NATIONAL GENERATORS FORUM

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

By email: submissions@aemc.gov.au

Your Reference: EMO0008

Dear Dr Tamblyn,

Review into the role of hedging contracts in the existing NEM prudential framework – Comments on draft PricewaterhouseCoopers report

The National Generators Forum ("NGF") represents market facing generators in the National Electricity Market ("NEM"). As such, it is keenly interested in developments affecting the NEM pool and appreciates the opportunities to comment on the draft report on the *Role of hedging contracts in the existing NEM prudential framework* prepared by PricewaterhouseCoopers ("PwC").

Background to the review and NGF's key interest

The NGF has taken a proactive role in participating in the AEMC's current review into the role of hedging contracts in the existing NEM prudential framework ("review"). This has included participating in the AEMC advisory working group and lodging submissions to the various consultations relating to the review to date.

As we have previously stated, our interest is that any changes to the NEM prudential framework do not reduce the credit quality of the NEM. Subject to this threshold issue being met, the NGF would support enhancements to the framework that increase its efficiency and effectiveness.

Given the potential for misconceived changes adversely affecting pool credit quality and therefore increasing the risk of short payments to generators, the NGF supports the AEMC's comprehensive approach to the review to date.

NGF approach to reviewing the PwC report

The NGF has engaged a consortium consisting of Seed Advisory and Taylor Fry ("the Advisors") to review the numerical analysis undertaken by PwC and identify any outstanding risks that have not been identified in the PwC report. The NGF's Terms of Reference to the Advisors are included in Appendix A of their report.

Given the timeframe available for this review, the Advisors were limited to reviewing the information presented in the PwC report and the models proposed by the AEMC. They were not been asked to remodel or replicate the data analysis performed by PwC.

However, given their combined experience in NEM credit management and their Actuarial credentials, the Advisors have provided a thorough critical analysis of the PwC report, as well as suggested avenues for addressing its shortcomings and taking forward the AEMC work plan. The Advisors' report is attached for the AEMC's consideration.

While the Advisors' report speaks for itself, the NGF has developed the following views on the issues reviewed by PwC.

Summary of key NGF positions

After considering the PwC report and the report of the Advisors, the NGF has the following views:

- The PwC report has not adequately made the case that futures offset arrangements would provide sufficient security to warrant the proposed reduction in retailer credit support. Threshold legal questions around the FOA remain unresolved. The proposal to add an additional day to the prudential margin in order to manage additional risks is not appropriate and unlikely to be effective.

- A clearer definition, or consensus interpretation of the "reasonable worst case" definition under the rules is required to adequately assess the alternate MCL proposals. Preliminary analysis by PwC indicates a change to a more forward looking approach to MCL determination may be warranted.

- Existing reallocation arrangements appear adequate. However, further exploration of AEMO's termination right appears warranted.

Each of these recommendations is expanded on below.

Futures Offset Arrangements

In order to support a futures offset arrangement, the NGF would required several key issues to be addressed:

- *Threshold legal issues*

Prudential arrangements in the NEM must be structured to withstand legal challenge by the creditors or administrators of a participant in the event of a default. To date, the AEMC has not made available for review a detailed legal review of the proposal.

In the absence of such a review, the NGF is unable to support the Futures Offset proposal in its current form. This is because currently secured credit support is to be replaced by an unsecured promise of future payments by FOA users which appears both commercially unsound and highly susceptible to legal challenge. The Advisors are also concerned that there is a risk that SFE clearers may be able to make some residual claim over positive margins paid into an AEMO SDA in the event of default of a retailer using an FOA.

The NGF would require clarity on who may have claims over funds sourced from futures margin in the event of a participant default before considering whether to support the proposal. This is a threshold matter.

We agree that PwC is not able to address this question and an independent legal view is required.

- *Demonstration of a close relationship between futures margin and pool outstandings*

  PwC's analysis is insufficient to establish the existence of a strong and reliable relationship between futures margin and pool outstandings.

  One of the key objectives of the PwC analysis was to determine that the cashflows expected from futures margin would be sufficiently related to the pool outstandings of a retailer for it to be regarded as adequate security to warrant a reduction in the participants MCL.

  As outlined in the attached report by the NGF's Advisors, the approach taken by PwC does not provide sufficient evidence to establish the existence of such a relationship. Of particular concern, the PwC analysis fails to adequately explore the frequency and scale of occasions when the outstandings exceed the margin cashflows, despite the graphs presented showing significant value at risk in such events. In particular, the Advisors identified that the PwC analysis focused on a single special case FOA scenario and did not review the full range of scenarios that could be expected under live FOA usage.

  The Advisors' report identifies a range of other detailed concerns, which would need to be addressed before the NGF would be in a position to determine if the margin cashflows would represent a sufficient hedge against outstandings to warrant any MCL reduction.

- *Compelling evidence that NEM risk profile is not negatively impacted.*

  In addition to inadequacies in the PwC numerical analysis, the PwC report seems to gloss over a range of other risks, as well as failing to identify other matters identified by the Advisors,. This seems to be on the basis of a view that one additional day of Prudential Margin would cover any exposures created by the FOA proposal.

The NGF's Advisors have pointed out that the proposed solution of adding an additional day's MCL to the Prudential Margin is likely to be inadequate given that the likely loss in the event of a default is likely to coincide with high pool prices.

While some may argue that this risk is inherent in the existing prudential framework, and therefore the PwC recommendation does not lead to a deterioration of the current NEM prudential framework, the NGF does not support decision making on this basis.

If, as indicated by PwC and the Advisors, there are gaps in the existing framework, the AEMC should focus on addressing them and certainly not on expanding their scope.

The NGF recommends that weaknesses in the existing framework identified in the course of this review be urgently addressed by the AEMC. An approach to achieve this is outlined in the Advisors' discussion of MCL's.

PwC's recommendation that adding an existing day to the Prudential Margin would address any risks created by the FOA is not accepted by the NGF.

As a general comment, we are concerned that the model assessed by PwC is not Model 2 and is not clearly stated. We suggest that PwC should mark up the AEMC's Model 2 specification (on which their variant is based) and augment this with all of the other recommendations and changes they have proposed should be adopted. Such a clear statement would enhance the market's ability to properly understand the model that has been assessed.

Maximum Credit Limit Approach

More work is required in this area., However, the preliminary analysis put forward by PwC indicates that the existing mechanism is far from ideal, and an alternate approach – potentially based on futures based forward pricing estimate - deserves further exploration. Some element of stress test built into MCL's could also warrant further evaluation.

To its credit, the AEMC has identified that a lack of clarity in the rules definition of "reasonable worst case" is a serious problem in assessing the effectiveness and appropriateness of existing and proposed prudential arrangements.

The Advisors have echoed this concern, and articulated a standard framework for credit assessment that could be of interest to the Commission in future work on MCL's. In particular, we note that they have outlined conceptually the elements that would be expected to be contained within a "tighter" definition of "reasonable worst case". Consideration should be given to clarifying the rules definition of the prudential standard the NEM aims to achieve.

In relation to the PwC report, the NGF remains uncomfortable with the proposed 98 percentile interpretation of the current rules definition. In the language of the Advisors, this would appear to ignore the "long tail" nature of the loss distribution. From an NGF point of view, we remain concerned that the 98 percentile (particularly if taken on a time basis and not on an outstandings basis), is likely to leave the NEM exposed to typical peak pricing periods that occur regularly and are a necessary and predictable feature of the Energy Only Market, but whose frequency is likely to fall outside the 98 percentile definition.

A clearer definition, or at least a more commonly accepted interpretation, of "reasonable worst case" is required to allow proper evaluation of the various MCL approaches, the FOA and any other aspects of the prudential regime. The AEMC should pursue such a common understanding.

The Advisors have also identified that the use of annual measures for effectiveness and efficiency of the various MCL mechanisms used in the PwC report should be replaced with a weekly estimate to bring out those times when effectiveness and efficiency may be less than desired.

Reallocations

The NGF remains comfortable with the existing reallocation approach, but notes that PwC has indicated that there remains a low probability risk associated with the cascading default of a retailer following the execution by AEMO of its option to terminate a reallocation following a generator default.

While, in theory, this termination right may offer some protection to pool creditors, it is not clear that AEMO would have sufficient information about the financial position of reallocation counterparties to be sure that such an act would be beneficial rather than detrimental to pool creditors. A more detailed review of this right to determine if it does add to the NEM objective is supported.

We also note that PWC has suggested a review of the NEM rules to clarify AEMO's role and involvement in Swaps and Options. While the NGF strongly supports formula based reallocations, it recommends that the AEMC clarifies the issues raised by PwC in this area to ensure they do not adversely impact on clawback risk or present barriers to the timely implementation of formula based reallocation.

Please contact Mark Frewin via (03) 8628 1000 for further discussion of this matter.

Your Sincerely,

M. Roberts

Malcolm Roberts
<u>Executive Director</u>