4 May 2023

Charles Popple
Chair
Reliability Panel

Submitted online

Reference: REL0086

Dear Mr Popple,

Review of the Form of the Reliability Standard and APC

The Australian Financial Markets Association (AFMA) is responding to the Reliability Panel's consultation on their Review of the Form of the Reliability Standard and the Administered Price Cap (APC).

AFMA is the leading industry association promoting efficiency, integrity, and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets. Our role is to provide a forum for industry leadership and to advance the interests of the markets and their respective participants. Our membership is comprised of over 125 of Australia's leading financial market participants, including many of the energy firms who participate in the National Electricity Market (NEM).

As an advocate for participants in financial markets, AFMA is keen to ensure that settings in the underlying physical markets are appropriate for both the physical market and the financial market. Our submission focuses on the Panel's proposals to change the form of APC and our comments are directed at ensuring that APC is appropriate for both the physical and financial markets. Both physical and financial markets thrive on certainty and simplicity; and where possible AFMA advocates for easier to understand solutions in preference to the often illusory promise of precision presented by more complicated solutions. AFMA does not consider that there is an issue with the current form of APC as a fixed number, but we consider that it should be indexed to ensure it remains commercially relevant.

1. Context for the review

The extended periods of high NEM prices in mid-2022 highlighted the need to review a number of market settings, including APC which had been left unchanged for an extended period. Since the rate of APC was set, there has been significant changes to; other market settings, the mix of generation in the NEM and generator fuel costs. AEMO's decision to suspend the NEM in June 2022, which was in large part driven by the impracticality of attempting to schedule the market when APC was not high enough to allow many generators to recover their costs, underscored the need to increase APC but AFMA does not consider that it necessarily showed that there was a need to alter its form.

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, Angel Place, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7993 Email: secretariat@afma.com.au

Since the suspension, the previous inertia surrounding APC has been replaced by a flurry of activity with the AEMC temporarily increasing APC to $600 and the Panel recommending that the temporary increase be extended to 2028, at the slightly reduced level of $500. Given the recent activity around a long neglected market parameter, it is surprising the Panel is considering changing the form of APC as the Panel itself has recently decided that a higher value is appropriate until at least 2028 and the market is yet to have any experience of the impact of a higher APC.

AFMA Recommendations

i. There is no obvious case to move away from a fixed APC at this stage and any review of the form of APC should wait until the market has experience of the effectiveness of the recent increases.

2. Role of APC in the financial market

APC does not have a direct role in the financial market, but it is built into the pricing of the financial market instruments that participants use to manage risk in the NEM. The two most commonly traded financial products used to manage exposure to the NEM spot price are swaps and caps. Swaps allow participants to manage their exposure to the NEM spot price by entering into an agreement where the seller (typically a generator) receives a fixed payment in exchange for agreeing to make variable payments to the buyer (typically a retailer) when spot prices exceed the agreed fixed price. Swaps give sellers certainty about the price they will be able to sell electricity at and buyers certainty about the price they will buy at. Caps are a type of option that traditionally operate like an insurance product for buyers against high spot prices. In exchange for a premium, the seller of a cap (typically a generator) agrees that when spot prices exceed an agreed level (typically $300) they will pay the buyer the difference between $300 and the spot price.

APC does not have a direct role in the structure of either swaps or caps, but the value of each product is determined by reference to the spot price so APC will have an influence on their value during periods of administered pricing. When pricing swaps and caps market participants currently have confidence that during periods of extreme volatility, APC will limit their potential exposure. For APC to continue to perform this role over the long term, the market needs to have certainty about when administered pricing will apply and the price it will apply at. AFMA is concerned that the options proposed in the review introduce greater complexity and do not provide this certainty.

3. Concerns with proposed options

The review lists four options for the form of APC that the Panel will consider. In AFMA's view, none of the proposed options are appropriate for the needs of the financial market and that the current fixed price, with appropriate indexing, better suits the requirements of the market.

3.1. Lack of certainty

As discussed in section 2, APC is a component in the pricing of financial products, buyers and sellers therefore need to be able to understand it to price swaps and caps. The proposed dynamic APC options make this more difficult as rather than being a known fixed number, APC becomes a variable linked to either the gas price or potentially an unknow variable to be determined in a period of market disruption. Linking APC to the gas price would allow participants to forecast the future gas price and incorporate this into the pricing of swaps and caps but this would complicate the process and probably result in an increase in swap and cap prices as sellers build in a premium to account for the uncertainty of the future gas price. The other option of temporarily increasing APC following market disruptions is even more problematic as buyers and sellers would not be able to forecast their potential exposure, the problems with this option are discussed further below in section 3.3.

3.2. Challenges of linking APC to gas prices

Linking APC to a gas price has appeal in the physical market as currently gas powered generation is the most likely marginal fuel and therefore linking APC to these generators fuel costs is likely to result in it being set at a level that would allow them to recover their costs. Despite this, AFMA does not consider that this is the most appropriate approach both for the reasons of certainty set out in section 3.1 and because the gas price may not be an appropriate indicator in future events.

The problem of linking APC to a fuel cost can be seen by the issues encountered with the $300 APC in 2022. When this level was originally set it was considered to be the Short Run Marginal Cost (SRMC) of a liquid fuel plant, which at the time, was considered to be the most likely marginal generator during an administered pricing period. As discussed above, the rate of APC was then neglected for a long period, this may have been partly as $300 was considered to be more than adequate to compensate gas powered generators unless gas prices exceeded the (then inconceivable) level of $25 GJ, AFMA doubts that the SRMC of coal units was every seriously considered in the context of APC. In the events of 2022, APC was found to be inadequate not just for liquid fuel units but for gas and coal. In 2022, linking APC to a spot gas price such as Wallumbilla or JKM may have resulted in a more appropriate level of APC, but given the current rate of technological change in the NEM, AFMA does not think this will necessarily be the case in the future. In a future extreme event, where the relevant marginal cost could be; liquid fuels, the cost of charging a battery or the opportunity cost of a hydro plant, the gas price is not an appropriate proxy.

While AFMA does not support linking APC to gas prices we want to point out that if the Panel wishes to explore this option further the gas price index chosen will be very important. AFMA considers that it will be challenging to find an index that is timely, reflects the cost borne by the generator and provides certainty to the market. For instance, the Panel could choose between an index based on recently observed prices such as JKM or the ACCC's netback price, or a spot price such as the Gas Supply Hub. Using a published index based on historic prices gives the market greater certainty but introduces the risk that the most recent price in the series may not reflect recent price movements (that may have contributed to the market event). Alternatively, a spot price is more timely but gives the market less certainty and may be illiquid at the relevant time, meaning that it does not reflect actual costs. Transport costs are another factor that will complicate the choice of an index. AFMA would generally consider that a price linked to LNG exports would be a better reflection of costs in the market but if a NEM event occurs in Victoria, transport constraints could mean these prices may not reflect the true fuel cost in that region.

3.3. Temporary increases are undesirable

The fourth option proposed in the review is to keep APC as a fixed value but allow it to be temporarily escalated as a result of a market event or where the marginal generators SRMC is higher. AFMA considers this approach is highly problematic as it provides the least certainty of all the approaches and when triggered, would change the allocation of risk in existing financial products. As discussed in section 3.1, AFMA considers that it is desirable for the level of APC to be certain, this approach would not provide the market with certainty as during extreme market events (or potentially just if the marginal generator happens to have a high SRMC), the value of APC could be adjusted in a way that would not be clear to the market in advance and may not be known until after the administered pricing period has ended.

This approach is undesirable both because the uncertainty makes it difficult for the financial market to price the risk at the point an agreement is entered into but also because changing APC after an agreement has been entered into changes the allocation of risk between the parties, potentially with short or no notice. For instance, a generator who has sold a $300 cap on the basis of a $300 APC would not expect to run during an administered pricing period, if APC was changed during an administered pricing period, the generator would be exposed to a new risk that they had not priced and which they may not have adequate notice to manage by running their generator. This would be particularly problematic if APC were set based on a generators' SRMC, which probably could not be determined until after the event, as a result participants would not know what their exposure was during the event and could not react during the event to mitigate it. It is also worth noting the directions framework under the current rules provides a mechanism to compensate generators with a SRMC above APC. This arrangement worked well until 2022 when the low rate of APC made it impractical to direct a large number of generators. AFMA's view therefore is that a higher APC would mitigate these issues and that the ability to temporarily raise APC is only necessary when APC is set too low.

AFMA Recommendations

ii. A dynamic APC is not desirable as it would increase complexity and uncertainty in the financial market.
iii. Linking APC to a gas price is not preferred as it is unclear that this will necessarily be an appropriate benchmark in a future event.
iv. If the Panel wishes to explore using a gas benchmark further it should consult widely about the benchmark to ensure it is fit for purpose.
v. AFMA does not support a mechanism to temporarily increase APC in response to market events as it increases uncertainty and could change the allocation of risk under existing contracts with little or no notice.
vi. If the Panel wishes to explore a mechanism to temporarily increase APC it should consult broadly on the triggers and how the price would be set with a view to providing as much certainty as possible to the market.

4. Simple and certain

Financial markets thrive on certainty and where possible, prefer simple easily understood mechanisms. The combination of certainty and simplicity make it easier to price risk which results in more efficient pricing without the need to build additional margin into the pricing to manage the risk of the uncertainty or the cost of understanding additional complexity; and allows participants to offer longer term products when they are confident that the parameters underlying the product will not change unpredictably. These factors contribute to the development of healthy markets that offer efficient prices for products that participants can use to manage their risks.

The current fixed APC price meets the key criteria of simplicity and certainty as it is a known and easily understood value. In 2022, it was demonstrated that the level of APC was inadequate, AFMA's view is that this was due to the failure to increase APC, in the same way that other parameters were increased, rather than reflecting a fundamental problem with using a fixed value for APC. AFMA therefore proposes that APC should be indexed to CPI in the same way as the Market Price Cap and Cumulative Price Index. We note that in their directions paper for the Amending the Administered Price Cap rule change, the AEMC noted that if indexing of APC had been place it would have increased to $592,[1] i.e. approximately the level the rule change took it to.

AFMA's view is that changing the form of APC would be detrimental for the financial market as it would introduce unnecessary complexity and greater uncertainty. Our view is that the simplest and best approach is to make the increase to APC permanent and then index the value to CPI to ensure it remains commercially relevant.

AFMA Recommendations

vii. APC should remain a fixed price.
viii. The Panel's rule change should be amended to make the increase in APC permanent.
ix. APC should be indexed to CPI in the same way as the Market Price Cap and Cumulative Price Index.

AFMA would welcome the opportunity to discuss the Panel's review of the form of APC. Please contact me on 02 9776 7994 or by email at lgamble@afma.com.au.

Yours sincerely

Lindsay Gamble
Policy Director

[1] https://www.aemc.gov.au/sites/default/files/2022-09/APC%20Directions%20paper%202022_09_29.pdf