NATIONAL GENERATORS FORUM

Lvl 6, 60 Marcus Clarke St.,
postal: GPO Box 1301
Canberra ACT 2601
ABN 83 113 331 623

Tel: 02 6243 5120
Fax: 02 6243 5143
john.boshier@ngf.com.au
www.ngf.com.au

14 March 2008

The Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
SYDNEY NSW 2000
Email: submissions@aemc.gov.au

Dear Dr Tamblyn

Re: Futures Offset Arrangement rule change

The National Generators Forum (NGF) is pleased to have the opportunity to comment on the Futures Offset Arrangement (FOA) Rule change currently before the Australian Energy Market Commission (AEMC).

Generator principles related to NEM prudential arrangements

From a generators point of view, it is essential that confidence in the credit quality of the NEM pool is maintained. The NEM operates a mandatory gross pool, which requires all generators to sell their output into the pool. For this reason all investors and operators in generation assets need to be confident in pool credit quality to be sure that they will be paid for their output. Any perceived reduction in pool credit quality could reduce the appetite for investment in NEM generation, resulting in adverse impacts on the achievement of the Market Objective.

For these reasons, generators are strongly of the view that credit quality must be maintained at current levels.

While we support maintenance of existing NEM credit quality, we also support measures that will result in more efficient and effective prudential management in the NEM. Our review of the FOA, or any other prudential related rule changes, will be conducted within this overall framework. As such our position is well aligned with the market objective of a secure and efficient NEM.

Previous consideration of a similar offset proposal

In early 2007, the AEMC passed the "Reallocation" rule package initially proposed by NEMMCO (following substantial industry consultation). At the time, our understanding was that this package was intended to facilitate FOA style transactions through the introduction of a *Reallocator* participant category, and provision to NEMMCO of powers to make procedures to implement this approach.

While it appears that NEMMCO is yet to make procedures in this area, we understand that work has been progressing in this regard. In this context we are not clear why this new rule change is required, as it would seem the current Rules allow for FOA's.

This question does not appear to be addressed by the proponents in their submission.

Risk areas to be considered by the Commission

We are concerned that the proponents have failed to adequately address the risk impacts associated with this rule change proposal. Given the importance of NEM credit quality to the market objective, we believe a very thorough review of potential risks associated with this proposal is required.

Some areas that the NGF believes need to be reviewed by the Commission are set out below. We note that this list is not exhaustive, and would support the Commission seeking specialized prudential management expertise in fully assessing this proposal.

1. Ability of NEMMCO to claim funds in the event of a default.

   Our understanding was that the *Reallocator* participant category was created to ensure that NEMMCO had sufficient legal claim over a clearing member who had participated in an FOA to ensure funds could be recovered in the event of a default. We urge the Commission to seek legal advice to ensure that NEMMCO's ability to enforce claims against a clearing member in the event of a participant default or bankruptcy is clear.

2. Need to ensure that an FOA cannot be withdrawn prior to appropriate alternate security being lodged with NEMMCO

   If FOA amounts are to be used to reduce participant MCL calculations, then it is imperative that they cannot be removed without alternative security being lodged. It is inadequate to assume that a participant who has an FOA revoked by a clearing member will be able to respond to a margin call from NEMMCO immediately following this revocation. Clauses 9.1 and 9.2 of the proposed rule changes appear inconsistent with this principle. If these clauses remain, then an MCL reduction associated with an FOA should not be permitted.

3. Futures contracts should only be allowed to offset MCL calculations in the same region to which the contract is referenced

   It needs to be clarified that FOA's should only be able to be put in place when the futures contract is referenced to the same region as the relevant credit limit requirement. Use of futures contracts from other regions will not provide a guaranteed offset, and therefore should not be used to reduce credit limits.

4. Careful consideration needed before changing to Futures based forward price estimate in MCL calculations.

   Currently the rules require prudential requirements to be assessed on a "reasonable worst case" basis. Moving to a pure futures based price methodology could move to an expected price basis. In order to ensure credit protections in the NEM are maintained, the "reasonable worst case" requirement should be maintained.

   While there may well be merit in moving to a forward looking MCL methodology and the Rules do, in fact require such an approach (provided it is based on a reasonable worst case basis), the NGF considers that this should only be done after careful consideration. We understand that NEMMCO has previously considered making this change but did not proceed.

   We note that the proposal to use the futures price would have the benefits of providing a market consensus expectation of prices (which could then be adjusted to factor in a reasonable worst case expectation). However as futures prices represent a 91 day average such a change may result in the MCL inadequately modeling price volatility in the shorter term (ie. Market settlement cycle of 41 days). This impact may require additional compensation to ensure credit quality is maintained.

Another consideration in this area is to ensure that NEMMCO discretion is minimized so that prudential procedures can be applied robustly even in times of market credit stress. The potential impacts on MCL volatility from this proposal, and the ability of participant's to manage frequently fluctuating prudential requirements also needs to be considered by the AEMC.

Associated work streams

In addition to the rule changes of 2007 which aimed to facilitate FOA's, along with other more flexible prudential arrangements through NEMMCO procedures, the NGF is also aware that the MCE has recently launched a Financial Markets Working Group (FMWG). The objectives of the FMWG are focused on reviewing prudential management in the NEM, in an effort to increase their efficiency and effectiveness.

The current FOA rule change is being considered by this group, along with a number of other proposals to improve NEM prudential management. It may be beneficial for this current rule change to be deferred until that review is completed.

Summary

The NGF supports a strong prudential regime in the NEM, which is essential to support generation investment and therefore the NEM objective. Subject to maintenance of existing NEM credit quality, efforts to improve the efficiency and effectiveness of the regime are supported.

Given that rule changes in 2007 aimed to facilitate FOA's and other prudential improvements, we are not clear why this rule change is required (although we note NEMMCO has yet to implement procedures to support the recently introduced rules). In addition the FMWG is conducting a more comprehensive review of NEM prudential arrangements and it may be better to wait until this is complete before introducing further prudential rule changes.

In the event that the AEMC does decide to continue with deliberations on this rule change, we believe a comprehensive review of the risks associated with the change is conducted and that no change is made unless robust legal and quantitative analysis can show that NEM credit quality will not be reduced.

Yours sincerely

John Boshier
Executive Director