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Dr John Tamblyn
Chairman
Australian Energy Markets Commission
PO Box A2449
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Dear Dr Tamblyn,

EMO0008 – Review into the role of hedging contracts in the existing NEM prudential framework – Draft report

As the primary creditors of the NEM, the NGF members are critically interested in the ongoing credit quality of the pool. The issues under review by the Australian Energy Market Commission (AEMC) have the potential to impact on pool credit quality. NGF members are therefore highly interested in the outcomes of this review.

The review looks broadly at three areas: existing reallocation mechanisms; the prudential standard and Maximum Credit Limit (MCL) methodology; and the proposed Futures Offset Arrangement (FOA) mechanism.

NGF views on these matters are outlined below.

Existing Reallocation mechanisms

At a high level, the NGF is relatively comfortable with the direction foreshadowed in the recommendations related to the existing reallocation mechanisms.

Our only concern relates to the proposal for AEMO to inform a retailer reallocation counterparty if its generator counterparty receives a call notice and may be at risk of NEM default. We appreciate the intention of this proposal is to provide the retailer with additional time to replace the reallocation with alternative security. However, the competition consequences and inefficiencies of this information asymmetry outweigh the perceived benefit, potentially worsening the generator's position. The NGF therefore does not support this draft recommendation.

Prudential Standard and MCL Methodology

The NEM prudential standard is at the heart of the prudential framework. It is the basis for the credit support held by AEMO in relation to any pool debtors, and as such underpins the MCL. It is essential that this standard is clear and well articulated. In addition, it is important to ensure that all aspects of the prudential regime promote the standard.

Further work is required to determine the appropriate measure and definition of reasonable worst case, and the prudential standard more generally. AEMO is studying this matter as part of its own review of NEM prudential arrangements. The NGF believes that this AEMO process should take the lead on this matter over the next phase of NEM development. A further AEMC review is not desirable at this time. It is likely to be counterproductive by creating confusion and duplicating processes.

In terms of the approach set out in the draft report, the NGF cautions the AEMC about being too prescriptive about how AEMO should approach its own review. For example the AEMC should avoid specifics like setting a definitive prudential standard level at this stage. The NGF supports AEMO being able to move forward with a wide brief, having regard to the AEMC's positive work to date as well as international precedents and other factors of relevance for clearly defining an appropriate prudential standard.

We suggest the final recommendations to the MCE should simply identify AEMO as the appropriate body to undertake further work on the NEM prudential arrangements. We note that the AEMC will have the opportunity to further review the findings of the AEMO work – as any changes will need to be submitted to the AEMC for processing through the rule change procedure. This will allow a further review of any finding by the Commission at that stage.

On a related matter, the NGF considers that the Reduced MCL does not appear to meet the prudential standard. If the MCL meets the standard, then by definition the reduced MCL can not. The NGF is not suggesting the AEMC should address this issue in the context of this review. We expect that AEMO will consider this aspect of the prudential regime in its prudential review.

Futures Offset Arrangement Mechanism

In line with the principle set out above, the NGF believes that the entire NEM prudential framework must be set up to ensure that AEMO holds a secured position over parties owing funds to the pool. The security level should be at least up to the level defined in the Prudential Standard (which is under review). This is the fundamental design principle of the framework.

The proposed recommendation to introduce the FOA is not consistent with this design principle.

In our view the proposed FOA:

- replaces a secured debt position with an unsecured one;
- introduces great complexity to the prudential regime; and
- appears unlikely to deliver a product that would be attractive to retailers.

Even if these fundamental problems are put aside, the NGF does not believe it would be prudent to introduce this mechanism when the NEM prudential standard is under review. This is particularly the case when the estimated risks presented by the FOA proposal suggest it is clearly at the weak end of the NEM prudential spectrum.

Each of these issues is explored in more detail below.

FOA replaces a secured debt position with an unsecured one

The value proposition of the FOA is that a reduction in credit support would be made available to a participant that registered an FOA. This reduction is justified on the basis that the participant will be obliged under the rules to pay margin payments similar to what it may receive in margin payments under a futures contract to the NEM pool. A power of attorney arrangement over the participant's futures clearing account is proposed as a means to attempt to secure futures margin cash flows from the participant to AEMO.

The NGF remains unconvinced that the proposed arrangement would provide sufficient security over these possible margin receipts for several reasons, including:

- The retailer is not limited by the power of attorney from removing funds from its account prior to AEMO accessing them (nor is the relevant futures clearing member).
- The participant's segregated account is at risk of another unrelated participant default to the participant's clearer – bringing a new and totally unmanageable degree of risk to the NEM settlement[1].
- The participant may not have a net long futures position under this proposal meaning that in any event the positive margin from FOA registered futures positions may be overwhelmed by the negative margin payments required to satisfy unregistered short futures positions held by the participant with that clearer.

From a whole of NEM perspective, the FOA provides a reduction in the credit support required from a participant in exchange for an almost completely unsecured cash flow from registered futures contracts. This is a major divergence from the prudential framework.

At the review's public forum, the NGF suggested that placing a charge over cash flows into the segregated clearing account could increase security. A subsequent examination of the advice from Allens Arthur Robinson (AAR) has indicated this approach would be likely to be problematic; in addition, even if it could be put in place, most retailers would be unlikely to accept it.

On this basis, the NGF concludes that the reduced level of security delivered by the retailer direct FOA is unacceptable.

FOA proposal introduces great complexity into the prudential regime

A core concern with the proposed FOA model is that it is very complex and not well understood by the marketplace. The risk is that such complexity may leave loopholes that could be exploited by unscrupulous participants, increasing the risk of a large short payment to the NEM.

A lesson from the recent global financial crisis is that complex financial instruments, which are poorly understood by regulators and the marketplace, can enhance the potential for cascading financial collapse.

[1] See section 8.4(b) on page 22 of the *NEM Prudentials Review Advice on Futures Offset Arrangemetns, Allens Arthur Robinson, 22 December 2009.*

The issues raised in this submission suggest that the FOA proposal would expose the NEM to increasingly complex, non transparent and potentially significant short payment risks. The NGF is not comfortable with the exposure levels introduced by the FOA proposal.

FOA proposal appears unlikely to deliver a product that would be of interest to retailers

It is not clear to the NGF that the FOA product as specified by the AEMC would be attractive to retailers. The administrative overheads involved in the FOA proposal are high relative to the credit support reduction available.

However, it is clear that the FOA proposal will introduce additional risk to pool creditors. The marginal benefits to pool debtors, the significant costs they would face to implement the proposed FOA and the detrimental impacts on pool creditors lead the NGF to believe the proposal will not enhance the National Electricity Objective (NEO).

FOA should not be introduced due to ongoing review and likely change to NEM prudential standard

With the pool Prudential Standard and MCL methodology under review, we do not believe it would be prudent to introduce a new complex product into the NEM prudential framework at this time. Introducing the FOA at this time is premature given that:

- the work done to date on estimating the effectiveness of the FOA product against the existing regime has been controversial and far from clear; and
- any future review of the prudential standard appears likely to remove some of the weaknesses from the existing regime (eg. Reduced MCL).

Consideration of the risks associated with the FOA should be judged against improvements recommended by AEMO in its review of the prudential standard and MCL methodology.

AEMC assessment not consistent with existing NEM prudential arrangements

The AEMC seems to consider that a reinforced Prudential Margin offsets the lack of security over margin cash flows under the FOA proposal. In fact, the AEMC appears to use the additional Prudential Margin requirements as a way of disregarding the other imperfections of the FOA proposal.

The NGF does not dispute that the Prudential Margin is an important component of the existing NEM prudential regime. However, it is not the only component. The entirety of the existing regime needs to be implemented consistently in order to ensure its integrity. In particular, the NGF regards the entire MCL as an important part of the security held for each participant, not merely the Prudential Margin.

While there is a possibility that the AEMO review of the prudential arrangements may conclude that more emphasis on an enhanced Prudential Margin may be appropriate – to date no such decision has been taken. Importantly, any such change would be expected to see a significant increase in Prudential Margin requirements if it was implemented. On this basis, the FOA proposal should be designed to be consistent with the existing NEM regime, not a possible future one.

The NGF does not believe it is appropriate to introduce the FOA, based on the rationale presented to date by the Commission.

The existing NEM prudential regime already allows for the use of futures based offset products

The existing framework explicitly contemplates financial intermediaries becoming parties to the pool to allow them to lodge reallocation transactions (via the reallocator participant category). This facility was put in place to allow for innovative credit support arrangements to be developed off market and then used to offset pool credit support requirements.

This concept allows financial intermediaries to manage the complexities and commercial risks associated with using Futures or other possible mechanisms to back credit support products to pool participants.

To the extent that these parties can manage credit risks of their counterparties and meet NEM pool credit support requirements in a more efficient way than retailers alone, then they can reduce costs for retailers compared to what retailers may face in meeting pool requirements directly.

The failure of such arrangements to emerge to date has been used as evidence of some form of regulatory barrier to allow futures to be used for prudential offsets. On the contrary, the NGF view is that the failure of futures backed reallocations to emerge is due to the significant risks associated with such a structure. The costs required to cover the commercial risks involved appear to exceed the benefits a potential pool participant could receive from using these products.

NGF members are concerned that the current FOA proposal will result in these costs and risks being forced onto the NEM creditors without any due compensation. In effect, this would embed an inefficient cross-subsidy between creditors and less credit worthy participants.

In summary, the FOA proposal appears to expose pool creditors to risks that have been assessed as uncommercial by the credit provision market.

Conclusion on FOAs

The NGF does not support the draft report's conclusion that the FOA proposal should be implemented. At a fundamental level, the proposal replaces a secured debt position with an unsecured one – creating an inconsistency within, and weakening the NEM prudential framework. The NGF is unconvinced that any retailer direct model is workable or delivers benefits to retailers without detracting from the credit worthiness of the pool. In addition, that no reallocator participants operate in the market is an indication that the costs and risks of futures offsets outweigh any benefits they may deliver; it is this unacceptable risk exposure that would be passed onto the generators under the current proposal. Finally, the NGF does not believe it would be prudent or consistent with good process to introduce this mechanism when the NEM prudential standard is currently under review.

For these reasons, the NGF does not consider the FOA proposal would promote the NEO and therefore should not be implemented.

Please contact Mr Mark Frewin, telephone 03 8628 1000, to clarify any of the matters raised above.

Yours sincerely,

Malcolm Roberts
Executive Director