NATIONAL GENERATORS FORUM

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Dr John Tamblyn
Chairman, Australian Energy Markets Commission
PO Box A2449
Sydney South
NSW 1235
Your reference: EMO0008

Dear Dr Tamblyn,

Review into the role of hedging contracts in the existing NEM prudential framework – issues paper

As the primary creditors to the NEM pool, generators are pleased to have the opportunity to comment on this important review.

Context of the review

NEM prudential arrangements have been in place largely in their current form since the commencement of the NEM, and have proved effective to date. From a generators perspective, it is critical that the arrangements continue to deliver a high degree of certainty that funds owed by the NEM pool to its creditors will be paid. This allows generators to invest in the NEM with confidence, and without having to factor undue credit risk into investment premiums.

While we believe the existing arrangements have been appropriate to date, we are conscious of several factors that are likely to increase the pressure on the existing prudential arrangement in the near future. These include:

- the impending privatisation of the NSW retail sector, which will remove the NSW Treasury from being a credit support provider for a large share of the NEM retail sector (30% according to the issues paper) – this will increase the demands on the private banking sector for additional credit support; and
- Government plans to implement a CPRS which is likely to significantly increase prudential requirements for market participants through increases to the average NEM pool price. The CPRS may also increase pressure on participant credit positions by imposing prudential obligations of its own.

These factors are exacerbated by the Global Financial Crisis which is generally reducing the availability and increasing the cost of credit across all sectors.

In this context, it is timely for the AEMC to review the prudential requirements of the NEM with a view to reducing systemic risk, while maintaining the robustness of the current arrangements and examining the best alternatives to ensure that any financial failure across the electricity sector does not manifest itself as a short payment to the NEM pool.

The NGF supports the objective of reducing systemic risk in the sector provided that this does not come at the cost of reduced credit quality of the NEM pool. Such an outcome would not be consistent with the National Electricity Objective (NEO), and would be likely to result in significant cost to the sector in both financial and potentially system security terms.

Primary NGF recommendation – Significantly shorten the pool settlement cycle

With this in mind, the single change that would have the highest impact in terms of reducing NEM credit support requirements – and systemic risk - while maintaining the current level of credit quality in the NEM would be to significantly shorten the NEM pool settlement cycle.

Such an option would lower the amount of outstandings within the NEM, which would reduce the level of credit support required to maintain the same NEM credit quality – thereby maintaining the robustness of the existing prudential arrangements. This would produce benefits from reduced credit requirements in the primary NEM market, while simultaneously reducing credit requirements in secondary markets.

Apart from the obvious savings in terms of credit support in these secondary markets, this would have the potential to increase efficiency of trading in these markets by reducing the risk of them “locking up” due to counterparty credit limits preventing efficient trades as market prices rise (a material problem in the drought linked price rises of 2007).

We also note that this change could be made without any material impact on the credit risk profile of the NEM. In contrast, some of the other proposals under consideration (eg. the Futures Offset proposal) continue to raise concerns around impacts on pool credit quality.

No other single change is likely to reduce systemic risk in NEM prudential arrangements to this extent while maintaining the quality of NEM pool credit. For this reason we strongly support the AEMC taking this proposal forward as the primary focus of the Review.

Our views on the other matters raised in the issues paper are outlined below.

Assessment framework for the review

The primary assessment criteria for the review should be that the credit quality of the NEM is improved or at least maintained. This criteria underpins the reasoning for the prudential regime – and any weakening of pool credit quality would be likely to have the undesirable impacts outlined above.

Underneath this overarching principle, the sub-principles of increasing the efficiency of capital usage and operational effectiveness are supported. However we re-emphasise that these can only ever be secondary considerations and cannot be used to justify changes that would reduce the achievement of the primary criteria.

On the question of the cost of capital to retailers to trade in the NEM, it is relevant to note that under FOAs a retailer gets no reduction in MCL unless it opens up futures positions and thus takes on a liability to initial and variation margins. Likewise, a retailer that reallocates can reasonably expect that the generator taking on a direct credit exposure to the retailer will itself require credit support, or a premium price for taking on the credit risk. The point is that retailers will confront creditworthiness issues no matter who they deal with, and it not efficient to seek to socialise these risks across the NEM.

Reallocation arrangements

Overall the NGF is relatively comfortable with the existing reallocation arrangements, and believes that their usage will continue to develop as the market matures and competition drives further efficiencies in the sector.

We note that reallocation transactions cannot be unilaterally terminated, and in fact can only be terminated by agreement of both parties (or by NEMMCO). Even in such circumstances the framework should be reviewed to ensure that participant agreed reallocations cannot be terminated without replacement credit support having been put in place by the pool debtor. We note that NEMMCO has a unilateral termination right – and we support this being reviewed to ensure that it can only be triggered if one party has defaulted, and only as a last resort option in order to support NEMMCO's role to protect the stability and security of the NEM's credit worthiness.

It may be worth reviewing the credit support requirements around heavily reallocated generators to ensure that pool creditors are adequately covered in the event of financial default of such a participant. Consideration of potential concentration risks under extensive reallocation should also be undertaken. In reference to this, we note that the process for retailer suspension following default is relatively clear, but the implications of suspending a generator following a financial default to the pool may warrant further consideration to ensure that financial integrity and system security in the NEM are appropriately balanced.

We note that generators active in the derivatives market are already required to hold AFSL's, so we do not see this as a barrier to reallocation. Key barriers to reallocation are commercial – rather then procedural. Parties to reallocations need to agree terms related to how any benefits of reduced credit support costs are shared, as well as what level of credit support between the parties is appropriate (and how does the cost of this compare with other options available to the retailer). As outlined above, these commercial issues will be overcome as competition forces parties to come to terms on these issues in order to harvest efficiencies.

Futures offset arrangements

The NGF has been supportive of the current implementation of the reallocation participant category. This approach followed the approach used for other reallocations by allowing participants to reallocate debit and credit positions between themselves as per the existing process. At this time, this option was envisaged to allow clearing houses, and their clients to have non-NEM derivative positions taken into account when determining NEM prudential requirements without increasing or creating new risks in the NEM prudential arrangements.

When it emerged that clearing members were unwilling to be bound by the NEM rules, it became clear this mechanism would not allow futures positions to be reallocated as originally hoped. NGF considers that an integral component of the NEM prudential framework to that clearing houses agree to be bound to the NEM rules (if and FOA is to be implemented).

In lieu of this approach various other options have been proposed which seek to alter the NEM prudential arrangements to allow futures positions to be considered in the context of reallocation arrangements. Currently, proposals have yet to articulate a mechanism in sufficient detail, which would deliver futures based reallocation, while maintaining existing pool credit quality.

In order to deliver on this credit quality objective, reductions in credit support based on FOAs should not be allowed unless:

- the commitment to pay monies to NEMMCO is an absolute and unqualified one;
- legally robust and enforceable under the Rules;
- not terminable at will;
- made by a person as creditworthy as the banks NEMMCO currently accepts bank guarantees from; and
- with no greater risk of clawback.

NGF considers that the objective of maintaining the creditworthiness of the NEM's current prudential arrangements is consistent with the NEO.

We note that the most recent variant – referred to as a direct retailer FOA – appears to be substantial departure from the original principal of allowing counterparties to the pool to exchange debit and credit positions. Rather this approach appears to suggest that retailers can voluntarily reduce their credit support requirements if they can show they have futures in place.

This raises the question – why can't a retailer voluntarily reduce its credit support if it can show it has other contracts in place (eg. OTC, or direct bi-lateral contracts)?

The reason that this isn't currently accepted is that regardless of the contracts a retailer has in place, there are any other number of financial obligations it may have entered into which mean it may not be able to pass difference payments (or margin receipts in the case of futures) to NEMMCO to meet its pool obligations. Put another way, without NEMMCO having full knowledge of all financial commitments of the retailer, it would be imprudent to accept a lower level or standard of credit support from the retailer.

Clearly it is impractical for NEMMCO to obtain such knowledge, and so retailers are mandated to fully meet the prudential requirements regardless of their internal hedging arrangements.

We note that the yet to be implemented swap and option reallocation approach aims to provide scope for contractual counterparty's to reflect contract positions into the NEM. It is important to note that this occurs by the parties exchanging NEM pool exposures, not by only one of them changing exposures. In this way it is akin to the existing rules concept of reallocator participants.

To adopt the direct FOA proposal would appear to be equivalent to making the provision of credit support optional to retailers – which would undermine the core underlying objectives of the whole prudential framework. In this light, it is difficult to see the direct FOA model being acceptable to maintaining NEM pool credit quality.

In addition, the NGF remains concerned about other aspects of the various FOA models, such as the wrapping up of all the various risks and non-idealities associated with the model into the proposed “B” effectiveness discounting factor. The use of “kludge” factors such as this in a framework as critical as the NEM prudential framework does not sit well with NGF members and we oppose this concept on the grounds it would materially increase the chance of short payment during a default.

Finally – it will be critical to ensure that any FOA model that does emerge cannot be unilaterally terminated, and that any termination mutually agreed by the parties cannot be implemented without replacement credit support having been put in place by the post termination debtor. NEMMCO unilateral termination rights should be aligned with those under the reallocation approach – and only be usable as a last resort to protect the creditworthiness of the NEM.

While we have a range of concerns with the various FOA models, the NGF is committed to working through the detailed implementation questions in good faith to see if a workable model can be established that does not undermine the key objective of maintaining or improving overall NEM credit quality.

As a final comment on this area, we note that any benefits in improving NEM prudential cost efficiency and operational effectiveness that would accrue under any FOA model are likely to be dwarfed by the systemic risk benefits and credit support requirement reduction available from a major shortening of the NEM settlement cycle. Hence, the AEMC’s review should focus heavily on the costs and benefits from this option with regard to the NEO.

MCL methodology

A significant review of the NEM prudential framework such as this one would not be complete without examining the basis of the MCL calculation.

Of the various approaches canvassed in the paper, we make the following observations:

- use of futures prices in MCL calculations are not supported, as these prices are a market consensus of risk adjusted price expectations. As such they do not represent a reasonable worst case scenario as required under the rules, and so would need to be adjusted by some form of volatility factor. It is not clear why this approach would be any more beneficial than the current approach which uses a historic cost adjusted for volatility;
- the lack of a futures contracts for Tasmania, and illiquidity in the South Australian futures contracts, means that either the existing MCL method would need to be maintained for these NEM regions or some other mechanism would need to be proposed and adopted. This would lead to multiple MCL approaches being applied across the NEM which may raise the possibility differing levels of credit support being set for different NEM regions, which would potentially increase uncertainty over NEM credit quality; and

- the concept of a stress test based definition of reasonable worst case has theoretical appeal, and deserves further examination. However, we would like to see further analysis on how this could impact on overall credit support requirements and the objectives of the review before making any final conclusions in this area. We note that such an approach coupled with a shorter settlement cycle may represent options worth considering.

Finally the AEMC has sought views on whether any changes should be implemented in rules or procedures. Given that prudential arrangements need to be robust against extreme market stress conditions where distressed participants and large sums of money will be involved, it is critical that key rights and obligations are set out in the rules and provide clear guidance to NEMMCO and other participants as to what is required of them. Any procedural issues and implementation matters can then be left to the more flexible procedure mechanism which can be more easily fine tuned over time as the regime evolves.

The NGF looks forward to continuing its participation in this prudential review process, and supports the AEMC initiative to carefully review the regime in today's market context. Please contact Mr Mark Frewin, telephone 03 8628 1000, to clarify any of the matters raised above.

Yours faithfully,

Alex Cruickshank
Chair, Market Working Group