



30 April 2010

Dr John Tamblyn  
Australian Energy Market Commission  
Level 5  
201 Elizabeth Street  
Sydney NSW 2000

By electronic submission: [www.aemc.gov.au](http://www.aemc.gov.au)

Dear Dr Tamblyn

**EMO0008 - Review into the role of hedging contracts in the existing NEM prudential framework - Draft Report**

Origin Energy Limited (Origin) welcomes the opportunity to provide a submission to the AEMC's Draft Report to the NEM prudential framework review.

Origin appreciates the AEMC's efforts on considering and making recommendations in this complicated area of the market. We have some concerns, however, with three of the key recommendations set out in the draft report.

First, we consider that the proposed FOA mechanism is overly complicated with a high administrative overhead for prospective users. Retailers may discount its value accordingly. In addition, given the concessions made to address termination risk and surety of payment issues, it is unclear whether the FOA proposal would ultimately deliver sufficient benefits to promote the National Electricity Objective (NEO).

Second, Origin does not support the proposed solution to manage the termination risk to retailers under reallocations. In principle, the proposal to provide advanced notice to a retailer of counter-party potentially close to a NEM default may be favourable. In practice, however, providing such notice to another market participant may raise more problems than it solves, including potential competition issues.

Lastly, we agree that the Australian Energy Market Operator (AEMO) is best placed to advise on the appropriateness of the existing prudential regime and recommend improvements. We do not consider it necessary for the AEMC to provide specific recommendations on the regime to the Ministerial Council on Energy (MCE). Doing so may unintentionally constrain AEMO's spectrum of options, potentially resulting in less efficient recommendations than may have otherwise been the case.

We discuss these issues in more detail below.

**Future offset arrangements**

We consider that the proposed FOA appears to be an overly complicated mechanism with a high administrative overhead for prospective users. Part of the complexity arises from



the model modifications to manage some of the risks around termination and surety of payment. Such complexity and the associated costs may make it a less attractive offset option for retailers. If few retailers are likely to use the mechanism due to its limited benefits and added complexity, it becomes unclear whether the FOA proposal could ultimately deliver sufficient benefits to promote the NEO.

In addition, some of the complex modifications may not be sufficient to mitigate the risks they seek to address. A relevant example is the proposed power of attorney amendment, which is proposed to address the possible payment shortfall in the case of an FOA counter-party default. The modification requires the retailer to grant AEMO with a power of attorney to direct monies from the SFE-related Client Segregated Account (CSA) into its corresponding NEM Security Deposit Account (SDA).

A power of attorney is unable to manage the risk if there are insufficient funds in the CSA, however. Such a situation could arise if another SFE counter-party defaults on its payments into the CSA, leaving the account short. It also does not manage the risk of the retailer issuing alternative directions to the SFCEP to pay funds to an account other than the SDA. While there may be penalties for the retailer, in the interim, the retailer's outstandings may breach its prudential guarantees. This may leave NEM settlement short.

Origin also suggests that the proposed FOAs are unnecessary. The current National Electricity Rules (NER) already allow for FOAs to be used in the prudential regime through a registered "reallocator". In 2007, the "reallocator" participant was established for the purposes of registered entities, like financial clearing houses, to participate in the NEM prudential regime.

We note that, to date, no one has registered using the reallocator category. The absence of reallocators may suggest the complexities and risks of incorporating futures directly into the NEM arrangements may outweigh any potential benefits. As the AEMC states, "the [SFE Clearing Participants] are...reluctant to be bound by the NEM Rules and take on the obligations". The complexities of managing termination risks and surety of payment as a reallocator do not disappear under the proposed FOAs; these risks are simply transferred from the reallocator to other NEM Registered Participants. We do not believe this transfer of risk is efficient, particularly if risks end up with participants less able to manage them when compared to the reallocator.

For these reasons, Origin does not support the proposed FOAs.

### **Termination risk to retailers under reallocations**

To assist retailers in managing the termination risk under reallocations, the AEMC has recommended that AEMO should be able to notify a retailer reallocation party of a call notice issued to the counter-party of the reallocation. While advanced notification may provide extra time for the retailer to source additional prudential coverage should its counter-party default, it may unintentionally give rise to some competition issues.

From the counter-party's perspective, they may be engaging in delicate conversations with the banks to manage their precarious financial position to avoid NEM default. Having the retailer know potential distress of its counter-party may make it more challenging for the counter-party to obtain the necessary credit to remain solvent if the retailer's actions to secure additional prudential coverage are noticed by others trading in the financial markets. If the counter-party is considered a default risk, it may be unable to



obtain the financial support to avoid default, thus NEM default becomes a self-fulfilling prophecy. The NEM is better off if it can reduce the risk of participant defaults.

There may also be anti-competitive and possibly insider-trading implications. If a retailer takes action to secure additional bank guarantees to cover its reallocation, is it considered to be trading on insider information? The AEMC noted that early warnings may be limited by confidentiality requirements, but it does not appear to have considered the potential competition implications. The AEMC may want to seek advice from the ACCC.

In addition, when using a reallocation to offset a prudential requirement, a prudent retailer should assume a certain level of counter-party default risk. The degree of the risk depends on a number of factors, including the credit-worthiness of the counter-party. The retailer's internal risk management processes establish appropriate risk tolerances and parameters that inform contracting decisions. Retailers should therefore factor into their reallocation decision-making the potential for counter-party default and manage their portfolio accordingly.

As a result, Origin considers that, in principle, advanced notice may seem to assist retailers but the practical consequences of the recommendation are likely to raise more substantive problems compared to the potential benefit. We do not support the proposal.

#### **MCL methodology and definition of "reasonable worst case"**

The AEMC recommends that the AEMO is best placed to advise on the appropriateness of the existing prudential regime and recommend improvements. Origin agrees and notes that AEMO's current work on the prudential framework has identified some possible shortfalls with the existing arrangements.

In order for AEMO to recommend a comprehensive and effective prudential regime, it needs sufficient flexibility to consider a spectrum of possible options. As such, the AEMC needs to be careful that its recommendations to the MCE do not constrain AEMO's scope unintentionally. The AEMC's draft recommendation on the appropriate prudential margin level for the reasonable worst case scenario is an example of a limiting proposal. We note the AEMC may want to identify its views if it were to progress its own analysis. We suggest, however, that the AEMC's Final Report to the MCE should not go beyond a recommendation for AEMO to be responsible for further work on setting an appropriate MCL methodology and defining the "reasonable worst case".

#### **Further information**

If you have any questions or would like to discuss this submission, please contact me on (02) 8345 5250 or Hannah Cole on (02) 8345 5500.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Tim O'Grady".

Tim O'Grady  
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Corporate Affairs