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Anna Collyer  
Chair  
Australian Energy Market Commission

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### **Amending the Administered Price Cap**

Dear Ms Collyer

The Australian Financial Markets Association (AFMA) is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets. AFMA represents the common interests of its members in dealing with issues relevant to the good reputation and efficiency and competitiveness of wholesale banking and financial markets in Australia. AFMA has more than 120 members reflecting the broad range of participants in financial markets, including the energy companies which are key participants in the National Electricity Market (NEM).

#### Context

The recent extended periods of high prices in the NEM have highlighted the need to review a number of market settings. In particular, AEMO's decision to suspend the NEM in June underscored the need to review the Administered Price Cap (APC). As identified by Alinta, APC has been left unchanged for an extended period, during which there have been significant changes to; other market settings, the mix of generation in the NEM and generators fuel costs. Recently this has resulted in periods when a significant number of plants have had short run marginal costs greater than \$300 MWh. AEMO's decision to suspend the NEM was in large part driven by the impracticality of attempting to schedule the market when APC was not high enough to allow a significant number of generators to recover their costs. AFMA considers that it is not desirable for the suspension to be repeated.

AFMA supports increasing APC but wants to highlight the impacts that making the change with a short implementation period is likely to have in the financial market. Our submission sets out some of the key impacts this change is likely to have but we appreciate that the AEMC may consider that current conditions in the physical market still justify making the change without a substantial implementation period.

## The role of caps

\$300 caps are one of the key financial derivative contracts used to manage price risk in the NEM and in AFMA's view are the product that would be most affected by this change. Caps are a type of option that can be traded both OTC and as futures. Traditionally they 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 \$300 they will pay the buyer the difference between \$300 and the spot price. Electricity derivatives are generally cash settled meaning the seller is not required to generate electricity but must make payments to the buyer when the spot price exceeds \$300. In practice generators who have sold caps will generally run when they anticipate prices may exceed \$300 to manage their spot price risk with their physical plant. For example if the spot price is \$500 a generator who has sold a cap would typically run resulting in them being paid \$500 in the spot market, they would then use \$200 of this (i.e the revenue between \$300 and the spot price) to pay the buyer of the cap.

Cap contracts are not explicitly linked to APC but in practice sellers of caps do not currently have to pay out during periods of APC and as a result generators who have sold caps may choose not to run during periods of APC. Implementing a higher APC will mean that during APC periods sellers will be exposed to the difference between APC and the current \$300 trigger in the cap contracts. As a result generators who have sold caps are probably more likely to run during these periods.

AFMA considers that increasing APC is likely to have the following effects on \$300 cap contracts which will probably result in wealth transfers from sellers of caps to buyers. Caps will become more valuable to buyers as they will now offer a greater level of protection during APC periods. People who have bought existing caps will therefore make a mark to market profit as the caps they hold now have a higher market value, sellers will make a mark to market loss as the premium they charged will now be lower than the market price. To a degree this will be a timing issue for the seller as they will have to account for revaluations immediately but there will be a delay in them collecting revenue until the period the cap relates to. While AFMA will not speculate on the level of the change in value we do not think the economics of \$300 caps will change during periods of normal market operation or market suspension so any change in value is likely to only relate to their increased value during the reasonably short periods of APC. As a result, we anticipate that the impact on valuations will be moderate, particularly as the market is already pricing in the current elevated spot prices which have made caps more valuable.

If the value of their existing caps increases sellers will be exposed to higher variation margin payments for caps sold as futures and for OTC trades that are subject to margining, as these payments are calculated based on variations in value of the cap in relation to the current market price. Sellers will therefore have to find additional collateral (e.g. post cash) to meet these margin payments. The magnitude of this impact will depend on the change in value of the caps, we would expect it to be small if the change in the value of caps is modest.

Sellers of caps who are generators are also likely to incur additional costs to run their generation during periods of APC. For example, a peaking gas generator who has sold a \$300 cap would be likely to run during periods of APC when the spot price is above \$300, to run they would need purchase additional gas and would incur additional wear and tear on their plant. Conversely buyers of caps are likely to have reduced variation margin payments on their existing positions and buyers who also own

generation may be able to avoid running costs during periods of APC as the caps will now offer them greater protection reducing the incentive to run their generation.

AFMA expects the market would respond if APC were increased so that cap contracts entered into after the change are likely to incorporate the increase in value. In the short term we expect that the price of caps would increase to reflect the seller's greater exposure during periods of APC. In the longer term new products may develop to supplement or replace the existing \$300 caps, we note FEX's recent decision to list a \$500 cap may indicate a desire for this type of product in the market.

#### Duration of increase

Alinta has proposed temporarily increasing APC for 12 months, or another suitable period determined by the AEMC. AFMA considers that a temporary increase in APC followed by a subsequent reduction to the current level is not desirable as the market would prefer more stable price signals. Our preference would be for any change to APC to be ongoing, noting that a subsequent change is likely as a result of the Reliability Panels' current work on market settings.

#### Final observations

AFMA considers that there is a substantial risk that events similar to those of June will occur again in the near future and that without changes to APC further market suspensions are likely. Changing APC is likely to have an impact on the value of existing contracts which would result in wealth transfers, as discussed above. Normally AFMA would not support rapid changes to market settings as we consider that markets should be given time to adjust and avoid market disruption. But in this case the AEMC must balance this risk against the uncertainty caused by more periods of market suspension.

AFMA would welcome the opportunity to directly discuss the implications of the amendment to the administered price cap to the electricity financial market. Please contact me on 02 9776 7994 or by email at [lgamble@afma.com.au](mailto:lgamble@afma.com.au).

Yours sincerely



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