AEMO
AUSTRALIAN ENERGY MARKET OPERATOR

30 April 2010

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Mr John Tamblyn
Chairman
Australian Energy Market Commission
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By online submission

Dear John Tamblyn

Draft Report – Review into the role of hedging contracts in the existing NEM prudential framework - AEMC Reference EMO0008

Thank you for the opportunity to provide this submission to the above Review.

AEMO would like offer the following observations into the AEMC draft report on "Review into the role of hedging contracts in the existing NEM prudential framework".

AEMO has actively participated in the AEMC work to date and continues to support further alternatives for the management of credit risks where these alternatives maintain or improve the risk position of the NEM. The draft report refers to advice regarding the clawback of Security Deposits. Our analysis suggests that there are aspects of this issue that require further consideration. Similarly our review of the Commission's proposal to utilise a Power of Attorney to secure payments from a Futures Clearing Participant has identified issues for further consideration. Given that AEMC advice on Security Deposits and the Power of Attorney have been implemented within the Futures Offset Arrangements (FOA) contract model as key risk mitigants, any change in view in this area will impact the current AEMC analysis.

We note that the AEMC has accepted feedback that clearing participants would not wish to be National Electricity Market (NEM) participants, and hence the FOA models have been developed on this basis. In our view it is important to remember that an FOA arrangement where all parties are bound to the NEM rules would likely be superior to the currently proposed model and hence should not be discounted.

There are new recommendations with respect to reallocations which we believe require further consideration, in particular the proposal to cap Maximum Credit Limit reductions for reallocations to the value of average load. AEMO believes this will impact NEM market participants and the risk identified is not relevant for these reallocation instruments. Also the proposal regarding the notification of call notices to reallocation counter parties will require further consideration, in particular, around the disclosure and commercial impacts on the release of such sensitive confidential information.

The proposed model for both implementation and ongoing operations of FoAs is relatively complex. In developing remedies to the identified problems there may be an increase in complexity of the proposed model. Before deciding to adopt a modified model, we recommend that the Commission evaluate the overall costs and benefits of the final scheme and whether that scheme meets the National Electricity Objective.. A number of detailed responses to the views sought by the AEMC can be found in the attached appendix.

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Given that the scope and models now under consideration the AEMC draft report have varied materially from those considered in the PricewaterhouseCoopers (PwC) final report "Review into the role of hedging contracts in the existing NEM prudential framework February 2010", we offer no further comments on the PWC report.

AEMO is pleased to continue to support the review and we look forward to the Commissions consideration of our submission. If there are any queries about this submission, please do not hesitate to contact Craig Parr, Senior Manager Metering and Settlements on 02 8884 5030.

Yours sincerely

Matt Zema
Managing Director and Chief Executive Officer

Attachments: A – Response to views sought and other comments

Appendix A: Response to views sought and other comments

Item 1 (Section 3.1.1, Page 43)

The Commission seeks stakeholder views on whether there is an additional period of risk under offset arrangements, compared to when such arrangements are not in place.

AEMO Response:

As raised in our submission to the draft PwC report, AEMO does not believe there is any additional period of risk under offset arrangements compared to when arrangements are not in place

Item 2 (Section 3.1.2, Page 44)

The Commission seeks stakeholder views on whether there are other costs or benefits that should be considered as part of the assessment.

AEMO Response:

AEMO has not identified any additional costs or benefits to be assessed, but notes the following

- AEMO will incur costs in building and operating the systems and processes required under the proposed model. AEMO has not currently quantified these costs, however can provide this information to the AEMC if required.
- Assessment of the proposal against the National Electricity Objective (NEO) will clearly be a necessary step if it is to be incorporated into the Rules. This should consider matters beyond transaction costs and financial savings, and encompasses the broader issues of market efficiency gains. Transfers of wealth would need also to be identified and assessed appropriately. To support analysis of this type in its review of prudential arrangements, AEMO has commissioned advice from the Competition Economics Group (CEG) as to how the NEO applies to assessing changes to settlement and prudential arrangements. Although AEMO expects to publish that report at a future time, it has not been released as yet. Nevertheless, AEMO would be prepared to provide a copy to AEMC on a confidential basis if that would be helpful.

Item 3 (Section 3.2.1, Page 51)

The Commission seeks views from stakeholders on its recommendations and reasoning in relation to the risk of clawback of funds held in the SDA by AEMO in the event of failure of a Market Participant.

AEMO Response:

AEMO acknowledges the advice obtained by the AEMC on this issue is based on a number of statements contained in AEMO publications as well as an analysis of the relevant parts of the NER.

We believe that AAR's conclusion that there does not appear to be a material risk of clawback rests, in part, on an assumption that an existing unsecured debt is not incurred until a statement is issued.

On page 48, AAR pointed to an analysis carried out in the context of when a GST liability arises. The question of when a 'taxable supply' occurs is not the same as the question of when a debt is incurred for the purposes of unfair preference law.

In circumstances where the supply of electricity is instantaneous and payment for that supply can only ever be made in arrears, it is at least arguable that the debt in respect of the supply of electricity, for the purposes of unfair preference law, arises once the supply is made and not when it is invoiced. Therefore, a security deposit may be available for an existing debt where it has been given to AEMO after the date of supply, but before the due date for payment and the security deposit is available to be applied towards the statement issued for the same billing period.

In this regard, AEMO also draws to your attention to the following Rules that make it clear that security deposits can be applied against outstanding amounts and for electricity supplied before the security deposit is provided although not yet billed:

- Rule 3.3.13A(a) provides that security deposits can be applied against unpaid final statements.
- Rule 3.3.13A(e) effectively requires AEMO, when exercising its discretion in the application of security deposits, to apply funds against the oldest final statements (ie the oldest supplies of electricity).

If a debtor/creditor relationship and an unsecured debt can exist before a final statement is issued (or arises because of earlier unpaid amounts), the first requirement for an unfair preference can be met where a security deposit is paid between the supply of electricity and the final statement or when other amounts are outstanding. Whether the security deposit constitutes an unfair preference in those circumstances will then depend on whether it is received in a relevant "clawback" period, whether the Market Participant is insolvent in that time, whether AEMO is placed in a preferential position by the payment and the extent to which AEMO can rely on the relevant defences.

We think that further consideration ought to be given towards this issue.

Item 4 (Section 3.2.2, Page 53)

The Commission seeks views from stakeholders on its recommendations and reasoning in relation to the requirement that offset arrangements must be underpinned by hedge contracts and that this requirement be a civil penalty provision.

AEMO Response:

AEMO does not have any issues with the recommendation to amend the reallocation procedures to require a confirmation of the presence of an underlying contract to the offset arrangement. We envisage that such a confirmation would be achieved by a checkbox during the reallocation registration process. AEMO would be concerned if there was a requirement to view or perform auditing on the contracts.

AEMO believes that several existing reallocation types (for example expost dollar offsets) may not directly reflect an underlying contract, so the confirmation may not be relevant.

AEMO recommends the AEMC consider situations where the offset arrangement is between entities related by a common owner, in which case the underlying contract may be an overarching covenant or similar instrument.

In summary, AEMO requests that the AEMC clarify the specific instruments to which this should apply, specifically:

1. Futures offsets
2. Swap, cap and floor offsets (both exante and expost)
3. Energy offsets (both exante and expost)
4. Dollar offsets (both exante and expost)

In regards to civil penalty provisions, AEMO expects that this would not form part of its operational duties, and does not offer any comment.

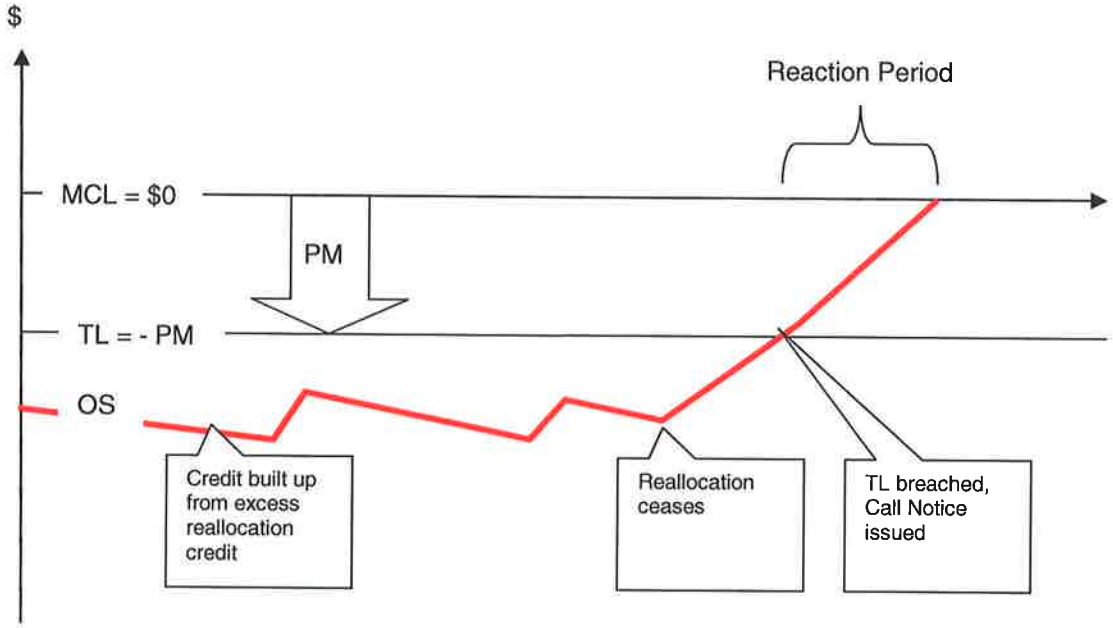
Item 5 (Section 3.2.3, Page 54)

The Commission seeks views from stakeholders on its recommendations and reasoning not to limit offset arrangements to average load, but to require AEMO's procedures to cap the reduction to the MCL to average load.

AEMO Response:

AEMO agrees with the recommendation not to limit offset arrangements to average load. However AEMO disagrees with the proposal to amend procedures to cap the reduction in Maximum Credit Limit (MCL) to average load.

AEMO has analysed the risks associated with reduction to the MCL where the level of Reallocation Agreement (RA) exceeds the average load, and do not believe there is any incremental risk to the NEM. In this circumstance, the participant would build up credit during the outstandings period, which would then be used to cover contingent liabilities incurred during the reaction period. The diagram below shows a typical scenario of a retailer with excess reallocation prior to failure:



It is important to note that the Prudential Margin (PM) is maintained, and acts the buffer under the circumstance that the reallocation ceases and the participant subsequently fails. However, because the MCL is $0 this results in a negative Trading Limit (TL) TL (= minus PM). The participant is required to ensure their OS is less than the TL, which effectively means the participant must ensure their OS is in credit by at least the PM, hence maintaining the buffer.

Allowing market participants to register offset arrangements in excess of average load is currently permitted, and is utilised in several circumstances:

1. In order to manage the prudential risk associated with peak load, and in particular where the peak load is coincident with high price events.
2. To allow the GST and loss factor adjustments to be offset. This is necessary because RA's are not subject to GST and loss factor in the calculation of credit limits, whereas energy amounts are.
3. To allow the MCL during the reaction period (which is based on load and not RA credit) to be offset by excess RA credit, in order to achieve a $0 MCL.

Item 6 (Section 3.2.4, Page 56)

The Commission seeks views from stakeholders on its recommendations and reasoning for AEMO to clarify the principles and/or procedures for the management of load profile risk under offset arrangements.

AEMO Response:

AEMO agrees there is a need to address load profile risk with load, generation, current offset arrangements and futures offset arrangements. AEMO proposes to amend its Credit Limits

Methodology to assess the energy and price components in discrete time blocks (eg. peak, off-peak), in order to mitigate the load profile risk.

Item 7 (Section 3.2.5, Page 58)

The Commission seeks views from stakeholders on its recommendations, that licensing issues should be addressed as part of ASIC's considerations on AEMO's application for an exemption from the requirements to hold a clearing and settlement facility license.

AEMO Response:

AEMO agrees with the recommendation that licensing and exemption requirements (if any) should be addressed by ASIC. However, we are aware that ASIC is taking into account the AEMC's independent review of reallocation mechanisms in reaching their decision. AEMC's review and the findings reached are therefore relevant.

Item 8 (Section 3.2.6, Page 60)

The Commission seeks views from stakeholders on its recommendations and reasoning on AEMO's right to not register offset arrangements and notice periods.

AEMO Response:

AEMO have no comment at this stage, however would like to respond to the specific wording of proposed Rule, in particular AEMO would like to ensure that any Rule contains a clear set of guidelines for AEMO to exercise this discretion.

Item 9 (Section 3.3.1, Page 63)

The Commission seeks views from stakeholders on its recommendations and reasoning in relation to RAs being considered an uncommercial transaction, and its impact on clawback risk.

AEMO Response:

AEMO has no comment.

Item 10 (Section 3.3.2, Page 65)

The Commission seeks views from stakeholders on its recommendations and reasoning on termination risk to the NEM under reallocation offset arrangements.

AEMO Response:

AEMO agrees that the termination risk under RAs is not material, and in most cases will be effectively mitigated. As previously advised, AEMO also agrees with the view that the two-party failure risk is not material.

Item 11 (Section 3.3.3, Page 68)

The Commission seeks views from stakeholders on its recommendations and reasoning on mitigation of termination risk to retailers under reallocation offset arrangements.

AEMO Response:

AEMO is concerned with recommendation for AEMO to modify the reallocation procedures to notify the RA counter-party in the event of a call notice.

Given the sensitivity of information related to a market participant's prudential status, AEMO does not believe it is appropriate for a Rules procedure to propose changes that would diminish the confidentiality of this information. If AEMC decides to progress this proposal, the commercial consequences need to be fully considered, and AEMO considers that any changes to require the notification of the RA counter-party be made a clear obligation in the Rules, and determined by the AEMC.

AEMO also recommends that any process to notify the RA counter-party be restricted to mitigate the specific termination risk, i.e. the debit party (generator) is being issued with a call notice and if the RA is terminated the credit party (retailer) would be subject to an increase in MCL. The scenario of where a call notice is issued to the credit party (retailer) should not result in notification to the debit party, as there is no termination risk and the notification may prejudice the retailer in current and future contract negotiations.

Item 12 (Section 3.4.2, Page 75)

The Commission seeks views from stakeholders on whether there are other ways (other than those outlined above) in which integration of futures contracts will increase the operation and efficiency of the NEM prudential framework.

AEMO Response:

AEMO have no comment.

Item 13 (Section 3.4.2, Page 81)

The Commission seeks views from retailers, SFECPs and AEMO on the feasibility of SFECPs becoming a party to FOAs, agreeing to 'hold' margins arising from futures contracts underpinning FOAs in a separate client sub account and agreeing not to net off those margins against a retailer's other positions.

AEMO Response:

AEMO supports the approach to have SFECP's become a party to FOAs, as AEMO believes this represents the least risk model for the management of FOAs. AEMO also notes that the inclusion of the Reallocator role in the Rules was intended to facilitate this model. AEMO further contends that the inclusion of additional creditors (bound by the Rules) in the NEM can increase the value of security, and reduce the exposure of the NEM to the failure of debtors.

Item 14 (Section 3.4.2, Page 84)

The Commission seeks views from retailers, SFECPs and AEMO on the proposal for AEMO to hold an irrevocable power of attorney over the retailer's right to receive funds in the CSA.

AEMO Response:

We note the comments made on page 83 as to how surety of payment can be increased through the use of an irrevocable power of attorney(POA), but we are uncertain as to how the use of a power of attorney (even if it is irrevocable) can override sections 437D and 468

of the Corporations Act and allow an unsecured creditor (assuming AEMO is not secured) to take an asset that would otherwise be available for creditors generally. We have also reviewed the complete copy of AAR's advice and note that the interaction between the power of attorney and the Corporations Act insolvency regime is not addressed.

The other issue, of course, is the consistency of legislative frameworks relating to powers of attorney, including the legislative requirements of the power of attorney for it to continue to apply in an insolvency context as well as the registration requirements in each of the different jurisdictions in the NEM.

Furthermore, while AAR have considered whether other forms of security could be taken by AEMO, they do not appear to have considered whether the POA by itself could be a charge. Consideration ought to be given as to whether the giving of a power of attorney in these circumstances creates a charge, moreover, one that might require registration. If it is a charge, the requirement for registration and the practicality of doing so (including what terms would need to be included in the instrument) should be considered in both the context of the existing law and the Personal Property Securities Act 2009, which is scheduled to come into effect in May 2011 and broadens the scope of security interests requiring registration.

Finally, the power of attorney, whether a security interest or not, could be affected by pre-existing securities and the POA might not prevent the Market Participant granting further security over the same payment.

We think that further consideration ought to be given towards these issues.

Item 15 (Section 3.4.2, Page 85)

The Commission seeks views from stakeholders on whether the additional PM and the power of attorney as proposed would adequately mitigate FOA termination risk and whether there are any other options that may help increase the surety of margin payments.

AEMO Response:

AEMO supports the recommendation to include additional PM as a means of reducing the FOA termination risk. However, AEMO does not believe that the methodology for calculating the PM has been adequately quantified in order to make an assessment of whether the FOA termination risk is mitigated.

As identified in our previous responses, AEMO does not believe there is sufficient consideration of the issues regarding power of attorney in order to mitigate the FOA termination risk.

Item 16 (Section 3.4.3, Page 91)

The Commission seeks views from stakeholders on its recommendations and reasoning for amendments to the Variation Margin Formula for an FOA.

The Commission seeks views from stakeholders on the proposal to apply an additional test, as described above, before VMPs are returned following a fall in futures prices.

AEMO Response:

AEMO is supportive of a Variation Margin Payment which recognises that futures' margins may be insufficient to meet the average price within the outstandings period for the load under FOA. Further, AEMO believes that the intention for the FOA credit support to be

supplemented by 'B' as and when margin payments are insufficient to cover FOA outstandings is a sensible approach. However, there appears to be some inconsistency between the determination of credit support and the 'FLP x FQ' factor within the derivation of B. There is also an inconsistency with the application of loss factor and GST. It is proposed that, to be consistent with the MCLfoa approach, B should be formulated as follows:

$$B = \text{Max}[OSfoa_t - ((E2 \times FLP \times 35 \times LF \times (GST+1) + SDAfoa)_t + \text{Max}[(DSPt - \text{Max}(FLP, DSPh])xFQ, 0]), \ 0]$$

In addition, on page 91 the report refers to the FLP bank guarantee. We request any reference to FLP bank guarantee within the report and Appendix B (Proposed FOA Model 2 – amended) should be removed and, if required, replaced with something akin to 'FOA trading limit'. The reason for this is twofold: the bank guarantee relating to MCLfoa will be significantly greater than the trading limit it provides (and to which the FOA outstandings should be related) once the PM terms are taken into account; and it is envisaged by AEMO that there will no differentiation between bank guarantees for MCL and MCLfoa.

AEMO supports the additional reset test that the 'FOA trading limit' plus the accumulated cash deposits (E2 x FLP x 35 x LF x (GST+1) + SDAfoa) on calculation day must be greater or equal to the FOA outstandings (OSfoa) once the reset has occurred.

AEMO observes that, should the AEMC choose to progress FOAs further, the operational detail for managing prudentials will require refinement within the parameters intended by the framework described in this report.

Item 17 (Section 3.4.4, Page 93)

The Commission seeks views from stakeholders on its recommendations and reasoning for the determination on MCL for energy under an FOA.

The Commission seeks views and reasons from stakeholders on whether Swaps and Options reallocation arrangements should work in conjunction with the RMCL.

AEMO Response:

The determination on MCL for energy under an FOA is generally acceptable to AEMO. However, there are GST and Loss Factor (LF) inconsistencies within the formulation that need rectifying. In all cases the additional trading limit provided by this formulation is equivalent to E2 x FLP x 35 x LF x (1+GST) which appears entirely appropriate.

AEMO agrees that the option for RMCL should not be available to FOA's.

. As pointed out in the draft report, the current MCL methodology does result in a scenario where retailer with swap reallocations may need to make margin payments, and even though AEMO does not believe this represents a material risk to the NEM, we propose that the AMEC consider that the option for RMCL should not be available to swap reallocations.

Item 18 (Section 3.4.5, Page 96)

The Commission seeks views from stakeholders on the recommendations and reasoning outlined above in relation to:

- *parties to an FOA;*
- *specifications of an FOA; and*

- *preconditions for FOA registration.*

The Commission seeks views from stakeholders on the recommendations and reasoning outlined above in relation penalties for breach of terms on FOAs.

AEMO Response:

In general AEMO advises that the FOA model described can be implemented if the AEMC decides to progress that Rule change, however as discussed previously we would prefer a model where the SFECP is a participant in the NEM.

Item 19 (Section 3.5, Page 101)

The Commission seeks views from stakeholders on the recommendations and reasoning for the mitigation of risks arising from internal offsetting of a gentailer's load and generation.

AEMO Response:

AEMO agrees with the recommendation as tabled in the report to amend the Rules for the determination of PM, and if the proposed changes are implemented, AEMO intends to modify the calculation of PM to remove the term VEG_R as specified below:

$$PM = Max[\Sigma_R (VEL_R - VEG_R) \times T_{RP}, 0] + Max[\Sigma_R (VRD_R - VRC_R + RD\$_R - RC\$_R) \times T_{RP}, 0]$$

As stated in previous responses, AEMO also agrees to progress amendments the Credit Limits Methodology to address load profiling risk between load and generation.

Item 20 (Section 4.3, Page 118)

The Commission seeks views from stakeholders on:

1. *the above approach to clarifying the "reasonable worst case" performance target; and*
2. *the proposed process for achieving stakeholder acceptance of the interpretation.*

The Commission also seeks stakeholders' views on whether the clarification of the "reasonable worst case" performance target should be pursued as part of this Review, noting that further consultations could delay the final report on this Review.

AEMO Response:

AEMO notes the work done by AEMC in an attempt to clarify the definition of reasonable worst case. Consistent with our earlier submission AEMO agrees that greater clarity in this area is essential.

While the work done by AEMC in relation to "reasonable worst case" makes a useful contribution in this area, it has not come to a landing, and the AEMC has suggested that AEMO carry out further work in this area.

As implied in the AEMC's Draft Report, AEMO is currently reviewing energy market prudential frameworks at a general level. Through the review, AEMO will aim to identify

material issues and propose mitigation measures where feasible. An industry based reference group has been established to assist in the review.

AEMO has commenced its investigation of "reasonable worst case" as an important element of the review. However, consistent with the broader scope of its review, AEMO intends to look more generally at how a prudential standard should be set for the NEM and, if appropriate, to propose improvements to the current mechanism. With input from the reference group, actuarial advice has been commissioned to support the investigation by looking at what prudential standard has been provided in practice in the NEM in the past (including by the prudential margin), considering standards, and advising how MCLs and prudential margin can be robustly calculated to meet a well defined standard. This approach takes a fairly open perspective on what the prudential regime is trying to achieve, and does not focus only on interpreting the current "reasonable worst case" Rule which has been shown to be troublesome, and AEMO's approach will be informed by the advice when it is received.

Accordingly, AEMO is concerned that the Draft Report sets out steps for further work in this area. While this is helpful information, and would be considered by AEMO in its review, it risks creating an expectation that the further work will follow a specific path which may not be consistent with AEMO's intended approach. It is therefore requested that the report be modified to reflect that AEMO will progress the matter in the context of its review, but being careful to avoid creating an impression that AEMO will follow a particular path in doing so.

In addition, we note that on p117 of the Draft Report, AEMC has recommended a framework for determination of the MCL along the following lines:

- The PM be determined on the basis of the 98th percentile 7 day load weighted average price expectations over the future MCL period; and
- The minimum TL be determined on the basis of the load weighted average price expectation over the future MCL period.

AEMO notes this recommendation, and considers that such a framework has potential to reduce the mandated level of collateral required to be lodged in advance, and offers participants the option of trading off the lodgement of additional collateral against the need to make adjustments more often. AEMO will consider this framework in the context of its review.

However, in relation to the FOA components of the AEMC review, there may be merit in considering how such a framework would interact with the AEMC's proposed FOA mechanism.

Other Comments

Section 3.4.3, Page 90

DSPh: DSPh = previous highest daily settlement price for futures contract since Effective Date during the NEM outstanding period, or, if it has been reset since that reset value.

Section 3.4.3, Page 91

It is recommended that all references to bank guarantee levels should be removed.

The outstandings relating to FOA load should not exceed the 'FOA Trading Limit' plus the cash held under the FOA

ie $OSfoa \leq (E2 \times FLP \times 35 \times LF \times (1+GST)) + (SDAfoa)$.

Hence, (FLP x FQ + SDAfoa)t should be replaced with

(E2 x FLP x 35 x LF x (1+GST) + SDAfoa)t, where

(E2 x FLP x 35 x LF x (1+GST) + SDAfoa)t = the FOA trading limit plus FOA VMPs

These changes should also be made in Appendix B (Proposed FOA Model 2 – amended)

Section 3.4.4, Page 92

The MCLfoa formulation needs standardising for application of loss factor and GST.

AEMO propose that it should read as follows:

MCLfoa = E2 x FLP x 35 x LF x (1+GST) +

E2 x PR x VF x Trp x LF x (1+GST) +

E2 x(PR x VF – FLP) x Trp x LF x (1+GST)

E2 should be clarified as the daily load under the FOA rather than the Energy under FOA.

Load Profiling

Given that future contracts are, by their nature, flat loads it is important to recognise that the VF on the non FOA MCL is likely to increase when the FOA flat load is carved out. This will have an implication on the absolute reduction to credit support required under the FOA model.

Default Implications

In practice, the implementation of FOA, as proposed, will lead to a single MCL, bank guarantee amount, trading limit and prudential margin value. On a daily basis there will be two sets of validation – the current prudential check that the trading margin[1] is still ≥ zero and the check that the FOA requirements have been met. It is a feasible outcome that the trading margin could be ≥ zero whilst the FOA requirements have not been met. This will lead to a

[1] Trading Margin = Trading limit - Outstandings

call notice and, potentially default proceedings, under an FOA even though the participant still has 'fat' in its trading margin. This is a potential outcome which should be recognised.

Operation of FOA

The following diagram is presented to clarify the operation of the FOA as AEMO understands it. In this example 50% of the load has been covered by an FOA resulting in the base MCL – defined here as 'other' – being reduced by 50% (this is a simplification given the VF implications described above). The relative sizes of the FOA Trading Limit and PM is dependent upon the FLP, PR and VF and, as such, is illustrative only. Bank guarantees will be supplied, as now, to cover the total MCL amount. The total outstandings will at all times be maintained below the Trading Limit (FOA plus Other). Total outstandings can be reduced by both security deposits and FOA margin payments. In addition, on a daily basis the FOA outstandings component must not exceed the FOA Trading Limit plus FOA variable margin payments.