21 September 2012

Mr John Pierce
Mr Neville Henderson
Dr Brian Spalding
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Commissioners,

Reference: ERC0133

New prudential standard and framework in the NEM, Second consultation paper.

TRUenergy welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) second consultation paper on the proposed new prudential standard and framework in the NEM (*the second consultation paper*).

In the second consultation paper, the AEMC proposes to alter the calculation of the Prudential Margin (PM) by replacing clause 3.3.8(e) from the AEMC's draft rule determination 'National electricity amendment (new prudential standard and framework in the NEM) Rule 2012' (*the draft determination*).

The proposed change 'would allow AEMO to limit credit offsets where there is a reasonable probability that the offset may not be effective during the reaction period'. This change was requested by AEMO.

In its concurrent development of draft Credit Limit Procedures (CLP) AEMO has proposed that in calculating the PM, provision should be made 'for complete loss of a gentailers single largest generation facility for the entire reaction period.' We understand AEMO would apply a similar offset for prospective reallocations provided by generators.

TRUenergy does not support the change proposed in the second consultation paper as it would substantially increase prudential costs, which would ultimately be met by consumers. Importantly, no analysis or quantification of costs and benefits is provided by AEMO or the AEMC to demonstrate that there will be a net benefit to consumers or the market, or that the change is consistent with the proposed prudential standard of a 2% probability of loss given default (pLGD).

TRUenergy recognises the important role that appropriate prudential arrangements play in the efficient operation of the NEM and is generally supportive of the proposed new prudential framework. We believe the new prudential standard and framework as described in the AEMC's draft determination represents a substantial improvement on the current arrangements. The AEMC should proceed to make the changes in the draft determination without the modifications proposed in the second consultation paper.

However, if the AEMC is disposed to make changes in response to AEMO's proposal, then prior to making its determination the AEMC should undertake detailed quantitative analysis of the costs and benefits of the proposal and then consult further when participants are in a position to better understand the full implications. Such analysis should include scenarios that look at the cause of defaults, exposures from default, impact on the prudential standard and alternative options for insuring the market against default from these rare events. TRUenergy understands that only AEMO has the necessary data to undertake this analysis.

Response to the specific questions raised by the AEMC

AEMC Question 1: Amending the Prudential Margin Calculation: *should clause 3.3.8(e) as it appears in the draft determination be amended such that all forms of positive and negative elements are to be included in calculating the prudential margin?*

TRUenergy accepts the principle that 'reallocations' and 'trading amounts' should be treated equitably under the rules in the calculation of prudential margin, to the extent that their risk profile is the same.

There may be differences in the risk profile between trading amounts and reallocations, particularly reallocations between unrelated entities where there is no natural hedge between generator revenues and retail costs. TRUenergy understands that AEMO intends to ensure the 'firmness' of prospective reallocations by refusing a request to modify an agreement if the change would increase prudential risks to the market.

AEMC Question 2: Should AEMO be granted the ability to reduce the assumed contribution of the reallocation and trading amounts in the calculation of the PM to allow for situations in which those elements may not be effective during the reaction period?

TRUenergy does not support the proposal to grant AEMO discretion to reduce the assumed contribution of reallocation and trading amounts in the calculation of the PM. The impacts of this approach are that it would increase uncertainty and costs for market participants without having demonstrated clear benefits for consumers or the market.

No clear case has been made to justify the proposed change and there is no evidence to suggest that a significant problem exists that would justify further amendment beyond that described in the draft determination.

Specifically, we do not support allowing AEMO discretion to discount trading amounts in proportion to the capacity of the largest generation facility in a portfolio. AEMO has not provided evidence or analysis to support this proposal:

- there is no apparent connection between the proposal and the prudential standard, or quantification of the impact on the prudential standard;
- the proposal will lead to a significant increase in prudential costs for market participants, however no evidence of benefits for consumers or the market is provided;
- complete loss of a generation facility is a very low likelihood event and holding prudential coverage for such events is unlikely to be efficient; and
- no exploration of alternative options, such as insurance, has been provided.

AEMO suggests in their proposal that a scenario where a gentailer continues to operate only some of their generation facilities during the reaction period is 'reasonably probable'. No evidence is provided to support this view. We believe that this scenario is unlikely and there is no evidence to suggest that financial failure (default) of a gentailer is likely to be linked to the physical failure of a generation facility.

The physical failure of an entire generation facility is very unlikely, significantly less likely than loss of a single generating unit (n-1) or the likelihood implicit in the current definition of a reasonable worst case as 'a position that, while not being impossible, is to a probability level that the estimate would not be exceeded more than once in 48 months'. For example, Yallourn Power Station was severely impacted by flooding of the associated brown coal mine due to failure of a river diversion in 2012. However, even in this rare and extreme circumstance, the Power Station continued to generate at all times. Capacity available to the market was significantly reduced, however at least 1 unit was always available.

It is also unlikely to be in the interests of creditors or shareholders to allow an otherwise viable gentailer to default due to a physical disruption, as this would lead to suspension and transfer of all its customers under Retailer of Last Resort provisions.

Prospective reallocations between unrelated parties may be at greater risk of default in the event of generator failure, however assuming complete failure of the largest generating facility in calculating PM would still appear to be a very conservative and high cost approach.

Further, if generation is discounted as proposed by AEMO, this would appear to result in the net prudential requirements for the NEM being calculated assuming several of the largest generators in the NEM fail concurrently (the largest generator in each portfolio).

This would appear to be an inefficient use of capital. Obtaining credit risk insurance to protect against such low likelihood events may be more efficient.

Question 3: if yes is the answer to Q2, what guidelines, if any, should be included in the rules to guide AEMO's decision making when using its discretion to discount elements from the PM calculation?

TRUenergy does not support the proposal to grant AEMO discretion to reduce the assumed contribution of reallocation and trading amounts in the calculation of the PM.

If the AEMC is disposed to granting AEMO discretion to reduce reallocation and trading amounts in the calculation of PM, then this should be clearly defined in the rules and explicitly linked to achieving the NEM prudential standard and contributing to the National Electricity Objective.

Prior to establishing a discount methodology in the credit limit procedure, AEMO should be required to:

a. analyse the proposal quantitatively against the Prudential Standard to ensure it is consistent;

b. quantify the expected costs and benefits to the market as a whole to ensure the benefits outweigh the costs; and

c. identify and compare against alternative options to achieve the objective.

Question 4: *AEMO's drafting requires AEMO to 'have regard' to the prudential standard when assessing the risk that the offset amounts may not be effective. Is this an appropriate obligation to include in the clause.*

It is appropriate that AEMO should 'have regard' to the prudential standard when assessing the risk that the offset amounts may not be effective. However as noted above this is not sufficient. If this change is made, the rules should explicitly require AEMO to ensure: consistency with the prudential standard; that the benefits outweigh the costs; and that there are not lower cost alternatives available.

Queston 5: *AEMO's drafting prevents the prudential margin from being negative. Is this an appropriate constraint?*

TRUenergy supports the principle that the prudential margin should not be negative. This is also consistent with the AEMC's draft determination.

We thank the AEMC for the opportunity to respond to this Rule change. For any questions regarding this submission, please contact Mr. Ralph Griffiths – Wholesale Regulation Manager at TRUenergy on Tel: 03 8628 1034.

Regards

Signed for email

Ralph Griffiths
Wholesale Regulation Manager
TRUenergy