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6 January 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Via www.aemc.gov.au

Dear Mr Pierce

NEW Prudential Standard and Framework in the NEM

Alinta Energy welcomes the opportunity to make a submission in response to the Australian Energy Market Commission's (AEMC) consultation paper on the National Electricity Amendment (New Prudential Standard and Framework in the NEM) Rule 2011, proposed by the Australian Energy Market Operator (AEMO).

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia. Alinta Energy has over 2500MW of generation facilities in Australia (and New Zealand), and maintains retail energy customers in Western Australia, South Australia and Victoria with a commitment to growth in the National Electricity Market (NEM).

Alinta Energy is committed to contributing to energy market developments across Australia and in all regions of the NEM as it pursues its forward growth strategy.

Alinta Energy supports the proposed changes to the Prudential Standard

Prudential considerations have a significant impact on the operation of firms in the NEM and as such Alinta Energy endorses efforts to improve clarity and operation of the existing framework. As discussed below, we believe the revision of the current approach and removal of the reasonable worse case provision, abandonment of the Reduced Maximum Credit Limit (RMCL), and introduction of seasonal and load factors represent sensible enhancements to the prudential framework.

Alinta Energy agrees that the proposal will:

- strengthen the relationship between minimum credit support obligations for retailers and the risks arising from the factors affecting individual firms;
- provide a signal to retailers to appropriately manage risk, and incentivise retailers to, for the most part, take account of their potential failure on the market;
- improve transparency and clarity of the prudential framework, and clarify the probability of generator exposure to short-payment; and
- reduce the cost of capital, reduce credit support in most regions, and better match credit support with risks over time and by season.

Reasonable worst case and the Reduced Maximum Credit Limit

The proposal acts upon the issues raised in the Seed and Taylor Fry Report: 'The Prudential Standard in the National Electricity Market' (Seed Report) where the effectiveness of the RMCL and the current standard was scrutinised.

While both the RMCL and the Maximum Credit Limit (MCL) leave generators exposed to potentially significant losses, the analysis in the Seed Report confirmed the RMCL was exacerbating generator exposure to short-payments, and reducing the clarity with which the prudential standard operates.

Alinta Energy supports removal of the RMCL. We note, it could be argued that the introduction of the RMCL only had a marginal impact on risk; measured as 4 per cent probability of loss given default (to use the proposal's terminology) up from 2 per cent under the standard MCL. We appreciate some participants may oppose the change on this basis.

Conversely, Alinta Energy endorses the finding in the report by Competition Economic Group entitled 'Assessing efficiency in settlement and prudential arrangements for energy markets' (the CEG Report) that a retailer would be behaving rationally by not considering the implications of their failure on other NEM participants in the absence of a prudential framework. Thus the existence of a prudential framework has the effect of giving 'retailers appropriate incentive to manage risks and, importantly, to ensure that retailers do not have an artificial incentive to take on too much risk.'

As such, given the potential size of loss, should a short-payment occur, a reduction from 4 per cent to 2 per cent is significant for generators facing the risk of said short-payment and strengthens the incentives for retailers to take account of that risk.

It should be recalled, that this risk is neither easily managed, nor determined by the actions of generators. Hence, it is appropriate to take all available steps to minimise the risk of short-payment and thereby improve surety of payment for generators.

On this basis, Alinta Energy does not support calls to revisit the 2 per cent measure in order to identify an alternative optimal measure. As indicated by CEG, an alternative which increased risk exposure to generators would incentivise retailers to not manage their risk of loss given default. While we appreciate retailers' desire to reduce their prudential obligations they remain the best party to manage the risk of their own default in the NEM.

Alinta Energy believes the analysis, to date, has been robust, and as such support the rule change proposal proceeding.

Seasonal factors and load profiles

While noting potential concerns for new entrants and individual retailers, Alinta Energy, on balance, supports the analysis in the Seed Report that differentiation between retailers and time of year is important as the incidence of high prices and load differ in peak periods, primarily over summer and winter, and by customer type.

There is an argument that retailers who use bank guarantees are unlikely to benefit from a sculpted approach to credit support and Alinta Energy note's that AGL raised this point as part of the AEMO 'Energy Market Prudential Review'.

Alinta Energy agrees that at least initially this may be the case; however, it does not mean credit facilities cannot be secured in the future to reflect this sculpted approach as guaranteeing institutions will be provided with greater clarity about the risk they are carrying. The approach also better identifies, reflects and manages the actual risk being carried in the market at that time as a consequence of retailers' positions, which is informative more broadly.

We support monitoring of this approach going forward in AEMO's annual reviews of participants prudential settings under the proposed clause 3.3.8(i), as previously suggested by Loy Yang Marketing Management Company and the National Generators Forum, to ensure that the approach appropriately captures the shape for all participants.

Reaction period

Alinta Energy notes the inconsistency between the definitions of the reaction period and endorses clarification.

Alinta Energy supports a definition which captures the assumed nature of the seven day period noting that a period shorter than seven days is possible. In this regard, the AEMC definition appears appropriate; however, it may be necessary to denote that seven days is not only 'assumed' but the 'maximum' number of days allowed for the reaction period.

More broadly, Alinta Energy notes the AEMC's comments regarding the nature of the 2 per cent PLGD would not be impacted by a reduction in the reaction period. Alinta Energy is open to consideration of proposals whereby the reaction period can be adjusted downwards in order to minimise risk to generators.

Does the proposal for a platform for reform of the Prudential Framework

Alinta Energy agrees that the proposal forms a more effective basis from which to introduce additional reforms to the prudential frameworks a number of which Alinta Energy would seek to actively use, such as future offset agreements.

The current framework does not provide the appropriate clarity from which to introduce such reforms and hence we encourage the AEMC to approve AEMO's proposal. An area where Alinta Energy believes further reform is required is the ongoing risk of generator short-payment.

Is further assessment of the proposal warranted?

Given there has been a general push to develop and adopt a new prudential framework there may be value in conducting a further independent peer review of the proposal. Alinta Energy is not endorsing a substantial and timely review but suggests a desktop review by a credit risk expert independent of the development process may provide participants with additional comfort and could support the AEMC's draft determination within existing timeframes.

Risk of short-payment remains

As is currently the case, the proposed Prudential Standard will not have the effect of eliminating the risk of short-payment to generators as the credit support held by AEMO is insufficient. In such a circumstance, the short-payment would be pro-rated across generators under clause 3.15.22 of the Rules.

Alinta Energy suggest the risk of short payment, while present, would come as a surprise to market participants if realised, given the stable operation of the NEM to date and the historical surety of payment.

A consequential benefit of the AEMC's and AEMO work on the prudential framework has been to draw attention to this risk of short-payment, which under the proposal would continue to sit with generators, their insurers and financiers to assess and manage.

The existence of short-payment risk, in Alinta Energy's view, does not provide any beneficial incentives for generators. The primary driver, as indicated in the CEG Report, of the framework is to incentivise retailers to manage risk that it would be otherwise rational to expose generators to. Hence, the only reason for retaining the existing level of risk is that eliminating all short-payment for generators would be cost prohibitive for retailers (as detailed in the Seed Report) and would not be beneficial to market.

As such, Alinta Energy believes there is merit in investigating methods to better cushion the impact of any significant short payments should they arise to minimise the risk of cascading default. This includes identifying how the market and customers benefit from the reduced obligations placed on retailers and whether the costs of these reduced obligations should be borne by parties other than generators.

While this matter is not directly contained within the proposal, as surety of payment to generators is a fundamental precondition for the ongoing viability of the NEM, the proposal should be implemented in a way that allows for a reduction in the potential size of short-payment should additional reform be progressed. In particular, Alinta Energy notes the potential impacts of a change to the settlement cycle or the reaction period.

Conclusion

Alinta Energy welcomes the proposal and looks forward to further reform of the prudential framework moving forward. Should you have any queries in relation to this submission, please do not hesitate to contact me on, telephone, 02 9372 2633.

Yours sincerely,

Jamie Lowe
Manager, Market Regulation