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Dr John Tamblyn
Chairman
Australian Energy Markets Commission
Submissions@aemc.gov.au

Dear Dr Tamblyn,

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

1. International Power Australia (**IPRA**) is pleased to have the opportunity to make this further submission to the AEMC's review into the role of hedging contracts in the existing NEM prudential framework. IPRA also appreciates the Commission's agreement to the extension of the deadline for this submission.

2. IPRA clearly understands the drivers for the reduction in the costs of prudential requirements on NEM participants. However, we do not support measures that increase the financial risk to generators in an effort to achieve this. Since the National Electricity Law requires IPRA and other generators to sell their electricity through the NEM, and since generators have no opportunity under this framework to withhold supply for non-payment for physical energy, IPRA regards the maintenance of the existing credit risk profile of electricity generators in the NEM as paramount. If generators are required to bear non-payment risk to a greater extent than they currently do, they will demand higher prices in the NEM which, in the context of the energy-only market, will ultimately flow through to the prices consumers pay for their electricity. We suggest this would be contrary to the National Electricity Objective.

   2.1 It is also an issue that any weakening of prudential standards for the NEM may lead to ratings agencies, financiers and other third parties marking generators' creditworthiness down, leading to likely increases in the cost of external financing. Any increase in generator's capital market costs would again, ultimately flow to consumers in the form of higher prices.

3. IPRA opposes moves to draw or integrate the financial market into the NEM environment. The NEM is an obligatory physical market for the economic delivery of energy to consumers, with a prudential framework that was carefully and appropriately developed so as to ensure that AEMO (then NEMMCO) is able to pay for physical generation. We believe a secondary financial market which acts independently of the physical should not be annexed to the NEM without consideration of the overall functionality of the NEM, and its possible redesign. IPRA cannot support any proposal which seeks to adjust the prudential requirements for purchasers of electricity by including aspects of this secondary (derivative trading) market, particularly when doing so reduces the NEM prudential standard and increases the risk that generators will not be paid for its physical generation

   3.1 A related point is that IPRA also considers it would be unwise to make any substantive changes to NEM prudential arrangements at a time when AEMO's separate review into those arrangements, and their adequacy is still underway.

4. The proposed futures offset arrangements (**FOAs**) would reduce the prudential quality of the NEM and so IPRA continues to oppose their introduction. Under this proposal retailers would receive a decrease in their maximum credit limit (**MCL**) that would significantly outstrip the proposed additional prudential margin (**APM**). Retailers would have decreased MCLs without there being any guarantee that, in exchange, AEMO would receive, and would be able to retain, retailers' positive variation margin payments (**PVMPs**) as security against high spot prices.

5. In particular, IPRA considers that FOAs should not be regarded as anything better than an unsecured promise made by a retailer to make payments into a security deposit account (**SDA**). This is clearly inferior to the bank guarantee the FOA replaces.

6. We agree with the conclusion reached by the AEMC in this respect:

   "The Commission is not satisfied that the unilateral commitment by a retailer under the Rules and the terms of an FOA can be taken as being of an equivalent quality to the unconditional bank guarantee it replaces."[1]

7. Consequently, with the AEMC itself having recognised this and many other risks associated with FOAs (some highlighted later in this submission), IPRA is puzzled how the AEMC reaches a conclusion that recommends in favour of FOAs, notwithstanding the measures the AEMC has proposed to address those risks., These include the APM, will inevitably leave AEMO with a lesser total amount of credit support to call upon when a retailer goes into default, and the introduction of a power of attorney. IPRA sees a significant disconnect between the analysis in the body of the draft report and the recommendations emanating from the Commission.

[1] See p.81 of the AEMC's draft report.

8. Furthermore, while the reduction in the cost of credit support a retailer would have to provide to AEMO would benefit that retailer, we cannot see in the draft report that the AEMC has considered whether the result of the FOA proposal might be an overall increase in the credit support that retailers and generators collectively are required to provide, not merely to AEMO but also to their futures market clearers (**SFECPs**). IPRA suggests that the AEMC should not recommend in favour of FOAs unless it can demonstrate that FOAs will lead to an overall reduction in NEM-wide credit support costs, rather than just a reduction in the cost of credit support required to be provided by retailers to AEMO. Only in this way could it be expected that FOAs will lead to lower electricity prices for consumers.

    8.1 For example, when entering into a futures contract, each of the retailer and the generator are required to make initial margin payments to its SFECP, e.g., a base load contract for one MW in Quarter 1 2011 in NSW currently requires each party to pay to their SFECP, in cash, an initial margin of $9,500.

9. We make the following particular points in support of this submission:

    9.1 There are many reasons why the amount of a retailer's PVMPs may not end up first in the client segregated account (**CSA**) maintained by the retailer's SFECP, and secondly in an SDA where they might be applied by AEMO against monies owing by the retailer. We agree with the conclusions the AEMC has reached in this respect:

    > *"... it is not possible to determine with certainty that a Client's obligations to AEMO under an FOA will always be backed by margin payments from SFECPs."*[2]
    >
    > *" ... the Commission is concerned that margin payments arising from futures contracts will not always be sufficient to meet the VMPs to AEMO."*[3]

    Reasons why the amount of the PVMPs may not end up in an SDA include:

    9.1.1 The PVMP is not paid into the CSA because the amount of the PVMP is offset by other amounts payable by the retailer to the SFECP such as brokerage and by negative variation margin payments under other futures contracts.

    9.1.2 The retailer has no right to the whole amount of the PVMP in the CSA because of other amounts owing by the retailer and also by other clients of the SFECP: the CSA is not a segregated account covering the retailer only but rather one covering all of the SFECP's clients.

    9.1.3 The retailer terminates the underlying futures contract.

    9.1.4 The SFECP terminates the underlying futures contract.

    9.1.5 The SFECP terminates its relationship with the retailer. We understand has occurred and SFECP termination can occur in a very short time frame, i.e., with only a couple of weeks notice.

2 See p.72 of the AEMC's draft report.
3 See p.81 of the AEMC's draft report.

9.1.6 The SFECP breaches its obligation to pay the PVMP into the CSA.

9.1.7 The retailer breaches its obligation to pay the amount of the PVMP into the SDA, whether from the CSA or otherwise.

9.1.8 Difficulties are encountered in enforcing the proposed power of attorney over the retailer's right to amounts in the CSA, e.g., the SFECP ignores demands made under the power of attorney or an external administrator of the retailer prevents the SFECP from responding to demands made under the power of attorney.

We suggest the AEMC might consider instructing Allens Arthur Robinson to advise on this topic. It seems doubtful to us that, if a retailer went into external administration, AEMO would be entitled to receive and to retain payments from the CSA, given that it would only be an unsecured creditor of the retailer.

9.2 Furthermore, it is no answer to the concerns raised in paragraph 9.1 that in many of the instances mentioned there the retailer will breach the FOA. There of course will be implications for the retailer if it breaches the FOA and the National Electricity Rules but the point remains that, despite the breach, the amount of the PVMPs still does not end up in the SDA and AEMO will end up with less credit support covering retailers' liabilities in the NEM than what it would have under the current arrangements.

We agree with the conclusion reached by the AEMC in this respect:

> *"Whilst a retailer who registers an FOA will have obligations under the Rules and the terms of an FOA to make the VMPs as and when they are due, the arrangements do not provide adequate surety that such payment will be made (that is, where a retailer is in breach of Rules or contract)."*[4]

9.3 It is doubtful that Allens Arthur Robinson are correct in concluding first that there is no material risk that a liquidator of an insolvent retailer would be able to clawback monies paid into an SDA under current legal structures, and secondly that there will be no greater risk when the monies are paid into an SDA under an FOA. In particular:

9.3.1 Given that the supply of electricity is instantaneous and payment for that supply can only ever be made in arrears, we doubt that it is correct to say that no debt arises when the supply is made and that a debt only arises later when the debt is invoiced.

9.3.2 Furthermore, given that on the day the monies are paid into an SDA they may be applied under clause 3.3.13A of the Rules against monies owing by a retailer under any final statement that has been issued on or prior to that day, we doubt that it is correct to say that those monies are not paid in respect of a debt that the retailer owes to AEMO.

[4] See p.75 of the AEMC's draft report.

9.3.3 In particular, monies will be paid into an SDA under an FOA due to an increase in the retailer's outstandings, in effect as security for that increase in amounts payable to AEMO.

9.3.4 Moreover, it may be more difficult for AEMO to establish that it should not have known or suspected that a retailer was insolvent in circumstances where monies are paid into an SDA under an FOA, as opposed to payments into an SDA in other circumstances. The payments would be required when spot prices are high. If spot prices remained at high levels for any extended period AEMO might reasonably expect that a retailer would be at risk of falling into financial distress, particularly if FOAs and reallocations were to become the norm. In that case AEMO would know whether, after taking FOAs and reallocations into account, the retailer had a residual exposure to spot prices.

9.3.5 We cannot see the relevance of the GST treatment of payments into SDAs to how those payments might be clawed back under insolvency laws.

9.4 IPRA does not understand why the AEMC has proposed that the solution to these difficulties with the PVMPs is the APM.

9.4.1 IPRA supports the AEMC in having assessed FOAs against whether the prudential quality of the NEM is improved or at least maintained.[5]

9.4.2 As we understand the formulae in section 7.1 and 7.2 of appendix B of the AEMC's draft report, it will always be the case that the amount of the APM will be significantly less than the amount of the decrease in the MCL. In particular, the amount of the APM will reflect the surplus of the average historical price, as adjusted by the volatility factor, over the futures lodgement price, with that surplus applied to the product of the load under the FOA and the 7 day reaction period. The decrease in the MCL will reflect that same surplus applied to the product of that same load and the longer credit time period. That means that, in the case where the MCL is worked out on the basis of a 42 day credit time period, the decrease in the MCL is 6 times the amount of the APM; in a reduced MCL scenario where the credit time period is 28 days the decrease in the MCL is 4 times the amount of the APM.

9.4.3 It follows from this that, at the critical time when a retailer defaults, AEMO will have significantly less credit support to draw on to cover the retailer's liabilities in the NEM.

[5] See p.39 of the AEMC's draft report.

9.4.4 Prior to the default, the retailer may have paid PVMPs into an SDA. However, in any assessment of the impact of FOAs on the prudential quality of the NEM, we suggest the scenarios the AEMC ought to focus on are those involving the greatest risks for NEM creditors, e.g.: (1) where the retailer defaults with no amounts previously having had to have been paid into an SDA; and (2) where the default occurs when there is a dramatic increase in spot prices (which may well have triggered the default) in which case the further liabilities incurred during the reaction period might be expected to overwhelm any amounts previously paid into an SDA.

9.4.5 In this respect the draft report recognises the concern, raised by AEMO, that a number of scenarios can be easily identified where the current PM would be inadequate to cover the period taken to suspend a retailer.[6] In those circumstances AEMO is able to draw on any excess of that part of the credit support covering the retailer's existing outstandings, to cover the new liabilities incurred by the retailer in the reaction period. Under FOAs, a lesser amount of that excess credit support would be available to AEMO and the APM would not make up the difference. AEMO would be at greater risk of not having sufficient credit support to cover new liabilities incurred in the reaction period.

9.5 Finally, IPRA cannot see that it is appropriate to compare the prudential quality of the NEM under FOAs with its quality under swap and option reallocations given those reallocations are yet to be implemented and so their impact on prudential quality can only be assessed academically, i.e., there can be no assessment yet of whether AEMO actually had sufficient credit support in actual high spot price and other scenarios in which market participants actually had swap and option reallocations in place.

10. If you have any questions in relation to this submission, please contact Mr Andrew Bett on 03 9617 8314 or at andrew.bett@ipplc.com.au.

Yours faithfully,

PAUL MAGUIRE
Finance Director

STEPHEN ORR
Commercial Director

6 See p.40 of the AEMC's draft report.