebidding. Once the demand curve/dispatch price has passed the level of the APC in TI 4, the peaking generator, shown in yellow, is dispatched. From this point, the peaking generator seeks to avoid cycling on and off during the next nine trading intervals by rebidding its minimum “must run” capacity into lower price bands.³⁵ This example shows capacity rebid to price bands between \$0 and \$40 per/MWh; in reality, generators may offer into price bands below \$0/MWh.³⁶

This rebidding strategy means that the plant is dispatched consistently, with slight ramping up and down, until the price begins to drop in TI13. At this point the generator is confident that it is unlikely to be called on again, rebids its capacity back into higher price bands and is switched off.

Figure 6.2 **Rebidding strategy under an APC**



³⁵ Minimum must run capacity reflects the fact that units are physically required to operate at a minimum level of output. The range of these minimum output levels varies with generator model. The volume of capacity rebid also reflects that different operating costs are associated with running at low or medium levels of output.

³⁶ During the Synergen compensation claim, Synergen did not rebid capacity until it was fully dispatched up to its maximum price band. At this point, it rebid capacity into the minimum price band of -\$1000/MWh to ensure dispatch. For further information regarding the specifics of Synergen's claim See *Expert panel Recommendations to the AEMC: Assessment of Synergen's claim for compensation*, Expert panel, August 2010.

Implications of unit cycling

Allowing generators to rebid and remain eligible for compensation throughout the eligibility period is likely to provide a beneficial outcome. This reflects the fact that cycling of peaking units can have negative consequences for individual generators and can create supply reliability risks for the market as a whole.

Generators generally avoid cycling of units due to plant limitations and the cost implications of this behaviour. In some cases, physical limitations themselves prevent cycling. Generators have advised that peaking units may be subject to lock-out periods, meaning that they cannot be restarted for up to several hours once shut down. In other instances, generating units are required to run for a minimum amount of time once started and cannot shut down until that time has passed.

There are also a number of cost implications associated with cycling, generally related to plant availability. For example, many peaking units require a minimum amount of time to be brought up to synchronicity with the power system and further time to ramp up to full output. This time spent starting and ramping the unit reduces the capability of the unit to access high prices or fulfil contracted positions. Start-up of units also entails the use of fixed volumes of fuel which cannot be utilised to produce energy.

Cycling also has consequences for reliability of supply. Standard unit operating schedules allow for a certain number of starts before the unit must be taken offline for maintenance, which is normally planned for low demand periods. Cycling can therefore bring forward this required maintenance, reducing the generator's ability to access later periods of peak prices and increasing the risk that the unit will not be available during high demand periods. Generators have also advised there is a heightened risk of critical plant failure when starting peaking units. The materiality of this risk depends upon the age of the unit in question, with older units at greater risk.

These supply reliability risks are particularly acute during an administered price period. If the underlying conditions which led to the triggering of the cumulative price threshold and commencement of an administered price period have not yet subsided, there is a strong probability that demand levels will continue to be high during an administered price period. Indeed, during the January/February 2009 administered price period in South Australia, demand levels were around 45% higher than average annual South Australian demand. Plant unavailability due to cycling of units during such a period could have major reliability implications for the market.

Costs and benefits of allowing some rebidding of capacity to occur

Given these factors, there is a strong argument that allowing generators to rebid and remain eligible for compensation will improve the likelihood of peaking capacity being available as needed during an administered price period. As AEMO stated during the assessment of the Synergen compensation claim, rebidding of Synergen's capacity had the effect of "maintaining ... generation at sustainable levels so that generators were

able to move to full output quickly to assist in meeting system load variations, and minimising risk of premature shutdown.”³⁷

However, it is also true that rebidding of capacity into lower price bands may result in some productive inefficiencies. By bidding in a manner which may be non-cost reflective, peaking units may displace other, lower cost generators in the merit order.³⁸

While the potential for disorderly bidding and related productive inefficiencies is a risk associated with rebidding, it is likely that the reliability benefits which flow from this behaviour outweigh the costs in the particular circumstances of an administered price period.

As the panel argued in the Synergen compensation claim, “the notification of an administered price period and the imposition of an APC necessarily modify and distort normal function of the market...the rules identify that continued supply of energy during an administered price period [is] a key objective of the compensation provisions, not the normal operation of the competitive market”.³⁹ Minimising security and reliability risks is therefore an appropriate focus and is in alignment with the NEO.

Another risk of allowing generators to rebid capacity is that once the initial triggering criterion has passed, peaking generators may continue to rebid capacity and remain dispatched for a period longer than that which is required to meet demand. Such an outcome would increase the extent of any productive inefficiencies related to merit order displacement and would result in higher compensation claim amounts.

However, it does not appear that peaking generators have a strong incentive to behave in a way that would result in their units being operated for longer than is strictly necessary. Multiple start/stops and extended operation of units brings forward maintenance schedules, which may impact on the generator’s capacity to access high prices and meet its contracted positions.

More importantly, generators are only eligible to claim direct and opportunity costs through the compensation provisions. Given that there is no opportunity to earn a return on capital or profit, there appears to be little incentive for generators to prolong output beyond that which is necessary to the market. A generator’s primary incentive during the compensation period is to minimise the stresses placed on their units, rather than to seek any form of monetary return.

Despite the fact that there appears to be a low probability that generators would prolong their dispatch unnecessarily by rebidding, the eligibility criteria include a limiting factor to address this potential outcome. Given that the eligibility period concludes at the end of the trading day, any high cost generator still dispatched at that time will no longer be eligible to claim compensation (until such time as the spot price is again capped by the APC).

³⁷ AEMC, *Expert panel Recommendations to the AEMC: Assessment of Synergen's claim for compensation*, Expert panel, August 2010, section 3.2.

³⁸ This assumes that a “cost reflective” bid includes only short run variable and operating costs and does not factor in the opportunity costs of avoided cycling.

³⁹ AEMC, *Expert panel Recommendations to the AEMC: Assessment of Synergen's claim for compensation*, Expert panel, August 2010, section 3.2.

Proposed eligibility criteria allow some scope for rebidding

The proposed eligibility criteria provide generators with greater scope to engage in rebidding behaviour by deliberately removing a number of ambiguities or restrictions in the current criteria.

Firstly, any references to dispatch offers or rebids have been removed from the eligibility criteria.

Secondly, the proposed criteria maintain eligibility across all trading intervals in the eligibility period, regardless of whether the price drops below the level of the APC in some of those intervals.⁴⁰ As discussed, a key factor which has informed the structure of the proposed criteria is the physical characteristics and limitations associated with peaking unit operation. In particular, the eligibility criteria recognise the potential market benefits associated with allowing such plant to be operated continuously, under certain market conditions.

Restricting eligibility to only those trading intervals where the spot price is capped by the APC could penalise generators for operating their units in such a manner. A generator who had rebid to promote consistent dispatch (as in figure 6.2 above) would incur losses, while a generator who did not rebid faces the risk of its units cycling as the price fluctuates. Alternatively, a generator may seek to avoid either outcome by rebidding its capacity as unavailable. However, the generator would then face the risk of being directed by AEMO in the event of scarcity of supply, and receiving uncertain revenue under the clause 3.15.7 directions provisions.

Generally speaking, reducing the temporal restrictions on when a generator can claim compensation (subsequent to the APC having actively capped the price) is in line with recognising the benefits of operating peaking units in a smooth, continuous manner when required.

6.3.3 Eligibility criteria for scheduled generators in an export price capped region

The most likely situation in which a scheduled generator will incur a loss is where that generator is located in the same region where the administered price period applies and the APC has actively capped the price. For the purposes of this section, we refer to the region in which the administered price period applies and the APC is actively capping the price as the "home region".

However, generators located in regions where the APC is not directly applied may also incur a loss. This may occur due to the effect of price scaling.

Price scaling is the process whereby the spot price in a region exporting power to the home region (the "exporting region") is capped at a level equal to the APC (adjusted for

⁴⁰ During the Synergen compensation claim, it was identified that the existing clauses are unclear as to whether compensation is limited to trading intervals where the APC is actively limiting the spot price. The AEMC's final decision awarded compensation for dispatch across all periods, regardless of whether or not the spot price was capped by the APC.

losses).⁴¹ For the purposes of this section, we refer to this situation as the application of the “export price cap” in the exporting region.

The export price cap applies only in those trading intervals when there is a flow from the exporting region toward the home region. It only applies where these two regions are linked by a regulated interconnector. This process is described in clause 3.14.2(e) of the rules and is designed to reduce the accrual of negative inter-regional residues in the presence of an APC in the home region.

To the extent that the export price cap reduces spot market revenues in the exporting region, it may also result in participants in that region incurring a loss. We consider that these participants should be eligible to claim compensation, given that the export of power from their region provides customers in the APC capped region with improved reliability of supply.

Similar to the arrangements described above, we recommend that the eligibility period for these scheduled generators should commence from such time as the regional reference price in their region is actively capped by the application of the export price cap.

The eligibility period for these scheduled generators continues until the end of the final dispatch interval in the final trading interval of that trading day.

As with generators who claim compensation within the home region, these generators are only eligible to claim for total net losses incurred during the eligibility period. This means that once the eligibility period has commenced, any losses incurred in trading intervals when the export price cap applies are netted off against revenue earned in all other trading intervals. The generator can only claim compensation if, after this netting off process has been calculated, the generator has incurred a loss.

Any revenue earned or costs incurred by the generator in periods prior to the commencement of the eligibility period are excluded from the calculation of the generator’s total losses and total compensable costs.

⁴¹ The inverse situation occurs when an administered floor price applies in the home region. In this instance, spot prices in all regions with an energy flow away from the home region must be equal to or greater than the administered floor price multiplied by the average loss factor.

7 Eligibility for other classes of market participant

7.1 Issues with the current arrangements

Eligibility for scheduled loads, scheduled network service providers and ancillary service providers

Under the existing arrangements, scheduled loads, scheduled network service providers and ancillary service loads and generators are also eligible to claim compensation.

As we identified in Chapter 4, the primary purpose of compensation is to maintain the incentive to supply energy and other services during an administered price period. It follows that eligibility for compensation should apply only where there is a clear risk that application of the APC may cause participants to incur a loss, reducing their incentive to supply energy and other services.

We do not consider that allowing all of these participant types to claim compensation necessarily satisfies these conditions.

References to application of the market price cap, market price floor and administered floor price for scheduled network service providers

Under existing clause 3.14.6(a1), scheduled network service providers are eligible to claim compensation due to the application of the market price cap or market floor price.

The focus of the compensation arrangements is based around the limitation of spot market revenue in the circumstances of an administered price period. Accordingly, it is not clear why these references to the market price cap and market floor price are included in the eligibility criteria.

References to market suspension

In the issues paper, we identified that clause 3.14.6(a) and 3.14.6(a2) refer to the application of the APC during market suspension as a condition for eligibility to claim compensation.

Given that market suspension does not result in the application of the APC and that the processes for price determination under market suspension are defined in clause 3.14.5, it is not clear why this reference is included in clause 3.14.6.

In its submission to the issues paper, International Power argued that the rules should allow for compensation to be paid to participants due to market suspension. International Power argued that both market suspension and the cumulative price threshold/APC mechanism have functions in common, in that spot price is determined by a separate process to dispatch price. Accordingly, it was argued that market suspension should be included as a basis for the payment of compensation.⁴²

⁴² International Power, issues paper submission, p.3.

TRUenergy supported removal of the term market suspension, but noted that if a participant was required to operate to support security during a market suspension then some form of compensation should be payable.⁴³

7.2 Recommendations

Eligibility for scheduled loads, scheduled network service providers and ancillary service providers

The Commission's primary consideration in determining whether a particular participant type should be eligible to claim compensation is whether the payment of compensation is necessary to maintain an incentive to supply energy services during an administered price period. Accordingly, compensation should only be payable where the application of the APC (or administered floor price) results in a participant incurring a net loss due to operating and providing energy services during an administered price period.

As discussed in chapter 6, we consider that a clear case can be made for scheduled generators to remain eligible to claim compensation.

We also consider that scheduled load and scheduled network service providers should remain eligible to claim compensation, in specific circumstances.

However, given these conditions, we do not consider that a clear case can be made for ancillary service providers to remain eligible to claim compensation. It appears unlikely that the application of the APC in ancillary services markets will actually result in ancillary service providers incurring a loss and therefore facing a disincentive to supply these services.

In making our recommendations, we have developed a range of scenarios in order to identify whether there is a real risk that the application of the APC or administered floor price will result in a participant incurring a loss. We consider that the scenarios developed are likely to cover the full range of likely outcomes. However, we welcome stakeholder comment and would appreciate detailed examples of any likely scenarios we have overlooked.

We discuss our reasoning for these recommendations in sections 7.3.1, 7.3.2 and 7.3.3.

References to application of the market price cap, market floor price and administered floor price in the eligibility criteria for scheduled network service providers

We do not consider that the market floor price, market price cap or administered floor price should be included in the eligibility criteria for scheduled network service providers. We discuss our reasoning for this recommendation in section 7.3.2.

Reference to market suspension

We do not consider that market suspension should act as trigger for eligibility to claim compensation. We discuss our reasoning for this recommendation in section 7.3.4.

⁴³ TRUenergy, issues paper submission, p.4.

7.3 Commissions considerations

7.3.1 Eligibility of scheduled loads

Currently, clause 3.4.6(a2) allows market participants who have submitted a dispatch bid in respect of a scheduled load to claim compensation. As is the case for scheduled generators, the existing eligibility criteria for these participants refer to the difference between the spot price and the participant's dispatch offer.

However, clause 3.14.6(a2) refers to a situation where, due to the application of the administered floor price, the spot price is greater than the spot price specified in the scheduled load's dispatch bid.

We consider that scheduled loads should be eligible to claim compensation. There is some risk that the application of the administered floor price could result in scheduled loads incurring a direct loss. This situation may arise where a scheduled load has made a dispatch bid to increase its consumption, if the price decreases to a sufficiently low level. Generally, this risk may exist for "normally off" scheduled loads.

Box 7.1: Normally on and normally off loads

Normally off scheduled loads submit a dispatch bid which consists of a series of price and quantity bands. These price bands indicate the price at or below which the scheduled load is willing to increase its electricity consumption, and the volume it is willing to consume at that price.

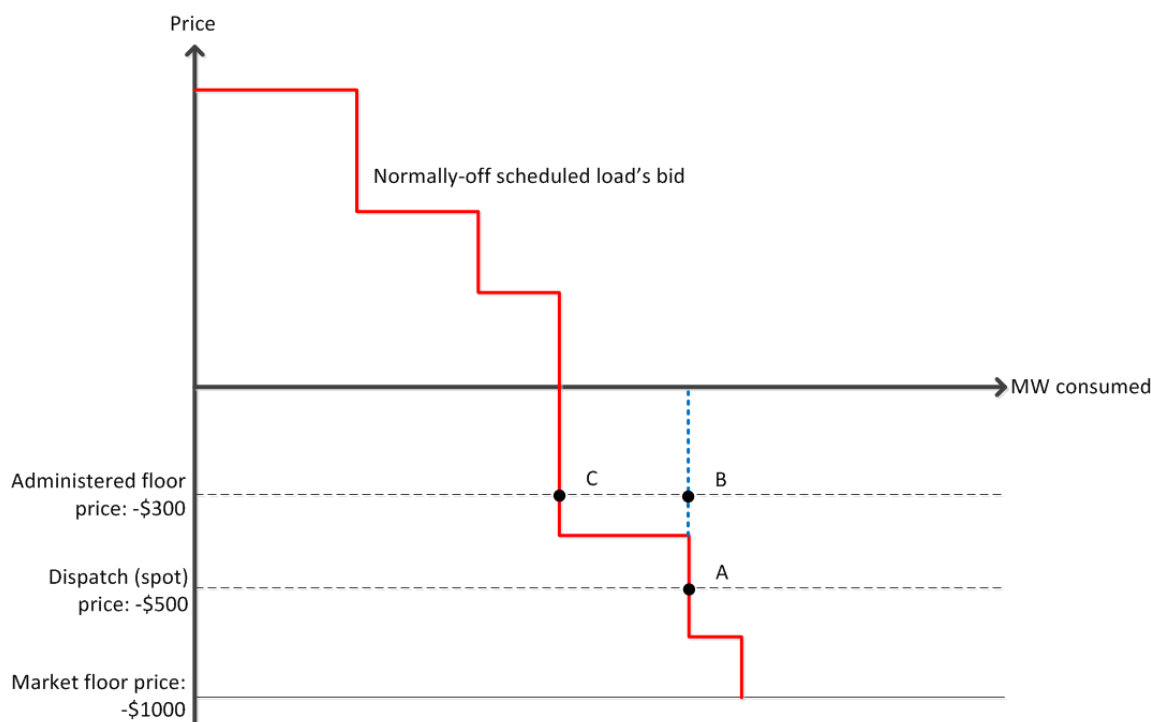
The inverse situation holds for a normally on scheduled load. These loads submit a dispatch offer which sets the price at or above which the scheduled load is willing to reduce its consumption.

At present, there are two normally off scheduled loads registered in the NEM. There are no normally on scheduled loads registered

Figure 7.1 demonstrates how a normally off load may incur a loss due to the application of the administered floor price.

As the spot price decreases, the normally off load increases its consumption. As the spot price drops below zero, the scheduled load begins to be paid increasing amounts to increase its consumption. At point A, the scheduled load would be consuming a volume of electricity equal to point A and being paid \$500/MWh to do so. Alternatively, if the spot price was equal to the administered floor price at point C, the scheduled load would wish to consume a smaller volume of electricity. However, given that underlying dispatch does not change in the presence of the administered floor price, the load will be dispatched to consume electricity at point B (which is the same volume as A) but will be paid only \$300/MWh.

Figure 7.1 Scheduled load dispatch offer



A normally off load may therefore incur costs due to the application of the administered floor price. These costs would be related to its increased consumption of electricity. Although we consider the likelihood of this situation to be relatively low, allowing these participants to claim compensation may provide some reliability benefit to customers. Furthermore, we do not consider that there is significant opportunity for any gaming or any likely perverse incentives that may arise out of this situation.

We have also considered normally on loads and whether such loads should be eligible to claim compensation due to the application of the APC. A normally on load reduces its consumption as the spot price rises; the benefit that it receives in doing so is the avoidance of these high prices. When the APC caps the price, these high spot market prices no longer exist. The load no longer receives any benefit by reducing its consumption.

Theoretically, a normally on load that made a dispatch offer to reduce consumption at a high price may be worse off under an APC. As an example, a normally on load may offer to reduce consumption by 10MW once the spot price reaches the level of \$12,000/MWh. Under normal market conditions, this load would benefit through the avoidance of high spot market prices. However, if called on to reduce consumption under an APC (remembering that the dispatch price is determined separately to the APC and may have reached \$12,000/MWh), the scheduled load is now no longer avoiding high spot prices. In this situation, the load is likely to rebid its capacity as unavailable.

While this situation is theoretically possible, we consider that it is very unlikely. There are currently no normally on scheduled loads in the NEM. Our understanding is that this kind of load reduction normally takes place through private bilateral demand side participation arrangements. Furthermore, it is unlikely that any meaningful measure of

cost could be determined to measure the “loss” incurred by such participants, making it extremely difficult to determine a viable compensable amount.

Accordingly, there is no reason for these kinds of scheduled loads to be eligible to claim compensation.

Our proposed eligibility criteria for scheduled load are basically the inverse form of that applied to scheduled generators. Once the spot price in a region has been actively limited by the administered floor price (prevented from dropping to a lower value than -\$300/MWh), scheduled loads in that region become eligible to claim compensation. This eligibility period continues until the end of the trading day.

As with scheduled generators, scheduled load will only receive compensation for any net loss incurred over the eligibility period.

In section 6.3.3 we described the arrangements for scheduled generators in regions where the regional reference price is affected by price scaling and the application of the export price cap. A similar situation may apply to scheduled loads. Clause 3.14.2(e)(4) allows for the price in any region with a flow away from an APC capped region to be equal to or greater than the administered floor price. Accordingly, scheduled loads in regions affected in this way are eligible to claim compensation for any net losses incurred. Similar arrangements as described in section 6.3.3 apply, inverted as necessary to apply to a scheduled load.

Lastly, we note the development of the demand response mechanism in the draft report of the AEMC’s Power of choice review.⁴⁴ This proposed mechanism would potentially allow consumers participating in the wholesale market to receive the spot market price for reducing their consumption.

There may be some potential for interaction between the proposed demand response mechanism and the changes to the compensation arrangements described in this review. However, the demand response mechanism is at this stage only a proposed model and has not been introduced into the rules. Accordingly, it may be necessary for further consideration to be given to these interactions at a later point in time.

7.3.2 Eligibility of scheduled network service providers and inclusion of references to market floor price/market price cap

Eligibility of scheduled network service providers to claim compensation

Currently, clause 3.14.6(a1) allows scheduled network service providers to claim compensation if, due to the application of the APC, market price cap, market floor price or administered floor price, revenue receivable is less than the minimum requirement specified in the network dispatch offer.⁴⁵

⁴⁴ AEMC, Power of choice - giving consumers options in the way they use electricity, draft report, 6 September 2012, Sydney, p.58.

⁴⁵ The more common term for scheduled network service provider is market network service provider. For the purposes of this review, the two terms are effectively interchangeable. However, as the current rules refer to scheduled network service providers, we have continued with this convention.

A scheduled network service provider acts as a merchant carrier of electricity between regions. It submits a network dispatch offer of ten price bands for each direction of inter-regional flow. An scheduled network service provider is dispatched by AEMO through the central dispatch process.

The dispatch offer submitted by an scheduled network service provider defines the minimum price difference that must exist between the two regions before the scheduled network service provider will transport power from one region to the other. The scheduled network service provider basically earns revenue through "buying" electricity in a lower priced region and "selling" this power in a higher priced region.⁴⁶

As described earlier in this report, clause 3.14.2(e) of the rules requires the scaling back of spot prices in regions which are exporting power to an APC capped region. However, these provisions apply only to regions connected by regulated interconnectors. Scheduled network service providers are by definition non-regulated interconnectors, so the price scaling provisions do not apply in this case. This means that even if the APC applies in the region into which the scheduled network service provider is importing power, the price in the exporting region will not be scaled or adjusted to the level of the APC.

This situation may result in an scheduled network service provider incurring a compensable loss due to the application of the APC. For example, if the scheduled network service provider was transporting power from an uncapped region at \$500/MWh toward an APC capped region at \$300/MWh, it would incur a net loss of \$200/MWh.⁴⁷

It follows that application of the APC creates a risk of a scheduled network service provider incurring a loss. This may reduce a scheduled network service provider's incentive to supply energy services during an administered price period, which may have negative reliability implications for customers in the importing region. Scheduled network service providers should therefore be eligible to claim compensation, in specific circumstances.

In developing our proposed eligibility criteria, we have recognised that scheduled network service providers make separate dispatch offers for each direction of flow. Similarly, the reliability benefit of maintaining supply through the scheduled network service provider accrues primarily to individuals in the importing region.

Accordingly, in our proposed approach, an scheduled network service provider becomes eligible to claim compensation at such time as the price in the region into which it is importing power is capped at the APC. It remains eligible to claim until the end of the eligibility period in that region. It is only eligible to claim for any net losses incurred throughout the eligibility period, for the direction of flow toward the price capped region.

⁴⁶ The structure of scheduled network service provider dispatch offers and revenue determination are described in clause 3.8.6A of the NER.

⁴⁷ For simplicity, this example excludes consideration of transmission losses.

References to application of the market price cap, market price floor and administered floor price in eligibility of scheduled network service providers

The rules currently allow scheduled network service providers to claim compensation due to the application of the market price cap, market floor price, APC or administered floor price.

As discussed above, we consider that a scheduled network service provider should be eligible to claim compensation due to the application of the APC in a region into which it is importing power. However, it is not clear that a scheduled network service provider's eligibility should extend to the presence of a market price cap, market floor price or administered floor price.

A scheduled network service provider may incur a reduction in revenue if the price is at the level of the market price cap in two regions, when it is transporting power between those regions. This may occur due to the application of inter-regional loss factors. A volume of power "purchased" in the exporting region at the market price cap will be reduced due to these losses in transportation, resulting in the scheduled network service provider "selling" a smaller volume of energy in the importing region at the market price cap.⁴⁸

Where prices are capped at the market price cap in both regions, the scheduled network service provider will incur a reduction in revenue equal to the volume of the inter-regional loss, multiplied by the market price cap.⁴⁹ The inverse result holds when the market floor price is applied with negative prices in both regions, although in this case, the scheduled network service provider is unlikely to incur a meaningful reduction in revenue.

We do not consider that this situation falls within the appropriate scope of the compensation arrangements. The purpose of compensation is to maintain incentives to supply during an administered price period, whereas the situation described above occurs outside of the constraints of an administered price period. If this relatively unlikely situation were to occur, we consider that AEMO's directions powers would be the appropriate mechanism to deal with any resultant reliability or security issues.

The application of an administered floor price may also affect scheduled network service provider revenue, in the situation where the scheduled network service provider is exporting power from a negatively priced region into another region. However, we do not consider that there are any meaningful reliability impacts associated with this situation. It also appears unlikely that this situation would occur in the NEM. We therefore consider that compensation is not warranted in these circumstances.

⁴⁸ Note that in this example, the term "loss" is used in terms of its meaning for power system operation, that is the physical MW volumes of energy which are lost (due to thermal resistance etc.) when electricity is transmitted across networks.

⁴⁹ For example, the scheduled network service provider "buys" 100MW of power for \$12,900 in region A. A loss factor of 1% means that only 99MW is actually delivered in region B. The scheduled network service providers therefore sells 99 MW of power for \$12900/MWh in region B, resulting in a net loss of $1\text{MW} * \$12,900/\text{MWh} = \$12,900\text{MWh}$.

7.3.3 Eligibility of ancillary service providers

Currently, clause 3.14.6(a3) allows market participants to claim compensation in respect of ancillary service generating units or ancillary service loads. Compensation may be claimed if, due to the application of the APC, the ancillary service price is lower than the price specified in the relevant market ancillary services offer.

In their submission to the issues paper, International Power highlighted that the ancillary services market price is determined by reference to whether energy market output is reduced to provide the ancillary service. This shapes the way a participant structures its ancillary services offers. International Power suggested that this effect should be considered by the AEMC when designing eligibility criteria.⁵⁰

We do not consider there is a clear case for providers of ancillary services to be eligible for compensation. There does not appear to be a clear risk that the application of the APC is likely to cause ancillary service providers to incur a net loss. It follows that there does not appear to be a material risk that the APC would reduce incentives for participants to supply these energy services.

Before discussing our assessment in more detail, it is worth providing a brief overview of the interactions between the energy and the ancillary services markets:

- Ancillary service providers receive payment for the enablement of capacity. This capacity is effectively held in "reserve" rather than being used in the energy market. For example, a generator offering a fast raise service is paid the ancillary service price for making capacity available to provide this increase in energy output.
- Ancillary service providers also receive payment for energy if they are actually called on to provide the offered service. In the above example, if the generator is called on to actually provide the fast raise service, it is paid the energy market price for this output.
- The APC can apply in ancillary service markets under two conditions. Firstly, an administered price period triggered by a breach of the cumulative price threshold in the energy market results in the application of the APC in both energy and ancillary service markets. Alternatively, an administered price period triggered by a breach of the cumulative price threshold in any ancillary service market results in the application of the APC in all ancillary service markets, but not in the energy market. This latter outcome has not yet occurred in the NEM.
- In dispatching the market, AEMO co-optimises dispatch in both energy and ancillary service markets. AEMO uses the lowest cost combination of energy and ancillary services necessary to maintain the security of the system. If AEMO must change a generator's output in the energy market in order to provide more ancillary services, the cost of making this change in the energy market is factored into the ancillary service price.

Given these factors, we consider that the application of the APC in an ancillary services market cannot itself cause a participant to incur a loss. This is because participants

⁵⁰ International Power, issues paper submission, p.4.

offering ancillary services do not incur compensable costs in doing so. The participant will not actually incur costs until such time as they are actually called on to provide the service. At that time, they will be eligible to claim compensation as a scheduled generator (or potentially as a scheduled load), if they have incurred compensable costs in the provision of energy services.

Below, we step through some examples which illustrate our reasoning.

As we identified above, all administered price period events in the NEM to date have been triggered by a breach of the cumulative price threshold in the energy market. This results in the application of the APC in both the energy and ancillary service markets. This is the far more likely type of administered price period event.

To continue with the example of the generator offering a fast raise service, we now assume that the generator is a high cost unit with direct or opportunity costs in excess of \$300/MWh. In this example, the APC applies in both energy and ancillary service markets.

If this generator is enabled to provide a fast raise service, it receives a payment through the ancillary service market for keeping capacity in reserve. The generator does not incur any costs from providing the ancillary service, as it is not actually generating electricity with this capacity. In fact, the generator does not begin to incur any cost until such time as it is called upon to actually provide the raise service and generate electricity in the energy market.

It follows that the application of the APC in the ancillary service markets does not actually result in the participant incurring a loss. While a loss may be incurred if the participant is called on to provide energy, it is eligible to claim compensation as a scheduled generator for the provision of this energy.

A less likely scenario is where an APC caps the price in ancillary service markets only. In this case, a generator facing high energy spot market prices may face a reduction in revenue if it is enabled in the APC capped ancillary service markets. This may occur because the generator's output in the energy market is reduced in order to provide reserve capacity in the ancillary service market.

An argument could therefore be made that application of the APC in ancillary service markets only may result in generators incurring a "loss". Traditionally defined, this is the opportunity cost to generators of providing capacity in the ancillary service markets.

However, this definition of opportunity cost is inconsistent with the general approach taken by the Commission in relation to compensation claims. Our approach to opportunity costs, as expressed in the current compensation guidelines, states that compensable opportunity costs should be based on the foreclosure of opportunities to use scarce resources more profitably, at a later point in time.⁵¹ The situation described above does not refer to any prevention of the use of scarce resources at a later point in time, but rather to the simultaneous price difference between two markets.

⁵¹ Section 10.3.2 and appendix A of the existing compensation guidelines provides a detailed overview of the Commission's current approach to opportunity costs.

Furthermore, in the 2008 *Compensation Arrangements under Administered Pricing Rule* change, the Commission moved away from consideration of dispatch prices when calculating compensation amounts. That is, the Commission determined that compensation should be awarded on the basis of actual direct and opportunity costs incurred, rather than on the difference between a participant's offer price and the capped price. Allowing participants to claim for foregone revenue based on their offers in the energy market would conflict with this overall approach.

We note that this arrangement could theoretically result in a situation where generators may reduce their offers in ancillary service markets, if they consider that dispatch in ancillary services markets would result in a reduction in their spot market revenue. However, under this relatively unlikely scenario, we note that AEMO's directions powers may be used to maintain an adequate supply of ancillary services to maintain system security.

Finally, we consider that parties who offer lower services are unlikely to incur a loss due to the application of the APC in ancillary services markets. An ancillary service generator can only offer lower services if it is already dispatched in the energy market and producing electricity. If called upon to provide the lower service, the generator reduces its output in the energy market, resulting in a fuel cost saving and a reduction in spot market revenue.

If a high cost generator is dispatched in the energy market and is incurring a loss, any reduction in its output must therefore result in a reduction in its losses. Accordingly, the application of the APC in the various ancillary service lower markets will not result in these participants incurring a loss. If anything, receipt of ancillary service payments by this generator will help to offset some of the losses incurred by generating in the energy market.

We have attempted to capture and analyse all likely or significant interactions between energy markets, ancillary service markets and the APC. However, we note that other interactions and risks may exist which have not been captured here. We welcome stakeholder comment on our proposed approach.

7.3.4 References to market suspension

We consider that references to market suspension in the existing eligibility criteria should be removed.

The rules currently refer to certain participant types being eligible to claim compensation "due to the application of an administered price cap during...a market suspension". However, clause 3.14.5, which sets out the process for the determination of spot prices under market suspension, makes no reference to the application of the APC. That is, the APC cannot be applied due to market suspension. We consider that the reference to market suspension in the current compensation arrangements is most likely a legacy from earlier versions of the national electricity rules or national electricity code.

Given that the primary purpose of the compensation arrangements is to address disincentives due to the application of the APC, it follows that market suspension is not an appropriate criteria for compensation eligibility.

Furthermore, the purpose and function of the cumulative price threshold/ APC mechanism and market suspension are markedly different. Application of the APC is designed to protect consumers from prolonged periods of high prices, whereas spot market suspension occurs due to circumstances such as system collapse or the declaration of a state of emergency. The critical circumstances underpinning a market suspension require a separate and clearly defined process for market operation. Accordingly, clause 3.14.5 provides a detailed process for the determination of spot prices under market suspension.

However, clause 3.14.4(e)(1) refers to AEMO issuing directions to participants during a market suspension. If market suspension were to occur and participants were directed, compensation could be claimed under the clause 3.15.7 provisions which set out the process for payments to directed participants.

We note International Power's argument that in both market suspension and the application of the APC the spot price is determined separately to the dispatch price. However, we consider that the very different underpinning circumstances of the APC and market suspension require a separate approach to the determination of payments to affected participants.

Summary of eligibility criteria

Table 7.1 below provides a summary of the eligibility criteria discussed in this chapter and in chapter 6.

Table 7.1 Summary of proposed eligibility criteria

Participant type	Eligible to claim	Eligibility period
Scheduled Generator	Yes	Commences when the spot price in a region is actively capped by the administered price cap
Scheduled Load	Yes	Commences when the spot price in a region is actively limited by the administered price floor
Scheduled network service provider	Yes	Commences when the spot price in a region into which the scheduled network service provider is importing power is actively capped by the administered price cap
Scheduled generator or load in a region subject to price scaling under clause 3.14.2(e)(2) or 3.14.2(e)(4)	Yes	Commences when the price in the participant's region is first actively capped or limited by the price scaling provisions of clause 3.14.2(e)(2) or 3.14.2(e)(4).
Ancillary service providers	No	

8 Cost recovery

8.1 Issues with the current arrangements

Clause 3.15.10 of the NER describes the current process for the recovery of compensation costs from market customers.

The existing process requires AEMO to recover the cost of compensation from market customers who purchased electricity from a region where the spot price was affected by administered pricing.⁵² AEMO determines the amounts payable by market customers according to their individual share of total energy consumption, on a trading interval basis.

In the issues paper we identified some ambiguities related to this cost recovery process, as well as uncertainties relating to the interaction between cost recovery and the price scaling provisions contained in clause 3.14.2(e).

The existing rules are unclear as to the timeframes and process for cost recovery. While AEMO is required to recover the cost of compensation in proportion to market customers' energy consumption, it is not clear how this energy consumption should be calculated.

In particular, the rules refer to the recovery of compensation costs from market customers based on their energy consumption in any region "affected by the imposition of an administered price". The meaning of this is unclear, as the term "administered price" is not itself defined in the rules,

The meaning of the word "affected" is also unclear. It is difficult to determine whether compensation costs should be recovered only from market customers in regions "affected" through the direct application of the APC or the administered floor price, or also from market customers in those regions where the spot price has been "affected" through application of the price scaling provisions in clause 3.14.2(e).

The existing rules also appear to allocate the cost of compensation to market customers based on their energy consumption during individual trading intervals. This highly granular approach to cost allocation may create substantial complexities in the cost recovery process. We consider that any benefits of this approach are outweighed by the regulatory and administrative costs associated with increased complexity.

Box 8.1 summarises the existing cost recovery process included in the rules.

Box 8.1: Clause 3.15.10 compensation payment processes

NER clause 3.15.10 sets out the process to be followed by AEMO in allocating the costs of compensation to customers.

AEMO is required to determine an amount payable by all market customers who purchased electricity from the spot market in a region in which the regional reference price was affected by the imposition of an administered price or the market price cap, or the market floor price in the trading interval or trading

⁵² Market customers are defined under clause 2.3.4 of the NER.

intervals in respect of which such compensation has been awarded.

AEMO is required to determine the amounts payable for each relevant trading interval by each of the affected Market Customers under clause 3.15.10(a) as follows:

$$\frac{APC \times E_i}{\sum E_i}$$

Where:

- **APC** is the total amount of any compensation payments awarded by the AEMC to Scheduled Generators, Market Participants which submitted dispatch bids, or Scheduled Network Service Providers in respect of that trading interval in accordance with clause 3.14.6
- **E_i** is the sum of all of the Market Customer's adjusted gross energy amounts, determined in accordance with clauses 3.15.4 and 3.15.5, in respect of each trading interval in the billing period and each connection point for which the Market Customer is financially responsible in any region or regions affected by the imposition of an administered price or the market price cap or the market floor price
- **ΣE_i** is the sum of all amounts determined as "E_i" in accordance with clause 3.15.10 for all Market Customers in all regions affected by the imposition of an administered price or the market price cap or the market floor price in that trading interval.

International Power noted that the existing arrangements for cost recovery do not accurately reflect the way in which some costs are incurred. For example, costs associated with starting up a unit cannot be easily allocated to a specific trading interval. International Power called for improved clarity as to how these kinds of costs are allocated.⁵³

A related issue is the ability of retailers to recover the cost of compensation. Currently, the rules do not specify how retailers are to pass through these costs to their end use customers.

Retailers have argued that this may create substantial risks. Origin has stated that in the absence of an effective pass through process, these un-hedgeable risks may have an impact on a retailer's viability.⁵⁴

More generally, Origin highlighted that the payment of compensation costs may create substantial financial stress for retailers and argued that this impact on retailers should be considered by the AEMC when determining compensation amounts.

⁵³ International Power, issues paper submission, p.7.

⁵⁴ Origin, issues paper submission, p.1.

8.2 Recommendation

Cost recovery mechanism

We consider that the existing processes for the recovery of the costs of compensation are unclear and require amendment. Our proposed approach to cost recovery therefore seeks to clarify and expand upon the existing arrangements. This should provide the market with improved certainty as to how the costs of compensation will be calculated and allocated to market customers.

Under our proposed approach, the AEMC would calculate a total compensable amount for each compensation eligibility period, based on the difference between a participant's total costs incurred and total spot market revenue earned during that eligibility period.

This total compensable amount would then be recovered from market customers in the region where the APC or administered price floor applied, based on the total energy consumption of each market customer during the eligibility period.

In formulating an approach to cost recovery, we have sought to balance the efficient allocation of costs against the development of a reasonably simple and transparent cost recovery mechanism. While efficient cost allocation reduces cross subsidisation between customers, a straightforward and transparent approach helps to reduce administrative complexity. Transparency will also help reduce the likelihood of uncertainty or disputes regarding cost allocation following a compensation claim.

Retailer pass through

The Commission considers that end use consumers are the ultimate recipients of the reliability benefits associated with the payment of compensation. End use customers should therefore bear the full cost of the payment of compensation.

Retailers should not be constrained from passing the cost of compensation through to customers. However, we do not consider that the rules currently constrain retailers from passing these costs on fully to their end use customers.

Furthermore, we do not consider that section 34 of the NEL allows for the inclusion of matters relating to retail pricing in the rules.

However, we welcome comment from stakeholders on this issue, including, if applicable, examples of how the existing NER arrangements may be preventing efficient pass through.

8.3 Commission's considerations

8.3.1 The cost recovery mechanism

Under the existing rules, compensation costs are recovered from market customers in proportion to their energy consumption. We consider that this approach to cost allocation is efficient and should be retained. Accordingly, our proposed cost recovery mechanism recovers the total cost of compensation from market customers in proportion to their total energy consumption during an eligibility period.

When designing our approach to cost recovery, we considered the appropriate level of “granularity” when allocating the total compensable amount against market customers’ energy consumption. Adopting a more granular approach involves allocating costs to market customers based on their specific energy use at specific points in time.

Increased granularity improves the likelihood that the total compensable amount will be allocated to those parties who received the greatest benefit. This can help to reduce the likelihood of cross subsidisation between customers.

In developing our cost recovery approach, we considered a number of options with increasing levels of granularity of cost allocation. These options included allocating the cost of compensation based on market customers’ energy consumption during each trading interval, or allocation across multiple regions depending on levels of inter-regional flows.

However, we consider that increased granularity in cost allocation is likely to increase the complexity of claim assessment. For example, we found that it is likely to be very difficult to develop an effective and equitable approach to determining how the benefit of compensation was shared between regions. Similarly, allocation of costs to energy consumption on a per trading interval basis creates greater administrative complexity and increases the risk of disputes regarding cost allocation.

These complexities could create significant costs for both the AEMC and AEMO in administering compensation claims. They may also create uncertainty for participants, reducing the efficiency of operational and investment decisions. There is also increased potential for disputes regarding AEMO’s cost recovery process.

It follows that any approach to cost recovery must balance the need for the efficient allocation of costs against development of a transparent mechanism which is relatively simple to administer.

Given these factors, we recommend that total compensation costs should be recovered from market customers in proportion to their total energy consumption during the eligibility period. This cost should be recovered from market participants in the region in which the APC or administered floor price actively capped spot prices.

We consider that this approach strikes an appropriate balance between efficient allocation of costs and minimisation of complexity.

Below, we provide an overview of the process to be followed by the AEMC in determining the total compensable amount for each eligibility period.

We then explain in further detail our process for recovering this total compensable amount from market customers. Initially, we focus on the arrangements for recovery of compensable costs incurred by scheduled generators and loads located in the region where APC applied. We then extend our discussion to cost recovery in other, lower probability scenarios.

Determination of the total compensable amount for each eligibility period

As discussed in chapter six and seven, participants are only eligible to claim compensation if they have incurred a net loss due to operating during an eligibility period.

Under our proposed cost recovery mechanism, the AEMC will determine a total compensable amount for each eligibility period. This total compensable amount will be the difference between the total direct and opportunity costs incurred and total spot market revenue received by a participant during each eligibility period. Where this calculation results in a net loss, this will form the basis of the total compensable amount.

Where a participant has operated and incurred losses over multiple eligibility periods, the AEMC will determine a separate total compensable amount for that participant for each eligibility period.

In the situation where there is more than one claimant, the AEMC will determine a separate total compensable amount for each claimant, for each eligibility period.

While some costs will be clearly attributable to specific eligibility periods, this may not be the case for other kinds of costs. Generally, costs should be allocated to those eligibility periods in which they were incurred. However, in some cases, a pro-rated approach to the allocation of costs may be adopted. This is discussed in further detail in section 8.3.2.

Recovery of the compensable cost from market customers

The overarching principle informing the development of our cost recovery approach is that the cost of compensation should be recovered from market customers in proportion to the benefits they received from its payment.

As discussed in chapter four, we consider the primary objective of compensation is to maintain incentives on participants to supply energy and other services. The key benefit of the payment of compensation is therefore the maintenance of a reliable supply of energy during an administered price period.

Accordingly, our proposed cost recovery mechanism requires AEMO to recover the total compensable amount for each eligibility period from market customers, in proportion to their total energy consumption during the respective eligibility period.

We also consider that the primary beneficiaries of the continued supply of energy are those market customers located in the same region where the APC (or administered floor price) actively capped (or limited) prices. We therefore consider that the cost of compensation should be recovered from market customers in that region.

Lastly, we consider that compensation should only be recovered from customers in those regions where the APC (or administered floor price) was *directly* applied. The current rules do not specify this, instead referring to the recovery of the cost of compensation from customers in those regions “affected by the imposition of an administered price”.

The wording of this current clause creates a potential ambiguity, as it is possible for a region to be “affected” by the imposition of the APC, even if an administered price period and APC has not actually been triggered in that region.

Specifically, this situation may occur under the price scaling provisions included in NER clause 3.14.2(e), which requires the spot price in any region exporting power to an APC capped region to be limited to the level of the APC (adjusted for losses), for as long as there are export flows from that region toward the APC capped region. The current rules could therefore be interpreted to mean that the cost of compensation should also be recovered from market customers in these other regions which were “affected” by the application of the APC.

We consider that the rules should be clarified to state that the total compensable amount should be recovered only from market customers in regions where an APP applies and the APC (or administered floor price) has actively capped the spot price. Customers in regions where the spot price has been scaled back as per clause 3.14.6(e) should not bear any of the costs of compensation. We consider that this is appropriate, given that the primary reliability benefits associated with the payment of compensation in this instance is received by customers in the APC capped region.

Methodology for cost recovery

The current rules contain a formula to be used by AEMO in the recovery of compensation costs from market customers.

The proposed formula below is generally similar to that currently included in the rules. However, it refers to total energy consumed over the entirety of an eligibility period rather than an individual trading interval:

$$TCA_n \times \frac{\sum E_{i_n}}{\sum E_n}$$

Where:⁵⁵

- TCA_n is the total compensable amount for eligibility period n .
- $\sum E_{i_n}$ is the sum total of all energy consumed by a market customer, located in the APC capped region, during eligibility period n .
- $\sum E_n$ is the sum total of all energy consumed by all market customers in the APC capped region, during eligibility period n .

Below, we step through an example of how this cost recovery approach may be applied in practice.

⁵⁵ For expediency, we refer here only to application of the APC. However, the same arrangements apply following application of the administered price floor.

Box 8.2: Cost recovery

In this example, we consider a region where a single compensable participant (in this case, a scheduled generator) incurred a net loss due to operating during an eligibility period.

In this example, the eligibility period commences in trading interval eight, when the APC first caps the spot price in the region. The eligibility period continues until the end of trading day, in trading interval 48.

The AEMC takes the total costs incurred by the participant during the eligibility period and subtracts these from the total spot market revenue earned during the eligibility period.

For this example, we assume that this process results in the participant incurring a net loss. We assume that this loss was equal to \$50,000. This is the value of the total compensable amount.

Once this total amount has been determined by the AEMC, AEMO is responsible for recovery from market customers.

To do so, AEMO calculates the total amount of energy consumed by all market customers in the region during the eligibility period. This is represented by the cross-hatched area underneath the curve between trading intervals eight and 48. AEMO also determines the portion of this energy consumed by each market customer.

AEMO allocates the total compensable amount to market customers on a pro-rated basis, according to their share of the total energy consumption during the eligibility period.

For this example, we assume that total regional energy consumption during the eligibility period was 10,000MWh.

We also assume that there were three market customers in the region, whose total energy consumption during the eligibility period was 5,000MWh, 3,000MWh and 2,000MWh respectively.

Given the formula provided above, AEMO allocates the total compensable amount of \$50,000 for this eligibility period to each market customer as follows:

Customer 1 liability:

$$\$50,000 \times \frac{5,000MWh}{10,000MWh} = \$25,000$$

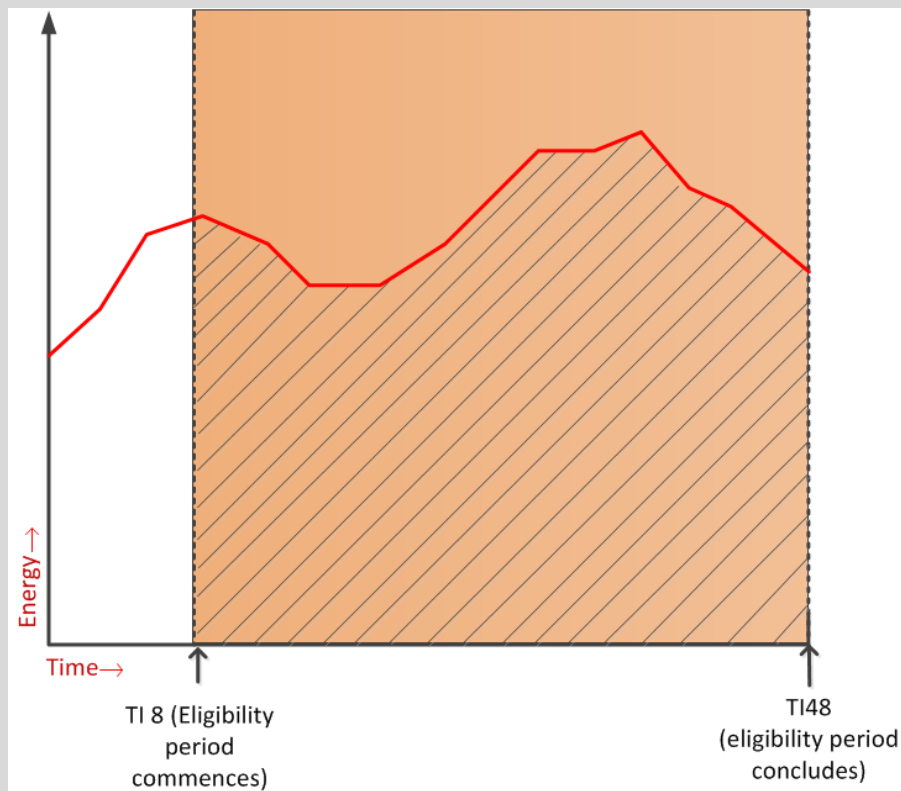
Customer 2 liability:

$$\$50,000 \times \frac{3,000MWh}{10,000MWh} = \$15,000$$

Customer 3 liability:

$$\$50,000 \times \frac{2,000MWh}{10,000MWh} = \$10,000$$

Figure 8.2 Cost recovery process



8.3.2 Lower probability scenarios – other participant types, multiple claimants, multiple APC capped regions

We consider that the most likely scenario where compensation may be claimed is where a single scheduled generator, located in an APC capped region, incurs a loss.

However, other potential scenarios exist where compensation may be awarded. We consider these below.

Cost recovery for scheduled generators in regions subject to the price scaling provisions

As discussed in section 6.3.3, participants in regions outside of the APC capped region may be eligible to claim compensation. This may occur where application of the clause 3.14.2(e) price scaling provisions results in these participants incurring a net loss.

In these circumstances, we consider that the primary beneficiaries of the payment of compensation are those market customers located in the region where the APC directly applied and actively capped prices. Customers in the APC capped region should

therefore bear the full cost of any compensation awarded to participants under this scenario.

As discussed in section 6.3.3, the eligibility period for compensable participants under this scenario commences when the spot price in the exporting region is first capped under the price scaling provisions. It concludes at the end of the trading day.

The total compensable amount for such participants should be determined in the same way as above. That is, the AEMC should consider the total spot market revenue received and total costs incurred by the participant throughout the relevant eligibility period.

The process for recovery should also follow the processes outlined above. The total compensable amount for each eligibility period should be recovered from market customers in the APC capped region (the importing region), in proportion to their total energy consumption during the relevant eligibility period. In this case, the relevant eligibility period commences when price scaling caps the spot price in the exporting region and concludes at the end of the trading day.

Cost recovery for scheduled load

As discussed in section 7.3.1, scheduled loads may be eligible to claim compensation if they have incurred a loss due to the application of the administered floor price.

As with scheduled generators, we consider that the primary beneficiaries of the payment of compensation in this situation are those customers in the region in which the administered floor price directly applied and actively limited prices. Customers in that region should therefore bear the full cost of any compensation awarded to scheduled load.

In section 7.3.1, we also described the situation of a scheduled load located in a region where the price scaling provisions applied. A scheduled load who has incurred a loss in this situation may be eligible to claim compensation. We consider that the cost of any compensation awarded in this situation should be recovered from market customers in the region in which the administered price floor directly applied and actively limited the price.

Cost recovery for scheduled network service providers

As discussed in section 7.3.2, scheduled network service providers may be eligible to claim compensation if they have incurred a loss due to the application of the APC.

In this scenario, we consider that the primary beneficiaries of the payment of compensation are those customers in the region into which the scheduled network service provider is importing power. That is, the loss incurred by the scheduled network service provider is due to the application of the APC in the importing region.

Customers in the importing region should therefore bear the full cost of any compensation claimed by an scheduled network service provider under this scenario.

As discussed in section 7.3.2, under our proposed approach the eligibility period for scheduled network service providers would commence when the spot price in the

region into which the scheduled network service provider is importing power is first capped at the APC. It concludes at the end of trading day.

The AEMC would determine the total compensable amount based on the scheduled network service provider's total costs incurred and revenue earned during the eligibility period. This total compensable amount would then be recovered from market customers in the APC capped region (the importing region) in proportion to their total energy consumption during the eligibility period.

Cost recovery for multiple claimants or multiple regions

It is possible that there may be multiple claimants in a single region, within one eligibility period. The arrangements described above would continue to hold in this case, with two separate total compensable amounts calculated (one for each claimant). The sum of the two compensable amounts would then be recovered from market customers in the APC capped region in proportion to their energy consumption during the cost recovery period.

It is also possible that an administered price period may apply in two regions simultaneously, and that the APC may actively cap prices in both regions at the same time. This would result in the triggering of an eligibility period in both regions.

The general principle for cost allocation in this case is that market customers in the same region as the compensable participant should bear the full costs of any compensation awarded to that participant.

This scenario may be extended to the situation where there are multiple claimants across multiple APC capped regions. In such a scenario, the total compensable cost for each claimant would be recovered from market customers in the same region as that claimant.

8.3.3 Structure of costs

In the December 2008 final determination of the *Compensation under administered pricing* rule change, we established what kinds of costs can be recovered through the compensation provisions. These were defined as a participant's short run marginal costs, incorporating direct and opportunity costs.

The compensation guidelines provide further information regarding the form of these direct and opportunity costs. Following completion of this review and any subsequent rule changes, it is likely that some amendments to the guidelines will be required.

Any amendments to the compensation guidelines will take place via a rules consultation procedure. Given that this is a separate process to this review, we will not be making any decisions regarding the final form of the guidelines at this stage.

However, there are several key issues which we consider are likely to be included in any future consultation regarding the guidelines. Below, we step through some of these issues, noting that others may be identified by the Commission when undertaking any consultation procedure.

Allocation of costs across multiple trading intervals

A compensable participant may make a claim for losses incurred from operating over multiple eligibility periods. As we described above, the AEMC will determine a separate total compensable amount for each eligibility period.

We consider that costs should be allocated to those eligibility periods in which they were incurred. For most kinds of costs this should be a relatively straight forward process. For example, it should be possible to allocate fuel or labour costs to the operation of a unit during a specific eligibility period.

However, it may be difficult to determine exactly when other costs were incurred. For example, costs associated with maintenance may be attributed to operation across multiple eligibility periods. Opportunity costs may also be relatively difficult to attribute to specific periods of operation.

Where costs cannot be clearly allocated to a particular eligibility period, the AEMC may seek to develop a pro-rated approach. This would allow for a proportional allocation of costs across multiple periods.

Structure of claims

Given the structure of the cost recovery process, we consider that the guidelines may need to include some information as to how claimants should provide cost data to the AEMC. For example, it is likely that fuel costs would need to be provided to the AEMC on the basis of the eligibility period in which they were incurred.

The guidelines may also need to provide information regarding the appropriate definition of what physical units should form the basis of a compensation claim.

Generally, we consider that the dispatchable unit identifier, as defined in chapter ten of the rules, is likely to be the appropriate definition of physical units to form the basis of compensation. However, we welcome stakeholder comment as to the appropriate definition of what units should form the basis of compensation claims.

8.3.4 Retailer pass through

The primary purpose of compensation is the maintenance of a reliable supply of energy and other services during an administered price period. The ultimate beneficiaries of the maintenance of this reliable supply are end use customers. It follows that these end use customers should ultimately bear the full cost of compensation.

Under our proposed arrangements, the cost of compensation is allocated to market customers. Generally, this refers to retailers. We consider that retailers should not be prevented from passing these costs through to their end use customers.

At present, it appears that existing arrangements provide some opportunity for the pass through of these costs. In the case of end use customers on regulated contracts, the existing jurisdictional retail price determination process may provide an avenue for

passing through compensation costs, through the inclusion of specific pass through provisions in regulated retail price determinations.⁵⁶

For customers on market contracts, the process of contract negotiation should provide both parties with adequate opportunity to include clauses which facilitate efficient pass through.

Stakeholders have suggested that amendments to the rules designed to facilitate the pass through of compensation costs would substantially reduce retailer costs. In particular, Origin has stated that the classification of AEMO fees determines the ability of retailers to pass through the costs of compensation.⁵⁷ Although Origin's submission does not elaborate on this point, our understanding of Origin's argument is that defining the cost of compensation in a similar way to the definition of an AEMO fee in the rules would make it easier for retailers to pass this cost through in their market contracts.

However, at this stage we have not been provided with a clear explanation of exactly how the existing rules are impeding the efficient pass through of compensation costs, nor any indication of the materiality of this issue. Stakeholders have also not provided any detail as to what kinds of amendments to the rules they consider necessary to address any such issue, or what kinds of efficiency benefits might be associated with any such amendment.

Furthermore, we are not convinced that including an explicit compensation cost pass through mechanism in the rules would be appropriate. This is based on a reading of section 34 and schedule 1 to the National Electricity Law (NEL), which set out the subject matter which is appropriate for inclusion in the national electricity rules.⁵⁸ Importantly, this section of the NEL contains no reference to the structure of retail pricing or the pass through of retailer costs.

However, we note that other sections of schedule 1 refer to matters which may be relevant to the recovery of compensation costs by retailers, including the determination of participant fees, as well as services provided under the rules in respect of which the rules require payment.

While we do not consider that the rules currently impede the efficient recovery of compensation costs from customers, we welcome any stakeholder suggestions regarding potential amendments which might improve the efficiency of cost recovery. Stakeholders should clearly describe what amendments are necessary in order to facilitate this outcome, noting the restrictions on the matters that are appropriate for inclusion in the rules, as listed in section 34 and schedule 1 to the NEL.

⁵⁶ We note that currently, no jurisdictional retail price regulation arrangements make an explicit allowance for the pass through of compensation costs. However, we consider that there is nothing preventing such pass through mechanisms being included in the development of regulated retail price determinations.

⁵⁷ Origin, issues paper submission, p.1.

⁵⁸ *National Electricity (South Australia) Act 1996 (SA)*

9 Next steps

The AEMC welcomes stakeholder comments on the policy discussions and recommendations made above. Stakeholder input is central to the development of our thinking and will help us to examine all relevant issues.

All stakeholder comments will be considered in the development of the final report, which we expect to publish and provide to SCER in the first half of 2013.

It is our intention that this report will include a draft version of a rule change proposal, incorporating the key recommendations made in this review. This draft rule change proposal may be adapted and sent back to us as a formal rule change request.

Implementation of any recommendations will require further work following completion of this review:

- The rules will require amendment to incorporate the proposed changes to the assessment framework, public consultation processes, purpose clauses, eligibility and cost recovery.
- Following these changes to the rules, the guidelines will also require amendment, via the rules consultation procedures. As well as accommodating the recommendations made in this report and the changes proposed in any subsequent rule change, the guidelines consultation process may also consider further issues, such as the appropriate form and parameters of opportunity cost definition.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
APC	Administered Price Cap
NEL	National Electricity Law
NEM	National Energy Market
NEO	National Electricity Objective
NER	National Electricity rules
SCER	Standing Council on Resources and Energy