5 May 2017

10 Eagle Street
Brisbane QLD 4122
T 07 3347 3100

Istvan Szabo
Australian Energy Market Commission

Lodged online

Dear Istvan

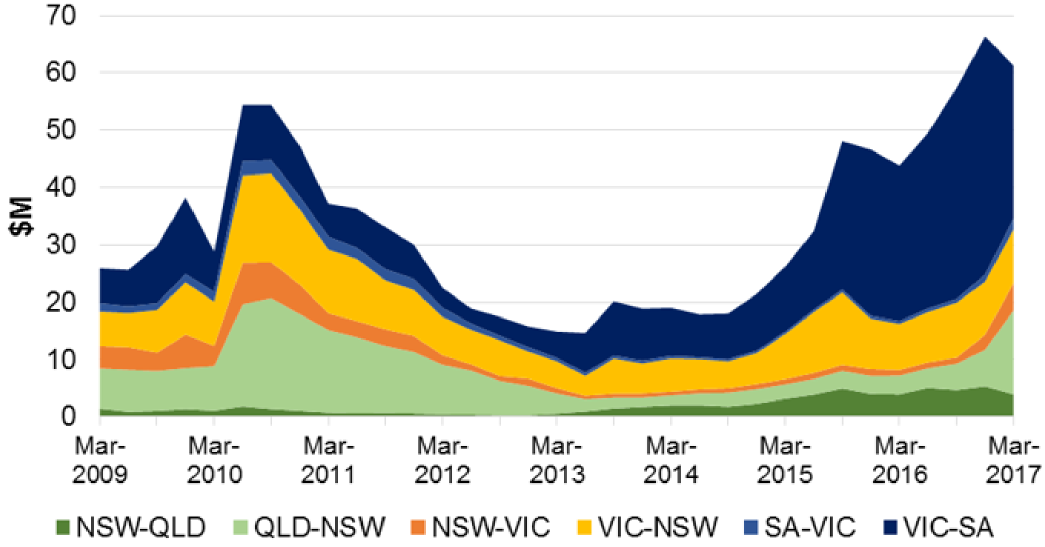
Response to consultation paper on Secondary Trading of Settlement Residue Distribution Units rule change proposal

The Australian Energy Market Operator (AEMO) welcomes the opportunity to provide a submission to the Australian Energy Market Commission's (AEMC) consultation paper on the above rule change request by Westpac.

The effect of the proposed rule change would be to enable the Settlement Residue Committee (SRC) to consider implementing secondary trading of Settlements Residue Distribution Agreement (SRDA) units through the existing Settlements Residue Auction (SRA) run by AEMO. AEMO, in its role as the auction operator and Chair of the SRC, assisted Westpac in preparing the proposed rule at Appendix 2 of the proposal.

Recent SRA results have indicated that market participants are placing a greater value on SRDA units. **Figure 1** shows that the proceeds received from auctioning units has increased materially since March 2013, with record levels observed at the December 2016 and March 2017 auctions. Growth in auction proceeds over the last 12 months has coincided with the closure of major coal-fired power stations and a reduction in liquidity in the contract market in some regions, which may have resulted in more participants managing spot price risk by contracting inter-regionally and mitigating the basis risk through SRDA units.

Figure 1: Auction proceeds, March 2009 to March 2017[1]



[1] AEMO data and analysis.

Westpac estimates that the volume of SRDA units traded outside of a SRA is less than one per cent of the primary units. This is also evidenced by the small volume of units that AEMO has re-assigned outside of the SRA. In general, a liquid secondary market would be expected to provide participants with additional flexibility in building hedge positions, in the knowledge that they could confidently reduce a position in response to changed market conditions or portfolio requirements. With the value of SRAs increasing, a liquid secondary market is likely to be of growing importance to market participants.

By allowing the SRC to contemplate and potentially implement secondary trading through the SRA, the rule change proposal should promote the National Electricity Objective (NEO) by enhancing allocative efficiency, as the reduction in transaction costs will enable SRDA units to be more freely traded to those participants that value them the most.

AEMC's proposed approach to assessing the rule change request

AEMO has some concerns with the proposed approach to assessing the rule change proposal. It appears that the AEMC is intending to use the rule change request, which deals with a specific issue, to undertake a broad review of the SRA framework. In our view, most of the questions raised by the AEMC do not relate to the issue raised and are not within scope of the rule change proposal.

The rule change proposal raises a specific issue regarding secondary trading of SRDA units and the proponent has requested a minor change to the NER to enable the SRC to consider whether to change the SRA Rules to facilitate secondary trading of SRDA units. Under the governance arrangements for the Auction Rules set out in the NER, the SRC, which is made up of representatives from generators, retailers, TNSPs, customers, traders, governments and AEMO, approves SRA Rule changes after undertaking public consultation.

Given this, it is unclear how questions 1-8 in the consultation paper, such as those around whether the design of SRDA units remain appropriate and references to ACCC decisions in 1999, could assist the AEMC in determining whether to make the rule. If the AEMC does receive responses, the broad nature of the questions could illicit feedback that requires substantial analysis and consultation, with any solutions presumably out of scope of the current rule change process.

AEMO is concerned that the proposed scope does not relate to the issue raised by the rule change proposal and is likely to result in the AEMC having to unnecessarily initiate an extension to the rule making process. If the AEMC has concerns around these broader issues, then they could be referred to a review of the SRA framework initiated by the Energy Council or the AEMC. Alternatively, the issues could be explored through the AEMC's recently initiated Energy Sector Strategic Priorities Review.

Credit risk

The consultation paper has considered the allocation of risk in a scenario where a buyer in a secondary auction defaults.

SRA participation is limited to registered market participants, which implies holding a physical position or, in the case of a trader, being subject to "wholesale client" financial regulations. In the event an SRDA unit holder defaults in the existing primary market and is suspended, AEMO would cancel the units of the defaulting participant. AEMO then resells the defaulting participant's units at the next quarterly auction. To the extent there is a difference between the defaulting participant's purchase price and the resale price of the units, this risk is borne by the relevant TNSP through a change in SRA proceeds. While this has been the approach used since the inception of the SRA, the allocation of credit risk is a reasonable topic for consideration in a broader review of the SRA framework.

If the rule as proposed is made, and a secondary market is implemented by the SRC, a scenario needs to be considered where a buyer of secondary units defaults and is suspended. The approach in the rule change proposal is for the seller of secondary units to 'remain whole' and for the relevant TNSP to bear the risk through a reduction in SRA proceeds. This is consistent with the allocation of risk in the primary market.

A feature of incorporating a secondary market under this approach is that, in an extreme example, a TNSP could be required to make a payment to AEMO. The example is extreme because our analysis to-date suggests that the following events would need to materialise:

- A large number of SRDA units offered for re-sale in a single auction and purchased by a single buyer.
- Paradoxically, even though there is a large supply of units, the auction clearing price would need to be extremely high.
- The buyer of the units defaults and is suspended by AEMO.
- AEMO re-auctions the units and the clearing price is lower than that received by the seller, creating a shortfall in proceeds to pay the secondary seller.
- The losses incurred by those units are greater than all proceeds received by the affected TNSPs from other units sold in that auction.
- The relevant TNSP is required to make a payment to AEMO.

Even in this example, the economic outcome appears similar to the default of a major primary market participant, notwithstanding a potential cash flow from a TNSP to AEMO. If the AEMC disagrees with this view, and considers the risk to be significantly changed, then it may wish to consolidate the assessment framework in Chapter 4 to largely focus its analysis on risk allocation in a situation where a secondary buyer defaults.

One potential approach to a revised assessment framework is to set out a number of sub-elements that could form principles by which the AEMC will assess options for allocating the secondary market risk described above. These might include:

- Likelihood and materiality of the risk being considered;
- Relative cost burden for different types of participants, large and small;
- Impact on liquidity in primary and secondary SRA markets; and
- Impact on competition in wholesale and retail markets.

If you have any questions regarding this submission, please contact Daniel Hamel, Principal, Policy and Market Development on (07) 3347 4578.

Yours sincerely

Peter Geers
Executive General Manager, Markets