Energy Retailers Association
of Australia Incorporated

15 November 2009

The Chairman
The Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

Dear Sir

RE: Review of the Role of Hedging Contracts in the Existing National Electricity Market Prudential Framework

The Energy Retailers Association of Australia (ERAA) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) "Review of the role of hedging contracts in the existing National Electricity Market prudential framework" prepared by PricewaterhouseCoopers (PwC) and released in September 2009.

The ERAA is an independent association representing twenty retailers of electricity and gas throughout the National Electricity Market (NEM) and the jurisdictional gas markets. ERAA members collectively provide electricity to 11 million customers in the NEM and are the first point of contact for end-use customers for both gas and electricity.

General Comments

ERAA supports the objective of the AEMC's review in seeking to improve the efficiency of prudential arrangements in the NEM. Providing opportunities for retailers to lower the cost of their credit support through offsetting measures such as reallocation and futures contracts are areas worth serious consideration. We also support investigation of alternative ways of determining maximum credit limits for retailers. Credit support in the NEM is a significant cost for retailers, which is likely to increase as a result of global financial crisis and the imminent introduction of the Carbon Pollution Reduction Scheme (CPRS). The financial outlook of the NEM is uncertain with potential for price volatility to increase significantly.

Since prudential arrangements were introduced in the NEM some years ago, the trading of electricity contracts in the Over the Counter (OTC) market has evolved and matured. There is also an emerging confidence in the futures market, which is increasing steadily in volume and producing more consistent price signals. Consequently, the ERAA considers that the incorporation of futures off-set arrangements (FOAs) into prudential requirements may offer a useful alternative for retailers to lower their prudential costs.

That being said, the ERAA is also mindful that the FOA options proposed by the AEMC are relatively complex and potentially less secure than existing bank guarantees. It is important that any lowering of prudential costs, through whatever mechanisms is introduced, is appropriately weighed against any possible increase in the overall level of prudential risk to the NEM more generally. It is important therefore that any substantive changes being contemplated for the prudential framework are subjected to rigorous analysis, risk and cost and benefits assessment. Any un-intended consequences of the design framework may lead to increased incidents of financial distress. In the extreme cases, and without a reasonable built-in safeguard, it could trigger multiple suspensions and activate Retailer of Last Resort (ROLR) events. On the other hand, if a robust framework is constructed and judiciously implemented, credit support cost could be reduced and cost of entry for smaller retailers minimised with increased level of protection from credit exposure in the NEM. The ERAA is aware that at least one of the retailers facing financial distress in the past has indicated that FOA could have made a difference to its management of credit risk and suggested that the risk of triggering ROLR could have been reduced.

Specific Comments

In this broader context the ERAA offers the following more specific comments in relation to each of the proposals examined in the PwC report:

Reallocation

- The ERAA agrees with the report's assessment of the low risk to the NEM prudential quality of an involuntary de-registration of a reallocation agreement (RA) by AEMO;

- The ability for AEMO to terminate RA is however a potentially disruptive process for the retailers;

- The report suggests that RA could be terminated if a retailer breaches its prudential requirements. It is unclear if a RA could be terminated if the retailer is compliant with the underlying OTC and RA conditions. Any potential remedy for breaches of prudential arrangement could be jeopardised by the potential termination of an RA, compounding the task of securing the additional credit cover or security deposit;

- It is appropriate for Australian Energy Market Operator (AEMO) to define a transparent RA termination process that can effectively deal with the knock-on effect of generator default to restore an appropriate level of retailer's net credit cover within a reasonable period of time without increasing NEM's exposure to possible credit risk;

- Such a measure could encourage up-take of RA as a reliable alternative for efficient credit support for both generators and retailers; and,

- The ERAA concurs with PwC recommendation that the risk of a mismatch of peak/off-peak load profile in reallocation and actual consumption on retailer's potential exposure to shortfall in credit cover should be mitigated by clarification of AEMO's processes that assess and manage profiled reallocations.

FA model 2

- The theoretical assessment of the model appears to support the adequacy of credit cover for historical monthly average prices; given that credit support cover is monitored on a daily basis and any remedy is required in one day, ERAA is concerned that the analysis may not have revealed sufficiently the level of adequacy in credit cover for smaller intervals of extreme price movements;

- The predictive quality of the model is important as this is a forward looking model and there is some level of uncertainty as to the future shape of volatility in NEM spot prices with the added risk of potential decoupling with futures prices;

- An additional day for raising additional credit cover would reduce the risk of un-intended suspensions;

- More needs to be done to fully test the risk of severe shortfall on extreme price events and the potential mechanism to manage any unintentional impact of price spikes on otherwise prudent credit management by retailers especially during the transition period; and,

- It is unclear if claw back risk exists given the proposed FOA allows retailers to request for return of excess fund from a Security Deposit Account.

MCL

The ERAA Believes MCL proposals are insufficiently developed to be adopted at the moment, because:

- There seems to be benefits in moving to a more forward looking approach potentially using a futures price in some way;

- In calculating the Efficiency of the Stress Test Method, PwC have overlooked that a prudent retailer would/should be carrying sufficient cash (or callable lines) to meet an AEMO margin call should a stress event occur. Therefore, the ratio of Outstanding to MCL is not a relevant measure as it assumes that any cash not sitting with AEMO is free to be utilised elsewhere in the business (or re-distributed to shareholders). If liquid cash (or callable lines) is required to meet a stress test margin call at any time then it matters little whether this cash is with AEMO or in the bank (or whether the callable line is on-call or already committed to AEMO by way of bank guarantee); and

- Further exploration and development of these options would be supported.

Should you require any further information in relation to this submission please feel free to contact me on (02) 9437 6180.

Yours sincerely,

Cameron O'Reilly
Executive Director
Energy Retailers Association of Australia

Energy Retailers Association of Australia Incorporated
Suite 306, 460 Pacific Highway St Leonards NSW 2065
T (02) 9437 6180 F (02) 9437 6790 www.eraa.com.au ABN 24 103 742 605