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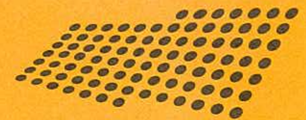

EnergyAustralia®

21 April 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
By email submissions@aemc.gov.au

Dear John,

Proposed Guidelines and explanatory statement relating to compensation under application of APP, market suspension, VoLL or market floor event

Thank you for this opportunity to comment on the above mentioned guidelines and explanatory statement.

As the Commission is aware, EnergyAustralia has previously raised concerns regarding compensation provisions in the National Electricity Rules (NER) under market failure scenarios. These were outlined in detail in our rule change proposal of 10 December 2007.

It is acknowledged that the Commission has in part accepted some of EnergyAustralia's proposals and decided not to adopt a regime based on the bids and offers of claimants in calculating compensation. Instead, the Commission has determined that compensation will be based on a participant's direct costs and opportunity costs. While EnergyAustralia has no significant objections to the direct cost approach and believes these should be appropriately catered for, we are of the view that the inclusion of opportunity costs in the compensation methodology does nothing to reduce the financial stress that is placed on retailers and their customers in instances of market failure. It is clear that any compensation based on opportunity costs will lead to very high levels of compensation being paid to generators.

Unhedgeable exposures

Following any event in which compensation is paid to generators, the amount paid is recovered from retailers in proportion to their market share. These compensation payments by retailers, therefore, are an uncertain proportion of the aggregate compensation payment to a number of generators. Since no individual generator can estimate in advance what proportion – if any – of the aggregate compensation it will receive, it is not in a position to offer hedge contracts to retailers that would insure a proportion of the aggregate amount. Furthermore, given the uncertainty over how

compensation amounts will be determined, it is highly unlikely that other organisations, such as commercial insurers, would offer hedging contracts.

To all intents and purposes, therefore, these compensation payments are unhedgeable, meaning that their full financial impact will fall on retailers and /or their customers. The consequences of large, uncertain and unhedgeable costs being imposed on retailers are summarised as follows (these were previously outlined in considerable detail in our original proposal):

(a) Maintaining risk capital

A prudent retailer will maintain a portfolio of hedging contracts so as to limit its overall exposure to volatility in the spot market. It will also hold "risk capital" to cover any residual exposure (i.e. capital that can easily and quickly be accessed and liquidated in the event that additional funds are required for settlements in extreme market conditions). To avoid, or substantially reduce, the risk of insolvency, a retailer must hold a level of risk capital equal to the financial impact of a "worst-case scenario", a credible market event or sequence of events with maximum financial impact.

Of course, risk capital must be paid for, and given that all retailers will be similarly exposed to APP compensation, the associated costs are likely to be passed through to customers (to the extent that any regulated retail price caps allow this) in higher retail margins. Indeed, given the level of risk capital required, it may be that many retailers – particularly those without access to a large parent company balance sheet – are simply unable to economically procure this capital. They must then either exit the market, or be at risk of insolvency should the worst-case scenario arise.

(b) Pass-through to customers

An alternative to maintaining this risk capital is to have arrangements to "pass-through" or "clawback" from customers the extra costs of APP compensation.

It is highly unlikely that even the largest and most well-informed customers would be prepared for such an event. Even customers that were aware of the relevant "pass-through" provision in their supply contracts would be unlikely to anticipate the magnitude of this clawback in the event of APP compensation. As a result, any clawback is likely to cause substantial disruption, distress and hardship for customers, particularly residential customers.

(c) Retailer insolvency

Retailers that did not hold risk capital and did not have pass-through arrangements would likely become insolvent as a result of APP under the direct cost / opportunity cost approach. If a substantial part of the retail market became insolvent, this may have secondary impacts on contract counterparties of insolvent retailers, leading to the sort of "systemic risk" that the APP arrangements are designed to avoid.

Whilst the "retailer of last resort" arrangements are designed to protect customers in the event of retailer insolvency, there will undoubtedly be some additional costs flowing to customers in this scenario. More significantly, the insolvencies will damage the perception and reputation of the energy retail sector, leading to higher costs of capital for existing retailers and a significant new entry barrier for new retail

Rationale for compensation provisions

Compensation provisions were initially included in the National Electricity Code (and subsequently replicated into the NER) to allow generators directed into the market by NEMMCO the opportunity to seek a determination if they were dissatisfied with the use of the spot price alone for energy produced during the period of the direction. The compensation provisions were aimed at providing generators with an assurance that their costs would be covered, while retaining market revenue if required to generate, replicating the breakeven decision a generator might take in making the decision to bid into the market.

Interrelated to this is the current level of the Administered Price Cap (APC) which was revised upwards by the AEMC during 2008. When triggered, this operates to limit participants' exposure to the wholesale spot market during periods of prolonged high prices (essentially market failure). Without this provision the market would experience substantial financial stress and potentially collapse. Its objective is to balance financial risk in the market overall rather than providing generators with a mechanism to obtain opportunistic return on their capital investments.

In summary, in moving the APC to $300/MWh, retailers have an effect already been exposed to greater financial risk. Accordingly, by modifying the compensation methodology to include provision for opportunity costs, the relevance of the APC comes into question as the market's ability to limit participants' exposure to financial risk is restricted by the potential existence of any foregone opportunities of one or more generators.

Should you require any further information or have any further questions regarding this response, please do not hesitate to contact Nicholas Convery, Executive Manager Retail Regulation, on (02) 9269 2485.

Yours sincerely

Phil Moody
General Manager - Wholesale Energy