Energy Retailers Association of Australia Limited

11 January 2012

Mr Paul Bell
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Paul,

Re: Consultation on New Prudential Standard and Framework in the NEM (ERC0133)

The Energy Retailers Association of Australia (ERAA) welcomes the opportunity to comment on the Australian Energy Market Commission (AEMC) consultation for the proposed implementation of a New Prudential Standard and Framework in the NEM (Consultation Paper).

The ERAA is the peak body representing the core of Australia's energy retail organisations. Membership is comprised of businesses operating predominantly in the electricity and gas markets in every State and Territory throughout Australia. These businesses collectively provide electricity to over 98% of customers in the NEM and are the first point of contact for end use customers of both electricity and gas.

In this submission the ERAA has not provided comment on the numerous issues raised in the Consultation Paper, as members of the ERAA will address these individually. In its review the AEMC, however, must have regard to:

- the impact that any proposed Rule change may have on the effectiveness of competition in the market and potential barriers to market entry,
- the impact that any proposed Rule change will have on retailers costs, in particular working capital costs, and potential impact on retail market offers, and
- the difficulty in Retailers providing constructive comment on the proposed Rule change considering that AEMO does not propose to release the methodology until after the AEMC publishes its Draft Determination.

It is within this context that the ERAA provides the following comments to the consultation paper and the Rule change proposal.

The ERAA supports replacing the "reasonable worst case" definition with a new definition for the prudential standard framework that is transparent and predictable as proposed in the Consultation Paper and the proposed application of a Probability of Loss Given Default (P (LGD)) definition. Having a clearer and more tangible prudential standard definition can support participant and investor confidence, which is likely to promote the National Electricity Objective.

That being said, participants cannot assess fully the implications of the new prudential standard without the methodology for determining their potential new credit support requirements. It is difficult for participants to understand how the new methodology would work in practice and hence the appropriateness of the new standard without the detail of the methodology. This is particularly important as the new methodology removes the existing RMCL provisions and proposes to account for specific retail load factors, which to date have not been applicable.

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The ERAA recommends that the AEMC provide participants sufficient time to assess fully AEMO's methodology prior to the close of consultation on the Draft Decision. Participants should have the opportunity to assess the methodology and incorporate any comments into their submissions to the AEMC's Draft Determination. The ERAA understands that AEMO intends to start its own consultation on the new credit limit methodology following the release of the AEMC's Draft Decision. We therefore request that the AEMC run an extended second round consultation to ensure sufficient overlap of these concurrent and inter-related consultations.

When establishing the new prudential standard, it is important that thought be given to ensure the standard represents a prudent level of risk for the market while simultaneously ensuring manageable credit support requirements for participants. The analysis undertaken by Seed Advisory and Taylor Fry during the AEMO Prudential Readiness Review determined that setting a NEM prudential standard of 2% P(LGD) could provide an achievable improvement in the performance of the current prudential arrangements without significantly increasing the NEM's average prudential requirements. It does not, as suggested by the AEMC, necessarily reflect the "optimal prudential coverage". [1]

The ERAA notes that AEMO is pursuing this Rule change as a priority before it considers further prudential reforms from its Energy Market Prudential Readiness Review. It is important that a well defined prudential standard is implemented on which these other reforms can be built. As part of the ongoing process to improve the prudential regime following this Rule change, the ERAA considers that a review into the continued appropriateness of the 2% value of P(LGD) should be undertaken. The 2% P(LGD) may be appropriate now to maintain – in essence – the status quo. However, after some experience, and following the introduction of other prudential reforms, a review is important to ensure the 2% continues to deliver an efficient level of prudential cover for the NEM. A review to establish the ongoing optimal value of P(LGD) should be independent and subject to public consultation.

The ERAA appreciates the consultative approach adopted by the AEMC and AEMO to date and facilitating a workshop with retailers on December 14, 2011 to run through the proposed Consultation Paper. Should you wish to discuss the details of this submission further please contact me on (02) 9241 6556 and I will be happy to facilitate such discussions with my member companies.

Yours sincerely

Cameron O'Reilly
Chief Executive Officer
Energy Retailers Association of Australia

[1] The analysis undertaken by Seed Advisory and Taylor Fry during AEMO's Energy Market Prudential Readiness Review found that the current P(LGD) in NEM is around 3.9%. This appears to be primarily attributable on the introduction of the Reduced Maximum Credit Limit (RMCL). The analysis also indicated that without the RMCL provisions, the P(LGD) would be around 2.2%.