30 April 2010

Dr John Tamblyn
Mr Neville Henderson
Mr Brian Spalding
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Commissioners

Re: Review into the Role of Hedging Contracts in the Existing NEM Prudential Framework

Introduction

Loy Yang Marketing Management Company (LYMMCo) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) Review into the Role of Hedging Contracts in the Existing NEM Prudential Framework (the Review), draft report.

LYMMCo trades the largest single privately-owned generator in the National Electricity Market (NEM). In total, LYMMCo dispatches in excess of 2,200 MW which represents around one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia. LYMMCo actively trades multiples of its capacity in the forward contracts market.

As creditors of the NEM pool, LYMMCo shares the concerns of other generators that some of the proposed changes in the draft report increase risk to market participants and undermine credit pool quality. Our views on the relevant matters contained in the draft report are set out below.

Reasonable worst case scenario and alternative Maximum Credit Limit (MCL) methodologies

The prudential margin, trading limit and MCL underpin the NEM prudential framework. It is essential that the prudential margin, trading limit, reasonable worst case and MCL are clear, well articulated and fit for purpose. Given the AEMC's analysis is inconclusive; LYMMCo:

- supports the absence of AEMC recommendations on the interpretation of "reasonable worse case" scenario or an alternative MCL methodology;
- supports consideration of the AEMC's options by the Australian Energy Market Operator (AEMO) as part of its separate review on prudential matters;
- supports the development of a rule change, if appropriate, by AEMO;
- does not support a further AEMC review at this time;
- believe the AEMC should consider the outcomes of the AEMO review in light of any proposed rule changes or substantial changes in the conclusiveness of the wider analysis surrounding the interpretation of "reasonable worse case" scenario or an alternative MCL methodology;

- is concerned that the AEMC's analysis, as outlined, is overly prescriptive and limits AEMO's willingness to consider alternative proposals and other factors which may be relevant; and
- supports the AEMC's rigorous assessment of any potential AEMO submitted rule change.

Reallocation Arrangements

LYMMCo has been a significant participant in the reallocation mechanisms for the past five years. LYMMCo remains comfortable with existing reallocation arrangements; however, we do not consider it appropriate for the AEMO to play a role in advising retailers of the possibility of default risk.

When entering into transactions, parties are already aware of the possibility of default risk. This is a feature of nearly all forms of credit extension including reallocation arrangements. Therefore, the use of reallocation will have an impact on default risk that all relevant parties need to factor into their decision-making process.

Hence, we do not see it as appropriate for AEMO to play the role of pseudo-advisor on the default risk for retailers or it appropriate for AEMO to be in a position to be making assessments of a generators potential to be at risk of default in what are essentially commercially determined arrangements. Furthermore, the potential for distorting outcomes and disputes, raises further concerns that outweigh any perceived benefit of this recommendation.

Futures Offset Arrangements (FOAs)

LYMMCo holds the view that the retailer direct FOAs are unworkable and unacceptable.

LYMMCo requires that the entire NEM prudential framework is set up to ensure that AEMO holds a secured position over parties owing funds to the pool at least up to the required standard. This is a fundamental requirement of participants and ensures confidence in the prudential framework.

Notwithstanding the potential erosion of this position through tools such as the Reduced MCL, it should not be assumed that changes to the prudential framework will not have the effect of significantly undermining the integrity of the credit pool and the confidence of market participants. LYMMCo suggests that FOAs may have a negative effect on the prudential framework and therefore do not support their introduction.

It is LYMMCo's belief, as shared with a significant number of generators, that the FOA proposal:

- would have the effect of using unsecured positions in place of secured debt positions;
- does not fit with the current prudential framework and has the effect of increasing complexity, including the use of complex financial instruments, for little, if any, benefit despite a definite increase in risk;
- represents a large administrative cost with a modest size in the reduction in credit support available, which is unlikely to be beneficial to retailers as was originally conceived;
- would increase weakness in the NEM prudential regime at a time when steps should be taken to maintain the quality of the credit pool;
- exposes NEM participants to a range of Sydney Futures Exchange risks that are new to NEM participants and potentially unmanageable (despite the integrity of that exchange's prudential framework), including:
    - may not have the effect of limiting the retailer's ability to remove funds sought by AEMO despite the imposition of a power of attorney;
    - a participants segregated account is at risk of another unrelated participant's default to the participant's clearer; and

    - a participant may not have a net long futures position, meaning that in any event the positive margin from FOAs registered futures positions may be overwhelmed by negative margin payments required to satisfy unregistered short futures positions held by the participant with that clearer.

- has the net effect of reducing NEM credit support in exchange for a less secure form of cash flow from registered futures contracts;
- has the potential to permit participant behaviour that could increase the risk of a large short payment to the NEM;
- has not been proposed in a way that gives generators comfort – both the power of attorney and the additional prudential margin requirements fail to satisfy our concerns;
- creates additional exposure to the credit quality of those retailers carrying the highest levels of risk;
- does not have a demonstrated place in the NEM; and
- does not meet the appropriate cost-benefit criteria to meet the National Electricity Objective.

Conclusions

Despite being mostly limited to certain classes of participant the existing reallocation arrangements function effectively and attract significant interest in the right circumstances. Creating additional complexity and more cost for generators may have unintended effects on the availability of reallocation arrangements overall.

While LYMMCo endorses the AEMC's approach to reallocation arrangements at a high-level and supports the recommendation that further work be undertaken by AEMO on the operation of the prudential framework we remain concerned with the proposal to allow for the use of FOAs. On that basis, we strongly recommend the AEMC not progress to recommending the introduction of FOAs due the increased risk exposure and reduction in the quality of the credit pool.

If you have any queries in relation to this submission please do not hesitate to contact me on, telephone (02) 9612 2236, or email: jamie_lowe@lymmco.com.au.

Yours faithfully,

Jamie Lowe
Manager, Regulation and Market Development