International Power (Australia) Pty Ltd
ABN 59 092 560 793

Level 37, Rialto North Tower
525 Collins Street
Melbourne, Victoria 3000
Australia

Tel +61 3 9617 8400
Fax +61 3 9617 8401
www.ipplc.com

18 March 2008

Dr J Tamblyn
Chairman
Australian Energy Markets Commission
Submissions@aemc.gov.au

Dear Sir,

RULE CHANGE – FUTURES OFFSET ARRANGEMENTS

1. International Power Australia (**IPRA**) is pleased to have the opportunity to make this first round submission in respect of the Rule change request received by the Australian Energy Markets Commission (**Commission**) from Australian Power and Gas Limited, Infratil Energy Australia Pty Ltd and Momentum Energy Pty Ltd (**Proponents**) in relation to futures offset arrangements (**FOAs**). IPRA also appreciates the Commission's agreement to the extension of the deadline for this submission.

2. IPRA entered the Australian electricity industry in 1996 and has since grown to become the country's largest private generator of electricity, owning and operating more than 3,600MW of renewable, gas-fired and brown coal-fired generating plants in Victoria, South Australia and Western Australia. IPRA also has a substantial second-tier retail business operating in Victoria and South Australia.

Submission

3. IPRA accepts that the prudential requirements in the national electricity market (**NEM**) currently imposed on retailers under the National Electricity Rules (**Rules**) are considered to be a burden by both existing and new entrant retailers. Whilst this has been an issue for the market for many years, IPRA does not consider there is an insurmountable barrier to entry of the sort the Proponents suggest, and point to the successful commencement of business by each of them and a significant number of other independent retailers over recent years.

4. Nevertheless, IPRA is sympathetic to the Commission and others continuing to examine whether Rule changes can be made which address NEM prudential issues, and so improve the environment for competition and liquidity in the market, provided those changes do not jeopardise the achievement of the national electricity objective and further and specifically provided those changes do not result in greater credit risk exposures being imposed on other sectors of the market in order to achieve benefits to (mainly small) retailers alone.

4. The purpose of the NEM prudential arrangements is to minimise and share the exposure of generators to retailer default, given that suspending supply to a defaulting retailer in the electricity environment is all but impossible and in any event would punish consumers for the default of their retailer.

5. Further, under the Rules generators do not receive revenue from the sale of electricity into the spot market until four weeks in arrears, exposing them to four weeks of credit risk. The following comments should be viewed in this context, because any reduction in the current (imperfect) level of credit protection represents at the very least a value transfer from generators, but ultimately an investment risk, and the risk of higher prices to consumers.

6. The Proponents' principal concern is to reduce the cost of the credit support retailers must provide under the Rules. The Proponents apparently consider their Rule change would do this and so would achieve the Proponents' and other retailers' commercial objectives.[1] It may also achieve the commercial objectives of d-Cypha Trade and of financial intermediaries whose interests advance in line with increases in the volume of trading in electricity futures on the Sydney Futures Exchange (**SFE**).

7. However, IPRA considers that the Proponent's Rule change will not advance the achievement of the national electricity objective. Furthermore, the proposed Rule would advance the position of retailers in a way that necessarily increases generators' credit risks.[2]

8. In particular, by changing the basis of the prudential requirements from a 'reasonable worst case' assessment of amounts retailers are likely to owe National Electricity Market Management Company Limited (**NEMMCO**) to one based on the forward price of SFE electricity futures, the Rule change significantly increases the risk that NEMMCO will be unable to fully discharge payments to generators when a retailer defaults. As already canvassed, under the Rules it is generators which ultimately bear the risk of retailer default.

---

1 The Commission might want to consider whether this is true. Retailers have to have in place credit support arrangements with their clearers. It may be that in certain circumstances the clearers' requirements are no less demanding than those of NEMMCO.

2 It is also ironic that the proposed Rule could result in generators' own negative variation margins being used to secure generators against retailer default.

9. A central aspect of the national electricity objective is the promotion of efficient investment in electricity services including the generation of electricity. The greater risk of not being paid for their generation that would result from the Proponent's Rule change would be a negative consideration in decisions made by investors in electricity generation. Another aspect of the national electricity objective is the long term interests of consumers with respect to the price of electricity. For bearing a greater risk of not being paid, generators will seek compensation in the form of increases in the price for their electricity, which increases ultimately must be passed through to consumers.

10. For these two fundamental reasons, IPRA opposes the proposed Rule change. The following are responses to specific aspects of the Rule change proposal that further bring its efficacy into question:

    10.1 In their Rule change request the Proponents have focussed on how the application of the 'reasonable worst case' approach during Q2 2007 left NEMMCO with a significant exposure to retailers. IPRA agrees that the outcomes that resulted from the application of that approach were unsatisfactory. However, IPRA does not consider that that is reason enough to abandon the 'reasonable worst case' approach altogether, as the Proponents contend. The principle that there should be a guarantee of payment being made to NEMMCO to a level of reasonable worst case – entrenched in schedule 3.3 of the Rules – remains consistent with the national electricity objective. Instead, what should happen now is that NEMMCO and others should do the necessary work, drawing upon the Q2 2007 experience, to ensure that in the future maximum credit limits (**MCLs**) are set by NEMMCO in a way which gives effect to the guarantee of payment principle, with NEMMCO not to be left with significant exposures to retailers.

    10.2 IPRA does not share the Proponents' view that SFE electricity futures prices represents a better basis for the future determination of retailers' MCLs relative to the current approach, and indeed whether those prices provide a better price signal to potential investors in electricity generation.

    The Commission should also consider whether, with the increasing number of bank and non-bank financial traders, offshore hedge funds and other speculators the Proponents anticipate entering into the market, SFE electricity futures prices may become increasingly affected by market manipulation and other distortions, or at the very least, how electricity futures prices may be affected by the involvement of participants not directly concerned with the underlying primary energy market.[3]

[3] Is the Commission satisfied that all of the volatility in forward prices in June and July 2007 was attributable to developments in the primary energy market?

10.3 Many of the points the Proponents make in support of their Rule change concern difficulties they see with reallocations. The Commission should consider carefully whether these difficulties are real. IPRA had understood that, under changes recently made to the provisions of the Rules dealing with reallocations, outcomes similar to those the Proponents want to achieve under FOAs could be achieved using reallocations. Given that NEMMCO has yet to finalise the procedures that will give effect to the recent Rule changes on reallocations, how can the Proponents be certain that their Rule change for FOAs is necessary? Put another way, to the extent the Proponents' criticism of reallocations is valid, is that only to the extent of the reallocations that were possible **before** the recent Rule changes on reallocations?

10.4 IPRA considers that the Proponents overstate any concern there may be about generators who have reallocated then suffering from an outage and thus becoming a creditor of NEMMCO and liable to meet prudential requirements as such. The possibility of an outage is a matter that NEMMCO is able to consider in calculating an MCL for a reallocating generator under the 'reasonable worst case' approach.

10.5 As IPRA understands the Rule change request, the result of an FOA being registered by NEMMCO would be that there would be a significant reduction in the amount of the bank guarantee required of a retailer, to the extent of the price under the underpinning SFE electricity futures. The justification given for this reduction is that, if NEMMCO's exposure to the retailer increases over time, NEMMCO will be receiving the benefit of the matching positive variation margins the retailer otherwise would be entitled to receive from its clearer.

But the FOA is in effect to be terminable at will, by either the retailer or the clearer, and it has not been proposed that termination of the FOA should be conditional on the retailer first having provided to NEMMCO a replacement bank guarantee. Rather, NEMMCO is to ask for the replacement bank guarantee after termination of the FOA.

This aspect of the proposed Rule change needs careful consideration.[4] The outcome which needs to be avoided is one where a retailer facing financial difficulties, or a clearer concerned about such a retailer, terminates the FOA, with the retailer having no realistic prospect of providing NEMMCO with a replacement bank guarantee. It may take some time for the default to be dealt with by NEMMCO and for the retailer's participation in the market suspended. Over that time NEMMCO's exposure to the retailer will increase, perhaps markedly so if spot prices are high.[5]

10.6 It is unclear on what basis the clearer's obligation arises.

---

4 It is no answer to the concerns this aspect of the Rule change raises that the position may be the same with reallocations. The concerns should be addressed equally in respect of both FOAs and reallocations.

5 IPRA cannot see how, with an FOA being terminable at will, FOAs would address the risk of a retailer deliberately bringing about its own suspension from the market at a time when it held profitable financial hedges: see paragraph 3.1.5 of the Proponents' Rule change request.

Does the clearer's obligation arise from an assignment of the retailer's right under its contract with the clearer to receive positive variation margin payments? If so, how can NEMMCO be satisfied as to the payments it can expect to receive without reviewing the retailer's contract with the clearer and, presumably, understanding the SFE's rules in relation to variation margins? What if there is an amendment, either to the retailer's contract with the clearer, or to the SFE's rules, in either case affecting the amount of the positive variation margins?

Alternatively, is the obligation instead an independent obligation on the clearer to make payments in an amount calculated under the Rules, presumably with the clearer then released from its obligation under its contract with the retailer to pay positive variation margins to the retailer? What if, over time, differences arise between the amount the clearer is to pay NEMMCO as calculated under the Rules and the way positive variation margins are calculated under the retailer's contract with the clearer or under the SFE's rules generally?

10.7 IPRA imagines it must be the case that, under the proposed Rule change, any reduction in a retailer's MCL for an FOA involving an SFE electricity futures referenced to a particular region would only be allowed by NEMMCO in respect of the corresponding exposure of NEMMCO to that retailer in respect of the spot price for that region.

10.8 It is also unclear what would be the nature of the clearer's obligation to NEMMCO. The clearer's obligation to make payments to NEMMCO should be one arising under the Rules, as retailers' payment obligations are, and so should have the force of law and be capable of being enforced under the Rules. The obligation should not be a contractual one only. Whether clearers would be prepared to accept the obligation under law is in IPRA's view questionable.

10.9 Under the proposed Rule change, an FOA will be a 'transaction' to which a retailer and NEMMCO are party, the result of which is intended to be that NEMMCO, as a creditor of the retailer, will receive from the retailer, in respect of debts that the retailer owes to NEMMCO, more than NEMMCO would receive if the FOA were set aside and NEMMCO were instead to prove for the debts in the winding up of the retailer. This means the FOA may well be an unfair preference and may be voidable as such, the possible result being that NEMMCO could be ordered to pay back amounts received from the retailer's clearer in the period before the winding up of the retailer commenced, i.e., there could be a clawback of the clearer's payments.[6] The risk of this may be greater than the risk of any clawback in respect of bank guarantees a retailer may have provided to NEMMCO, since those bank guarantees would have been provided by the retailer in complying with its obligations under the Rules rather than as a result of any 'transaction' between the retailer and NEMMCO.

---

6 This could be the case, for example, if NEMMCO could not prove to the court that it entered into the FOA in good faith with no reasonable grounds for suspecting the retailer was insolvent and a reasonable person in NEMMCO's circumstances would have had no such grounds.

If the clawback risk with FOAs is meaningful, or the risk is a greater one than it is with bank guarantees, then, because that risk would jeopardise the principle that there should be a guarantee of payment being made to NEMMCO, that would be reason enough not to proceed with the Rule change. The Proponents do not address this risk in their Rule change request.

11. If you have any questions in relation to this submission, please contact Mr Andrew Bett on 03 9617 8314 or at andrew.bett@ipplc.com.au.

12. IPRA looks forward to the Commission's draft decision.

Yours faithfully,

PAUL MAGUIRE
Finance Director