20 September 2012

Mr John Pierce
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted online: www.aemc.gov.au

Dear Mr Pierce

ERC0133 - NEW PRUDENTIAL STANDARD AND FRAMEWORK IN THE NATIONAL ELECTRICITY MARKET (NEM) – SECOND CONSULTATION PAPER

Origin Energy Limited (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC's) Second Consultation Paper in relation to a new prudential standard and framework in the NEM.

The Second Consultation Paper addresses the Australian Energy Market Operator's (AEMO's) supplementary submission on how reallocation and generation credit offsets should be taken into account in the calculation of a participant's credit support requirements.

Origin wishes to comment on the following two aspects of AEMO's supplementary submission:

- AEMO's discretion to determine the treatment of offsets in the Credit Limit Procedures (CLP); and
- AEMO's proposed methodology for calculating credit offsets for reallocations and physical generation in the prudential margin.

1. AEMO's discretion to determine offsets in the CLP

1.1. Support framework approach in principle

Origin is supportive of the AEMC's Draft Determination, which seeks to balance the level of detail on the credit limit framework specified in the National Electricity Rules (NER) and in AEMO's Procedures. The Draft Rule sets out the high-level principles and guidelines that define the prudential standard in the NER. AEMO's CLP then details the methodology to give effect to the prudential standard.

We consider that AEMO's proposal to incorporate into the CLP the detail around the methodology for determining credit offsets is consistent with the intent of the AEMC's Draft Determination. AEMO recommends the NER allows for credit offsetting, but affords AEMO the ability to determine the amount of offsetting in the CLP. Any limitations would be based on potential scenarios that could realistically transpire in the market. Origin therefore supports moving the detail for setting offsets from the NER to the CLP.

1.2. Concerns around last minute changes reducing robustness of overall process

We are concerned, however, that market participants may not have adequate opportunity to consider and assess AEMO's proposed offsetting methodology given the late stage at which AEMO is raising these amendments. Both the AEMC and AEMO have

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engaged in substantive consultation to ensure interested and affected parties understand AEMO's credit limit methodology and its application and relevance for individual businesses.

AEMO made the initial recommendation to replace the current "reasonable worst case" prudentials concept with a new statistical prudential standard in its Prudential Readiness Review in early 2011. A significant amount of work went into establishing the 2% Probability of Loss Given Default definition during that review. Since then, AEMO and market participants have invested significant effort and resources in the subsequent work undertaken in the intervening period between the finalisation of that review and the initiation of this Rule change and its associated CLP. As such, participants understand and have confidence in the prudential standard and framework, the reasons for change and the underlying credit limits methodology. It is not in the long term interests of consumers to undertake such a robust engagement process only to rush through amendments at the end.

To ensure due consideration of AEMO's proposed methodology changes, Origin proposes that the AEMC delay its decision to make its final Rule determination until stakeholders have had the opportunity to engage formally with AEMO. This can assure stakeholders that due consideration has been given to putting in place the most efficient and effective credit limits framework, which includes the underlying methodology.

We note that AEMO acknowledges that it is raising a new and significant policy change in the late stage of the AEMC's consultation process. We appreciate AEMO setting out its proposed offsetting methodology for generation and reallocation credits, which includes making available online calculators to determine the net impact of the methodology changes. However, participants have not had sufficient opportunity to digest and scrutinise these amendments. For example, our preliminary reviews have given rise to some reservations about AEMO's proposed methodology for calculating offsets for the prudential margin period (which we discuss in the next section).

We understand that AEMO intends to commence the next stage of its consultation on the CLP after the AEMC makes its final Rule determination. Given stakeholders are already raising issues with AEMO's proposed offsetting methodology, we have concerns about providing AEMO with unbridled discretion to change its methodology until stakeholders are assured that issues with the methodology are resolved.

We therefore consider it prudent for the AEMC to defer its final decision until after AEMO undertakes further consultation on these methodology amendments. This can provide stakeholders with assurance around the veracity and robustness of AEMO's overall methodology and provides them the confidence that it is appropriate for AEMO to have the responsibility to determine offset limits.

At the very least, we recommend the AEMC delay the start date of the Rule change and commencement of the new prudential methodology to ensure that AEMO has sufficient time to consult on its methodology and development and implement the associated systems and process changes. As outlined above, given stakeholders are already identifying issues with AEMO's amended methodology, it is crucial that sufficient time is available to test and respond to these and any further issues.

We understand that AEMO is currently working towards including this change as part of its mid-May 2013 IT release with a potential start date in June 2013. We do not think this allows adequate time for consultation and changes. We therefore suggest that the proposed Rule should not start before late 2013. This revised start date provides AEMO with the time necessary to undertake effective stakeholder consultation and then to make the consequential system and process changes required to give effect to the final methodology.

2. Concerns with AEMO's preliminary assessment of appropriate credit offsets

While Origin understands the AEMC is not making a determination on the specific issues related to AEMO's proposed credit offsets, we consider it relevant to set out our preliminary assessment in the context for our recommendation to defer the AEMC's final decision.

As we understand it, under the current arrangements, the calculation of the prudential margin does not permit the inclusion of reallocation credits to be offset against load; however, generation credits can be fully offset against load. AEMO considers both forms of credit offsets should be taken into account in the prudential margin, but to varying degrees. AEMO's position is that the current arrangements overstate the prudential benefits of generation credits but understate the benefits of reallocation credits. Following a simple analysis of three scenarios (no offset, full offset and partial offset), AEMO's preliminary conclusion is that reallocation credits should be fully offset while generation credits should only be partially offset in the prudential margin. Both forms of offset will be taken into account in the outstandings limit.

2.1. The value of generation credits versus reallocation credits

AEMO's proposed treatment of reallocation offsets versus generation offsets indicates that it does not ascribe the same value to the two types of credit offsets. Origin does not agree with this position. This is best demonstrated through an example.

Example

Assume there are two retailers with the exact same load. Retailer A does not have any generation but has a reallocation arrangement with a separate generator amounting to half its load. Retailer B is a gentailer with a single generation facility that is equal to half its load. Under AEMO's proposed credit offset arrangement, Retailer A would be able to fully offset its reallocation credit against its load whereas Retailer B would only be able to partially offset its generation credit against its load. As a result, Retailer A's credit support requirements would be less than Retailer B's.

This example indicates that AEMO effectively considers that reallocations are more firm that physical generation. Irrespective of the size or type of generation, this implies that generation within a retailer's portfolio is inherently more risky than generation outside of a retailer's own portfolio and as a result, financial contagion exists within a single entity but not across separate entities. Origin does not agree with this proposition.

The AEMC is currently investigating the risks to the efficient functioning of the NEM arising from financial interdependencies between market participants. In its Issues Paper,[1] its preliminary view is that the financial relationships and markets that underpin the efficient operations of the NEM are generally robust. Managing risk is an integral part of the operations of any energy business regardless of whether it is a generator, retailer or gentailer. Firstly, energy businesses employ a comprehensive suite of risk management mechanisms and strategies to mitigate the spectrum of risks that they may face. Secondly, overlaying these internal measures is a regulatory framework that seeks to ensure prudent risk-management.

[1] Available at: www.aemc.gov.au/Market-Reviews/Open/nem-financial-market-resilience.html.

Given the robustness of the risk management framework, it is not appropriate to assume that financial contagion is any more likely within a gentailer than across separate entities. If a gentailer lost its generation capacity, it has hedge contracts to cover that circumstance. A gentailer also has greater visibility of its own generation and hence is more likely to see, understand and respond effectively to any stress that a generation facility may be experiencing. A retailer does not have this same level of information with respect to a separate generator with which it has reallocations. As a result, it is unfair to value physical generation as being less firm than reallocations and hence unduly penalise those businesses, which adopt a risk management strategy that uses generation within their own portfolio, by not allowing the same level of offset for generation credits as for reallocation credits.

Origin considers it is more realistic and equitable that a participant's required level of credit support is neutral towards generation credits and reallocation credits. The prudential margin should allow the full outset of both forms of credit against load. This is supported by AEMO's supplementary submission, which recognises that this scenario is credible.

2.2. The single largest generation facility assumption

Origin has specific concerns with AEMO's assumption that generation offsets in the prudential margin should be limited to exclude a participant's single largest generation facility:

- The partial offset of generation credits is based on AEMO's view that it is reasonable to assume a gentailer's single largest generation facility would be inoperable through the entire reaction period, given it is likely that the loss is what contributed to the default event. While Origin grants this is a possible scenario, we do not feel sufficient evidence has been provided to support this is as the most likely scenario. As a result, we are concerned that this conclusion may unfairly disadvantage gentailers with large generation facilities without good reason.
- AEMO suggests the offset should be based on the largest generation facility. We would like to understand the justification for this. Any analysis of this assumption should also include an analysis of the use of generation facility compared to use of generation unit.
- Our preliminary assessment of AEMO's revised calculators shows that generation is devalued across all the regions although the single largest generation facility can only operate in a single region. In its supplementary submission, AEMO explains that it unreasonable to assume that multiple, geographically separate and separately operated facilities would all cease to operate for the duration of the reaction period. Given this, we would like to understand the rationale for then discounting generation across all regions. This treatment of generation credits penalises those participants that are active in more than one region. It does not recognise the inter-regional hedging arrangements used by participants to manage risk across regions.

These are substantive issues that require due consideration by both stakeholders and AEMO. This is why we are requesting that the AEMC consider deferring its final decision so that stakeholders can have confidence that these and other concerns will be addressed appropriately through AEMO's CLP consultation process.

3. Further information

Origin appreciates the AEMC providing this opportunity for stakeholders to respond to AEMO's supplementary submission. We also thank AEMO for providing updated calculators in order that participants can start to assess the methodology in advance of its own consultation on the necessary changes to the CLP.

This is an important issue that directly affects the amount of credit support required from participants. As a result, it is crucial that these requirements are set correctly; participants need to have certainty that AEMO's methodology is robust and is a true reflection of market conditions.

As mentioned above, we consider that in order for this to happen, the AEMC should delay the making its final Rule Determination until participants have more clarity as to how AEMO will incorporate its additional amendment into its CLP. At the very least, we consider the AEMC should set a commencement date for the Rule and new methodology that ensures AEMO and stakeholders have sufficient time to consider the credit limit methodology and implement it effectively. We consider a Rule start date in late 2013 promotes a more effective implementation.

Should you have any questions or wish to discuss this information further, please contact Hannah Heath (Manager, Regulatory Policy) on (02) 9503 5500 or hannah.heath@originenergy.com.au.

Yours sincerely,

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