Ergon Energy Corporation Limited

and

Ergon Energy Queensland Pty Ltd

New Prudential Standard and Framework in the NEM

Consultation Paper

Australian Energy Market Commission

6 January 2012

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This submission, which is available for publication, is made by:

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1 INTRODUCTION

Ergon Energy Corporation Limited (EECL) and Ergon Energy Queensland Pty Ltd (EEQ) welcome the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on its *New Prudential Standard and Framework in the National Electricity Market (NEM) Consultation Paper* (Consultation Paper).

This submission is provided by:

- EECL, in its capacity as a Distribution Network Service Provider in Queensland; and
- EEQ, in its capacity as a non-competing area retail entity in Queensland.

In this submission, EECL and EEQ are collectively referred to as 'Ergon Energy'.

In principle, Ergon Energy continues to support the implementation of a suite of measures to assist retailers with the management of prudential obligations and costs, including changes to the Maximum Credit Limit (MCL) and Prudential Margin (PM). Section 2 of this submission provides a number of specific comments relating to the proposed Rule change.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AEMC require.

2 SPECIFIC COMMENTS

This section discusses Ergon Energy's key concerns relating to the proposed Rule change put forward by the Australian Energy Market Operator (AEMO).

2.1 Platform for Reform of Prudential Framework in the NEM

Ergon Energy considers that any platform for reform of the Prudential Framework should be based on broader conservative financial market credit risk reforms being carried out under the Basel II accord. Otherwise, Market Participants can potentially be exposed to increased risk of default and associated losses.

2.2 Maximum Credit Limit

Under the proposed Rules, the MCL is the sum of the Outstandings Limit (OL) and the PM. The inclusion of the PM in the calculation of the MCL will have limited impact on EEQ as EEQ currently includes the PM when determining the amount of bank guarantees it provides to AEMO. This currently avoids the need for placement of short notice cash security deposits or additional guarantees in periods of higher than normal volatility. Consequently, Ergon Energy supports this inclusion.

2.3 Ambiguity of the Term "Reasonable Worst Case"

Ergon Energy agrees that the term "reasonable worst case" is ambiguous, and suggests that the ambiguity be removed from the National Electricity Rules (the Rules) and replaced with a statistical measure which is less open to interpretation. The proposed methodology is more transparent and consistent with credit risk measurement conventions.

2.4 Probability of Loss Given Default

Ergon Energy notes that without details for the calculation / derivation of the Probability of Loss Given Default (P(LGD)) and, in turn, the new credit support amount payable by EEQ under the proposed arrangements, we are unable to quantify the impact on EEQ and provide sufficient comment on this proposal. However, we are concerned that:

> *…the proposed Rule and operation of the new credit limit procedures is likely to increase the credit support required by retailers who have riskier portfolios, for example for retailers with a high load factor, and for the Queensland region.*[1]

Based on this, the proposed Rule change is likely to result in higher credit support costs for EEQ in the form of:

- Higher bank guarantees to be provided to AEMO; and
- Higher performance guarantee fees[2] to be charged by our creditor, the Queensland Treasury Corporation.

Depending on the level of the increase in credit support required for EEQ, our current internally approved guarantee limits may also need to be reviewed.

2.5 Transitional Arrangements

Ergon Energy generally supports the proposed transitional arrangements. We note that AEMO must develop and publish the credit limit procedures to take effect from the commencement of the proposed Rule change, and AEMO's intention to consult on these procedures following the publication of the AEMC's draft Determination on this Rule change request.

[1] AEMO (2011), *National Electricity Rule Request – New Prudential Standard and Framework*, 27 July 2011, p23.
[2] Calculated as a percentage of the bank guarantee amount.

In particular, we support the requirement for AEMO to review our existing prudential settings in accordance with the credit limit procedures within one month of the commencement of the proposed Rule change. However, we consider that sufficient notice from AEMO of the new assessed MCL will be required to enable new guarantees to be executed. The current bank guarantee process typically takes three to four weeks.

2.6 Review of Market Participants' Prudential Settings

Ergon Energy notes the proposed arrangements for AEMO to review the prudential settings of each Market Participant set out under clauses 3.3.8(i) to (k) of the proposed Rules. Once again, Ergon Energy considers that sufficient notice from AEMO of any changes and sufficient time within which to procure new guarantees is required. This is particularly relevant given the proposal to incorporate seasonal factors and load profiles when calculating the MCL and PM and the impact different seasonal impacts summer and winter can have on price and load volatility.