SUBMISSION ON NATIONAL ELECTRICITY AMENDMENT (FUTURES OFFSET ARRANGEMENTS) RULE 2008

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GLOSSARY

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
EAR	*Ex-ante* Reallocation
EUAA	Energy Users Association of Australia
FOA	Futures Offset Arrnagmenets
IT	Information Technology
MCL	Maximum Credit Limit
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
OtC	Over-the-counter
RoLR	Retailer of Law Resort
SDA	Security Deposit Amount
SFE	Sydney Futures Exchange
SFECC	SFE Clearing Corporating Pty Ltd

EXECUTIVE SUMMARY

The First Rule Change

The Energy Users Association of Ausstralia (EUAA) has some observations on the First Rule Change that warrant further investigation by the Australian Energy Market Commission (AEMC), and some queries regarding the robustness of the analysis supporting the First Rule Change produced by the Proponents. However, we do accept that the First Rule change, as a voluntary mechanism, has merit and would make a positive addition to the tool box of prudential instruments available to Market Participants to meet prudential obligations, and assist the smooth functioning of the market. These benefits are, of course, subject to cost recovery, operational alignment and integration issues being resolved between the SFE Clearing Corporation (SFECC) and National Electricity Market Management Corporation (NEMMCO). The EUAA's endorsement is also made subject to observations on the proposed wording of the Rule Change that are included within this document at Section 2.6.

The Second Rule Change

In relation to the Second Rule Change proposal, the EUAA is significantly more concerned that the fundamental structural shift in the way that market risk is assessed and managed has yet to be thoroughly investigated and evaluated. We would support the Second Rule Change provided the AEMC conducts further modelling and analysis, to assess, quantify and put in place a framework to manage these changes, and to ensure that maximum market benefits to all stakeholders, including electricity users, are derived from any changes.

1 INTRODUCTION

This submission details the comments of the Energy Users' Association of Australia (EUAA) to the Rule change Request submitted by Australian Power & Gas Ltd, Infratil Energy Australia Pty Ltd, Momentum Energy and d-cypha Trade (jointly referred to as "the Proponents") called National Electricity Amendment (Futures Offset Arrangements) Rule 2008 (the Rule), being reviewed by the Australian Energy Markets Commission (AEMC).

The EUAA is a non-profit organization focused entirely on energy issues. Members determine the EUAA's policy and direction, and our activities cover both state and national issues. The EUAA's membership represents a wide spectrum of end users located in all states. The EUAA has 100 members. These are predominantly large business users of energy in many sectors of the economy. All have a strong interest in ensuring that electricity in the National Electricity Market (NEM) is delivered efficiently and effectively, and that there is vigorous and effective competition within the retail market for energy services, including the financial markets that are associated with retail delivery of those services.

For the purposes of this analysis the EUAA dissects the proposal as advanced by the Proponents into its two constituent components:

- The First Rule Change: this covers the proposed introduction of the Futures Offset Arrangements (the First Rule Change); and

- The Second Rule Change: this covers the proposed change in the calculation of the Maximum Credit Limit (MCL) by using the corresponding quarterly SFE futures market price rather than the National Electricity Market Management Company (NEMMCO's) price determination methodology (the Second Rule Change).

In each section, the EUAA undertakes an analysis of the arguments put forward by the Proponents in support of the Rule Change and then suggests re-drafting of the Rule Change to provide an outcome that it considers has advantages over the form of the Rule Change suggested by the Proponents. The EUAA also offers comments in relation to each of the rule changes on areas that it considers need to be further investigated or resolved, before any rule changes are accepted.

The EUAA broadly supports the First Rule change along the lines represented by the Rule Change Request. However, we suggest several changes to the wording of the Rule change are required to clarify the operation of the proposal.

However, the EUAA presently offers more reserved support for the Second Rule Change in its current format, due to the risks that may be introduced into the National Electricity Market (NEM) through the adoption of that proposal. The Second Rule change proposes to amend the Maximum Credit Limit (MCL) formula through the replacement of the current methodology whereby NEMMCO considers the covariance of historical pool price volatility and pool prices within each NEM region, with the corresponding quarterly Sydney Futures Exchange (SFE) futures contract price in its current form.

If its concerns cannot be satisfactorily resolved, the EUAA would be supportive of a proposal where the MCL used a proxy price for calculation purposes is determined as the higher of either the current NEMMCO methodology or the relevant SFE futures price.

The EUAA is also concerned that the Second Rule Change is stylized by the Proponents as an ancillary change supporting the First Rule change rather than a substantive Rule change in its own right. The EUAA acknowledges the inter-relationships between the two proposals but disagrees with the view that the Second Rule Change is 'ancillary'. The Second Rule Change represents a fundamental change in the way that prudential risks are managed in the NEM, and as such due consideration should be applied equally to both the First and Second Rule Changes.

We suggest that the requirements of the National Electricity Law (NEL) for Rule change proposals may not have been satisfied for the Second Rule change proposal. The Proponents should be required to submit a Rule change proposal for the Second Rule Change which ensures that it is specifically meets the criteria specified under Regulation 8 of the *National Electricity (South Australia) Regulations*, and the AEMC issued guidelines for intended proponents: The Rule Change Process and how to lodge a Rule Change Proposal. The Proponents should be required to provide:

- an explanation of how the proposed Rule would address issues concerning the existing Rules;
- an explanation of how the proposed Rule would or would be likely to contribute to the achievement of the National Electricity Objective;
- an explanation of the expected benefits and costs of the proposed Rule change; and
- an explanation of the potential impacts of the proposed Rule change on those likely to be affected.

We now examine the Rule Change Request.

2 THE FIRST FULE CHANGE PROPOSAL

In this section the EUAA examines, firstly the supporting arguments of the Proponents regarding the First Rule Change. In this analysis the EUAA only comments on those areas where it has formed a view on the First Rule Change, and the potential or likely impacts of that Rule Change on the market.

The second part of this section addresses the wording of the First Rule Change and makes specific suggestions for re-drafting. This section also contains analysis as to why the First Rule Change, as drafted by the Proponents, may require some amendment.

2.1 The First Rule Change: Explanatory Document

In this section the EUAA reviews the arguments advanced by the Proponents for the First Rule Change, and provides commentary on these arguments and whether they represent valid and considered observations on the current and (proposed) future state of the operation of the NEM.

2.1.1 Background to the Proposed Rule

Definition of Risk in the NEM

It is claimed throughout the Proponent's submission that the First Rule Change will lower barriers to entry for new entrant retailers in the NEM. The Proponents claim that the change will allow new entrants to replace bank guarantee security lodged with NEMMCO by contra cash flows from their futures holding positions. The focus of the Proponents appears to be solely on the issue of credit risk within the NEM and does not extend to changes to other market risks that are affected by or brought about by the First Rule Change.

The Commission should be made aware of and recognise or acknowledge the additional operational, reputation / public perception and political risks that may arise in the NEM through a potentially undercapitalised new entrant retailer commencing retail operations in the energy market by using largely futures positions to provide a trading guarantee to NEMMCO. The danger with the entry of an undercapitalised retailer is that such a retailer might collapse. If this occurred, it would potentially increase the overall total risk of the pool for other Market Participants (even though under the First Rule Change – assuming that retailer voluntarily entered into a Futures Offset Arrangement (FOA) with NEMMCO – specific credit risk is removed).

However, the EUAA has a number of further observations in relation to each of these classes of risk. Consideration of the following issues is likely to be instrumental in forming an opinion about whether, and how, current guarantee arrangements can be amended. For example:

- **Operational Risk**: It is possible that overall operational risk may increase for the NEM with the introduction of the First Rule Change. This is so because all retailers, including Retailers of Last Resort (RoLR), would need to make information technology (IT) and other process / system changes to allow for amendments to the settlement statements issued by NEMMCO, regardless of whether

those retailers chose to implement FOA arrangements. NEMMCO would also need to undertake IT system and other process changes, and these may introduce new operational and implementation risks. Further, any 'retail failure' events may lead to cost escalation by retailers that have RoLR (Retailer of Last Resort) obligations. These retailers would need to ensure that they can cope with greater numbers of retailer and contagion threats across all retailers. Under the current NEM structure these costs would (ordinarily) be recovered from customers, including large users. The benefits of an increase in competition through this proposal should be balanced against the potential increase in operational risks this may cause – and the costs that may be passed on to consumers as a result.

- **Reputation / Public Perception Risk:** The First Rule Change may enable entry into the NEM of retailers who would previously have been unable to enter the market due to rigidity of NEMMCO's current prudential requirements. This increase in competitive entry would be welcome and beneficial. However, these retailers may be of lower credit standing than the existing market as a whole. This then, *ipso facto*, would appear to increase the overall risk of the market generally. The EUAA is unable to assess the relative magnitude of these counteracting effects, but the AEMC needs to carefully weigh-up the benefits of increased competition from the proposal against any increase in risks. The EUAA is cognisant of the reputational effects of the sole RoLR event (the Energy One event) that has already taken place and the reaction of sections of the market to that event (including adjustments to the cost for exposure to increased credit risk).

- **Political Risk:** If the effect of the First Rule Change were an increase in the risks that had political implications such as the occurrence of RoLR events, the the efficient operation of the market would also need to be assessedin relation to this. They also require examination as part of the review of costs and benefits of a Rule change proposal. Our assessment is that this sort of risk may be low for this proposal, but the AEMC should consider this question.

- **Credit Risk:** The Proposal should consider more fully total credit risk in relation to the First Rule Change. While the Proponents describe the potential reduction in retailer specific credit risk, they should consider more fully the impacts on the level of absolute credit risk across the NEM. The reasoning advanced for the First Rule Change also indicates that the Proponents may have not considered in sufficient detail the cost of this risk when assessing the costs / benefits of the proposed change. In a blind credit market where the identity of counterparties is not known, generators in the pool face aggregate credit risk for non-payment for physical energy supplied.

  The risk of that credit has a number of elements:

  - Initially generators must assess the risk of a retailer failing, and the concurrent risk of the existing (or proposed) prudential system also failing together, potentially resulting in a material shortfall to the generator.
  - The generator must also asses the credit risk change that occurs as a result of the entry into the market of a new retailer, and the impact of that entry on the overall credit worthiness of the 'blind' credit market supporting pool payments. The Proponents argue that the first risk (the risk of a retailer failing) is reduced where new entrant retailers make use of the FOAs, and that this is a

benefit to the market that results from the introduction of the Rule Change. However, the Proponents do not consider the 'credit risk change' resulting from the Rule. If this change in credit risk was adverse, this could result in a general increase in underlying pool prices as generators seek to gain compensation for a higher overall credit risk of the pool, due to the introduction of [potentially] undercapitalised retailers. This change in credit risk could be real or perceived. This second credit risk change requires detailed examination by the AEMC, as part of the cost / benefit analysis.

The EUAA is of the opinion that the AEMC's consideration of the Proposal would benefit from a more complete assessment of the risks that arise from the Rule change. It may therefore be appropriate for the AEMC to conduct a rigorous cost / benefit analysis before the Rule change can be adopted.

The EUAA is generally supportive of any revisions to the NER that will increase competition in the NEM. This may occur through the introduction of more new entrant retailers or through the direct hedging of customer loads through the futures market[1]. However, we are concerned that the potential benefits from any revised arrangements be comprehensively assessed, so that it can be clearly demonstrated that the benefit of these amendments outweigh any changes in the characteristics of the market, and the pricing implications that those increased risks have for Market Participants.

2.1.2 Earlier Retailer of Last Resort (RoLR) Incident

The Proponents appear to conclude that the RoLR events in the second quarter of 2002 (Q2 2007) illustrate that the existing NEM Prudential system has failed. The EUAA considers that these events illustrated that the NEM is capable of withstanding exogenous shocks. By focussing on the Energy One event the Proponents discount the resilience of the prudential system that has been demonstrated through the rebound of the NEM from other significant market events that have occurredin the past.

We encourage the AEMC in its current considerations to also review other market events that have resulted in significant call notices being issued by NEMMCO, to ensure a balanced perspective of systemic prudential issues is achieved.

2.1.3 MCL Formula and NEMMCO Prudential Monitoring

Daily monitoring (usually conducted overnight) by NEMMCO of the status of a Market Customer's position relative to that customer's Outstandings results in what is effectively a 24 hour delay until the further provision of security is required to cover a short position. The Proponents appear to believe that the timing risk of the operation of the prudential system in this manner is significant, and that it is remedied by the First Rule change, specifically the payment by the Sydney Futures Exchange Clearing Particpant (SFECP) towards the Sydney Futures Exchange Clearing Corporation (SFECC) of Security Deposit Amounts (SDAs). It is unclear from the First Rule change why this payment (which presumably would be made on the following day) exhibits less timing risk characteristics?

[1] The EUAA recognises that large end-user customers are presently able to avail themselves of retail spot pass-through contracts and hedge their own loads throught the SFE or OTC (Over the Counter) markets. the Rule change does not appear to contemplate that existing possibility.

The unstated benefit to the market appears to be the credit standing of the SFECC and the prudential benefit of daily margining as a debtor (which is implied to be equivalent to a full guarantee) once additional security is lodged. While we agree that the SFECC as a debtor is superior to some Market Participants, we do not share the view that this is a virtual guarantee and, as such, believe this benefit of the revised credit arrangements, while real, may not be as large as claimed. It is also vital that the payment of cash is credited to the SDA and is not classified as a receivable from the SFECC.

2.1.4 *Ex-ante* Reallocation

While the EUAA agrees that the EAR process is not operating with a volume that was originally envisaged, we note that it is, similar to the First Rule change, a voluntary scheme where Market Participants will only make use of the scheme if they derive a benefit from using these arrangements. In this regard low use of the scheme is not necessarily a sign of failure as the EAR does provide an alternative that is clearly used by some Market Participants to better manage (in their view) prudential exposure to the NEM.

2.1.5 Description of the proposed Rule

Item 3 in the description of the proposed rule states that NEMMCO and the affected Market Participant may agree on how the monies received under the First Rule change arrangements should be applied. The EUAA believes that the Rule should be prescriptive about the application of monies held by NEMMCO to remove any discretion that may lead to subsequent claims against NEMMCO. The EUAA believes that the monies should be applied to the relevant settlement period that prompted the provision of the SDA amount in the first instance.

2.2 Maximising Productive Efficiency (reducing risk-related costs)

Item 2 of this section of the Rule Change Request relates to the claim that the existing EAR arrangements encourage generators to engage in 'reckless' agreements. The Proponents' claim should be properly assessed as part of the cost / benefit analysis of the First Rule change, and we encourage the AEMC to seek specific evidence from the Proponents. Additionally, given the often interlocking nature of security arrangements for bank financing of generators, we consider it most unlikely that a generator would enter into an EAR and precipitate a credit event under their security documentation, and that this would most likely result in an overall default. It is also difficult to imagine a Market Customer taking on specific physical supply risk from a generator with a poor reliability record as this would also expose the Market Customer to increased risk for no additional benefit.

Item 4 criticises NEMMCO, as prudential administrator, for concluding that the average effect of pool price spikes was not reflective of the value of the pool price spike in the Q3 2007 MCL calculation for retailers operating in New South Wales (i.e. NEMMCO considered that it was appropriate to remove the Q2 results on the basis that they were abnormal). The EUAA understands that NEMMCO is allowed to remove 'abnormal' pricing results from relevant security calculations, if those pricing results can be considered '1 in 48' month outcomes, and that is is what happened in Q2 2007.

Item 5 states that the First Rule change:

> "*will avoid a NEM retailer deliberately exercising a free option to trigger its own default and suspension as a Market Customer in order to transfer its loss making pool supply commitments onto other retailers during high price outcomes, while continuing to benefit from it's profitable financial hedges as futures.*"

This statement is only correct if the First Rule change was to be mandatory, where all Market Participants would be required to lodge FOAs with NEMMCO, if they engage in futures trading. This is not the case with the voluntary system as proposed. Consequently, Item 5 of the Proponents' argument in favour of the Rule Change is not relevant to the AEMC's consideration of the proposed Rule change.

Item 6 focuses on the benefits that might flow from potentially reducing prudential compliance costs for Market Participants taking advantage of the First Rule change. However it does not identify, discuss or assess changes that result in other risks, such as those identified earlier in Section 2.1.1 - "Definition of Risk in the NEM". We encourage the AEMC to conduct a more holistic examination of the incremental changes in all risks and an assessment of the likely costs and benefits of these changes when assessing the Rule change.

2.3 Maximising Dynamic Efficiency (promoting competition)

The Proponents claim (in Item 7) that independent new entrant retailers are disadvantaged relative to existing retailers, due to their size, transaction costs and access to EAR.

We believe that there is an element of truth in these comments and that they do affect competition in the NEM. However, it would appear that the Rule Change Proposals submitted by the Proponents are not the most significant factors in this. For example, in Victoria smaller 'second tier' retailers have been more successful in entering the market due to a more favourable contracting situation with private sector generators.

The situation is also no different from other markets in which small and / or independent players do not (by definition) have scope or scale advantages, and do not have the established credit and other relationships that reduce transaction costs. The AEMC should examine the relative importance of this argument.

The AEMC needs to consider the Proponents' arguments in Item 7 in relation to an apparent tension between, firstly, encouraging new entrant retailers and further competition into the market and secondly, altering (increasing) market risk through the introduction of new retailers. Under some circumstances, the costs of increased market risk could outweigh the benefits from facilitating further new entrant retailer participation in the retail market. The net effect of these changes in risk profiles need to be carefully examined by the AEMC as part of the cost / benefit analysis, to ensure that they are fully captured and considered.

Whether the current Rules encourage vertical integration or not (as alleged by the Proponents) is not relevant for the purposes of assessing the First Rule change. The Proponents express the view that vertically integrated entities avail themselves of EAR arrangements to maximise dominant positions in the market. The only way in which the 'vertical integration' issue (which is really one for the ACCC) might be relevant to the

assessment of the proposal would be if the EAR and FOA regimes were competing schemes rather than complimentary scheme. As mentioned, these schemes appear to be complementary.

2.4 Issues with the Existing Rules

It appears that the major benefit derived from the First Rule Change under Item 1 is that the daily margining process of the SFECC is significantly more efficient than the margin call and prudential monitoring processes of NEMMCO. Given that both prudential systems require additional security to be provided within a narrow timeframe, with default causing suspension, this may be a difficult claim to support. Different Market Participants will or are likely to find benefit and detriment in the prudential monitoring and call requirements of both systems. For example a "cashed-up" retailer may prefer the SFE arrangement where daily cash margin calls are required, whereas a more asset rich (or better credit rated) retailer may prefer the provision of additional bank security (as a contingent liability). Each of these prudential responses are reasonable and the benefits and costs will differ depending on the financial structure of each retailer. The SFECC procedure appears to have an advantage by spreading of credit provision risk across the SFECC, and amongst a potentially larger number of credit providers (who support the SFECC) than those available in the bank guarantee market. In this regard, we see the First Rule change as being complementary to the existing prudential system.

The extent to which the SFE futures contract price represents the true consensus of the entire market (and thus is a good proxy for the market consensus price) as stated by the Proponents, in Item 7 is open to conjecture. This is because it represents only one proxy for a consensus view of forward prices and is not necessarily the most appropriate for use in the MCL calculations as proposed. Nonetheless, we do agree that the SFE futures market price is observable by all parties. At the time of settlement it is correct, as stated by the Proponents, that the SFE futures price equates to the average of the physical pool price. However, the deviations in the SFE futures market price between initial trading and the date of final settlement only reflects future price expectations. There is no evidence provided to support a claim that using the SFE futures market price is more accurate (except as the date of settlement approaches) than the NEMMCO price calculation methodology used in the MCL. In this regard a proper statistical analysis of this claim should be undertaken as part of the Rule Change process. There are also arbitrage implications for the market if there are significant differences in the forecasts generated under the MCL and Futures Market processes. We comment on this matter in depth in Section 3.1.

The Proponents appear to provide no tangible evidence that peak generators would increase hedging via SFE futures contracts in addition to existing hedges as a result of the FOA being introduced (thus producing the liquidity increase claimed). Indeed, it appears sensible to assume that, as generators are ordinarily cash flow recipients (and not subject to the NEM prudential requirements), no benefit accrues to peaking generators from the First Rule change. If a peaking generator chose to mitigate physical running risk, as stated by the Proponents, they are able to do so under current arrangements by using SFE futures contracts.

Item 9 implies that the EAR scheme is underutilised because Market Participants are reluctant to provide details of a hedge arrangement to NEMMCO due to the prospect that NEMMCO will leak this information to the broader market. When the EAR was originally introduced discussion about its operation centred around how the EAR would most likely be useful for recording OTC hedges that were large and flat (i.e. base load

requirements). In this scenario NEMMCO would not have access to portfolio details of the Retailers or Generators.

2.5 Expected benefits and costs of the proposed Rule Change

The most significant issue with the Proponent's cost / benefit analysis is that it appears to focus too closely on specific counterparty credit risk issues and the benefits that arise from the First Rule change. The cost / benefit analysis does not adequately assess all the risks that are changed (both beneficially and adversely) through the introduction of the Rule Change. Accordingly, the Proponent's submission needs to be investigated further by the AEMC, to determine whether there is a sufficiently robust case in favour of the Rule Change. We emphasis that this is not to say that there is not a sufficient case for the Rule Change. Rather, we comment that the grounds for a change have not necessarily been sufficiently demonstrated in the Proposal as it stands.

We also note that no consideration is made of the cost to NEMMCO of developing the necessary systems to implement the First Rule change. Equally, there is no explanation of how those costs would be recovered from Market Participants using the facility, consistent with a 'user pays' philosophy, and to avoid cost-smearing. The AEMC should ensure that the true costs of implementation and the recovery mechanism is considered and appropriately designed or outlined prior to endorsing any proposed Rule change.

Further, the AEMC should have regard to the total costs of implementing the proposal including costs incurred by the SFECC and intermediaries. The AEMC should ensure that the SFECC is able to operationally perform its role within the FOA structure. It would be prudent to include a clause within the Rule to ensure that it is ineffective until both NEMMCO and SFECC have "signed-off" that relevant underlying systems and processes are in place and tested.

Throughout this submission the EUAA has highlighted a series of risks that need to be considered and evaluated so that market participants can be confident that FOA trading arrangements can be introduced without upsetting smooth market operations. The EUAA has also discussed the benefits cited by the Proponents and concludes that many require further assessment to confirm their impact. However, the EUAA remains in favour of the First Rule change subject to wording amendments as specified in Section 2.6.

2.6 The First Rule Change – Comments on Rule wording

In this section we review the Rule change Request and make comment on the arguments advanced by the Proponents in favour of the First Rule change. We follow the numbering as provided in the Proponents submission.

3.3.8(f) The EUAA is concerned that the wording in this Rule change effectively places an obligation upon NEMMCO to modify its calculation timeframe to align with the SFE. This could be considered as amounting to a suggestion that the broad market should be required to modify its behaviour to satisfy the requirements of a small section of the market – and the change is only voluntary in any case. No analysis appears to be provided by the Proponents to reveal the benefits to the entire market of this change.

Further, the new clause includes the contentious phrase "*to maximise the benefits of Futures Offset Arrangements for Market Participants*'. This phrase places an obligation upon NEMMCO that is broadly unachievable: interests of different classes of Market Participants can be diametrically opposed. For example, Market Customers will have their benefit maximised (broadly) through the greatest reduction in MCL whereas Generation (in all registration classes) will maximise their benefit maximised by having Market Customer MCL's maximised.

The EUAA believes that the new clause 3.3.8 (f) should read as follows:

"*When applying the methodology used in determining maximum credit limits and prudential margins NEMMCO will have regard to aligning those limits to the maximum extent possible with the terms of electricity futures contracts.*"

3.3.8(h) The amendments suggested to this clause are unsupported by the Rule change Request, and require more supporting evidence to be accepted. The Proponents do not appear to have demonstrated that the existing prudential calculations are flawed, as the data and detail supporting calculation of charges are not provided to Market Participants. The change proposed provides for greater disclosure of information that is not identified anywhere in the Request as an issue of concern and should be rejected on this basis (including in the information box proceeding this change). The underlying rationale for this change should be spelt out with greater clarity.

3.3.9 The definition of SDA appears to allow for a receivable from an SFECC Participant to be included in the calculation. This definition implies that NEMMCO will have no counterparty liquidity or credit risk with the SFECC. While in theory this may be true, it is arguably important to introduce this new risk into the NEM prudential system only after extensive analysis. The EUAA believes that the definition of SDA should be amended to ensure that NEMMCO only takes account of monies that have been <u>paid</u> to NEMMCO by the SFECC (rather than the receivable being recognised).

3.3.13(a)(3) We suggest the wording of this clause be amended to remove the proposed new words "*which would give rise to a reduction in the Outstandings of the Market Participant.*"

3.15.11B(8) We consider that the words "*unless otherwise agreed to by NEMMCO and the Market Participant. Unless otherwise agreed to by NEMMCO, the*" should be removed. It may be beneficial for the Rules to recognise the use of the SDA by requiring the SDA to be used as part of the settlement of the weekly statement for that period for which the SDA was originally provided. That is, an SDA is usually provided by a Market Participant to cover a prudential requirement for a specific settlement period. It may be beneficial to require NEMMCO to use that deposit to settle that week as part payment rather then allow it to be returned to the Market Participant or dealt with differently. Wording for such an amendment could be drafted by the AEMC.

New clause The EUAA believes a new clause may be required that ensures that the costs of providing and operating the FOA system are recovered from its users.

3 THE SECOND RULE CHANGE PROPOSAL

In this section the EUAA examines the Proponent's supporting arguments for the Second Rule change, and offers comments on that proposal. The second part of this section specifically addresses the wording of the proposed Rule change and makes specific suggestions for re-drafting together, and contains an analysis of why the initial Rule as drafted by the Proponents requires amendment.

3.1 Appendix Six: Section 2.8

The Second Rule change proposal appears predicated on the view that the SFE futures contract price is a better forecast of the future NEM pool price, and is more preferable as a proxy than a backward looking average based upon historical price information.

The EUAA agrees that the SFE futures contract price represents one view as to the expected price by region in the NEM. Whether that view truly represents a "consensus" is debatable.

The EUAA is concerned that it is not clear that the proposal adds significant incremental value to NEMMCO's prudential exercise, over prudential methods currently employed. There are uncertainties introduced by the Second Rule Change proposal that may outweigh the certain knowledge that accompanies existing price methodology. Despite its flaws, that methodology is well understood by the market, is transparent, and has been deployed for, and supported the proper functioning of the market and the prudential system by NEMMCO for ten years. The existing prudential methods have also been tested against a number of crises, and (arguably) appear to have been robust enough.

There are uncertainties in introducing a new system for determining the value to be applied as the pool price for prudential purposes. The method as proposed has not been shown to have worked properly. Importantly the singular Energy One episode used as an example by the Proponents to support the introduction of a revised methodology reveals an apparent benefit in that instance – but does not, in our view, represent a thoroughly detailed enough analysis of the likely effect of the introduction of that methodology upon the NEM, It is not clear that the introduction of a revised methodology would have averted the Energy One incident, or whether that event would have occurred at all, or how variations of it might have occurred, even if the revised methodology were in operation.

Further analysis, encompassing an appropriate and extended timeframe is required to better understand the true effect of this proposed change. As a minimum, we suggest that the AEMC undertakes a statistical review of the correlation error between the initially traded SFE price (on the day of the trade) relative to the actual settlement price (looking forward) and NEMMCO's present methodology. The EUAA would argue that, if, over the long run (at least 4 or 5 years), the former does not deliver a statistically significant lower correlation error, then the case for change will, *prima facie*, not have been made.

In the interim , a way forward could be that the Rule be amended to change the MCL formula to use a proxy price for calculation purposes as the higher of either the current NEMMCO methodology or the relevant SFE futures price. Such a change would allow the SFE market price to be used while ensuring that the nature of

the existing blind credit market for generators is not reduced, and risk to generators is not increased, which is likely to increase pool prices.

The EUAA also reiterates its earlier comment that the Second Rule appears as an ancillary proposal supporting the First Rule change, and is not considered a substantive Rule change in its own right. The EUAA believes that the Rule change proposal requirements should be applied equally to both the First Rule change as well as the Second Rule change. The requirements of the National Electricity Law are that the same rigorous levels of analysis undertaken for the Second Rule change as the First Rule change.

3.2 The Second Rule Change – Comments on Rule wording

In this section we review the Rule Change Request in the manner that it is presented and make comment on the arguments advanced by the Proponents in favour of the Second Rule change. We follow the numbering as provided in the Proponents submission.

Our earlier comments on changes to clause 3.3.8(f) apply for the Second rule change as well as the following proposed changes:

S3.3.1(b)(2) As per our earlier comments, the words "*measured with reference to the most relevant SFE Electricity futures contract price*" should be replaced with "*having regard, among other things to the most relevant SFE Electricity futures contract price*".

4 CONCLUSION

The EUAA thanks the AEMC for the opportunity to comment on the Rule Change Request and provide its comments as part of the assessment process.

In conclusion, the EUAA has some queries regarding the analysis supporting the Rule Change produced by the Proponents, but does accept that the First Rule change as a voluntary mechanism has merit and would make a positive addition to the tool box of prudential instruments available to assist the smooth functioning of the market and encourage more competition. These benefits are, of course, subject to cost recovery, operational alignment and integration issues being sorted between the SFECC and NEMMCO. The EUAA's endorsement is also made subject to improvements in the supporting analysis and the proposed changes to Rule wording that have been included within this document at Section 2.6.

In relation to the Second Rule Change proposal, the EUAA is significantly more concerned with the fundamental structural shift in the way that market risk is managed should the proposal be accepted. As currently proposed, we believe that this change requires further investigation. The EUAA could, however, support a requirement that in prudential calculations NEMMCO use the higher of the either the NEMMCO determined pool price proxy or the relevant SFE futures contract price.

Prior to approving the Second Rule change we would suggest that the AEMC (or the Proponent) needs to undertake modelling and financial analysis of that change in order for the implications of that change to be properly understood.