

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Lodged electronically: www.aemc.gov.au

Dear Dr Tamblyn

ROLE OF HEDGING CONTRACTS IN THE NEM PRUDENTIAL FRAMEWORK

Macquarie Generation appreciates the opportunity to comment on the AEMC's *Review into the Role of Hedging Contracts in the Existing NEM Prudential Framework, Draft Report*, released publicly on 19 March 2010.

Macquarie Generation supports the detailed comments in the submission lodged by the National Generators Forum to the review. In particular, we share similar concerns regarding the complexity of the proposed Futures Offset Arrangement (FOA). We believe the proposed arrangements may create loopholes in the prudential arrangements causing confusion for market participants and risks for NEM creditors. The benefits of the proposed model are likely to outweigh the costs for the market as a whole, and there is little detailed analysis of these trade-offs. The model may deliver some benefit for small, second-tier retailers but at the cost of weakening the prudential framework, particularly the generation sector.

In addition to the concerns raised by the NGF, Macquarie Generation has identified a number of specific problems that may emerge if the proposed FOA arrangements are implemented in the proposed form.

Potential misuse of FOA contracts

The proposed FOAs provide an incentive for retailers to lodge futures contracts to reduce the quantum of bank guarantees held with AEMO. The level of any reduction in guarantees is determined by the Futures Lodgement Price (FLP) and Maximum Credit Limit (MCL).

It may make commercial sense for a retailer to minimise the FLP with the primary purpose of reducing its bank guarantee requirement.

By way of example, a retailer entering a \$0 contract will completely reduce its bank guarantee for the volume of electricity nominated in that transaction. Counterparties can agree a futures contract with a \$0 FLP through a block trade facility. These contracts are generally organised through a broking facility.

The counterparty to this arrangement would need some incentive to agree to this deal. A retailer could pay the counterparty a small fee or margin in order to encourage cooperation, potentially another small second tier retailer. This is more likely if the counterparty is facing some degree of financial stress. In this example, retailer A would lodge a 100MW buy and sell contract with retailer B for \$0. Retailer B would lodge a 100MW sell and buy contract for \$0. The net effect is that both retailers have reduced their prudential requirements without hedging their positions.

This example could be extended to an arrangement between a retailer and generator counterparty. Again, the retailer initiates two futures contracts with a generator through a broker. One contract is to buy a load profile from the generator with a strike price of \$0. At the same time, the retailer enters into a sell contract with the same counterparty using the same load profile with a strike price of \$0. The generator may be willing to agree to this deal if the retailer pays the generator a separate fee to encourage cooperation. The fee may be small but provides a guaranteed return for the generator.

We are concerned that the FOA may create opportunities for counterparties to construct artificial positions to minimise prudential obligations. These types of arrangement could damage the overall prudential quality of the market and expose all NEM creditors to further loss in a default event.

Inadequate penalties for failure

The Draft Report recommends three measures that would take effect in the event of a retailer default. We share the NGF's concerns that the "power of attorney" provision may not be effective in the event that retailer becomes insolvent but may still be able to redirect funds prior to the AEMO taking action to exercise its right to access those funds.

We also have concerns with the third measure, the "requirement on retailers to comply with terms and conditions of the FOA, failure of which could result in the termination of an FOA".

We believe this penalty is far from sufficient to protect the prudential quality of the NEM. If a retailer cannot meet terms and conditions of an FOA, we are not confident that it will be able to satisfy the terms and conditions of all other FOAs held by that retailer. We believe that if the FOA proposal is implemented, it would be prudent to terminate all other FOAs held by AEMO relating to the defaulting retailer. This would reduce the incentive for retailers to misuse FOAs by entering into contracts that have the primary purpose of lowering their prudential obligations.

Inefficiency in information provision

Under the proposed FOA mechanism, AEMO has no knowledge of the net futures position of a retailer. This enables a retailer to lodge a FOA even if it holds a negative net position. To improve information transparency, it might be helpful for retailers to use separate SFE clearing participants with one being used solely for FOAs.

Under this arrangement, AEMO would need the right to obtain information from the clearer participant about the net position of the retailer. This improvement in information disclosure would most likely require further changes to the NEM Rules. The AEMC would need to consider a legal structure that would give AEMO the right to access such information and specify the obligations on the clearer participant to report that information to AEMO.

Review timing

AEMO is currently reviewing the MCL methodology for all NEM transactions. This review could potentially result in significant changes to the overall quantum of credit support held in the NEM. Finalising and implementing a FOA mechanism before the completion of this review may introduce inconsistencies in the prudential framework.

Yours sincerely

 2/5/2010

Mr Tim Allen
Energy Trading Manager