



Eraring energy

10 October 2006

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RECEIVED
12 OCT 2006

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Dear Dr Tamblyn

Timing of Proposed Boundary Changes in the Snowy Region

Eraring Energy wishes to thank the AEMC for the opportunity given to comment on the above subject. The AEMC have specifically asked what steps participants would need to take to adjust to a new regional boundary structure and the timeframes they would require for implementation.

Eraring Energy has two distinct issues to consider as a result of potential boundary changes.

1. Changes to Market Trading IT Systems

Eraring Energy market trading IT systems would need to be modified to cater for any new regional boundary structure. It is expected that these changes can be carried out within 12 months from the date of final determination. Eraring Energy understands that in accordance with the clause 3.5.3 (b) of National Electricity Market Rules, at least one year advance notice must be given to participants for changes to regional boundaries.

2. Implications for Existing Derivative Contracts

Eraring Energy has sought legal advice to determine the implications to existing derivative contracts due to regional boundary changes.

All of the Eraring Energy derivative contracts are governed by International Swap and Derivative Association (ISDA) Master Agreements. Eraring Energy understands that this is the case for most of the derivative

contracts in the National Electricity Market. ISDA Master Agreements include provisions for "*market disruption events*".

Legal advice received by Eraring Energy confirmed that each of the boundary change proposals being considered by the AEMC for the Snowy Region can be treated as a "*market disruption event*". A copy of the legal advice is attached to this document.

When a market disruption event occurs, it is dealt with by way of "*disruption fallbacks*" as specified in the ISDA Master Agreements. This may be a lengthy process requiring significant time and resources from both parties to a derivative contract depending on the materiality of the regional boundary change. The boundary change proposal by Macquarie Generation would have greater materiality than that proposed by Snowy Hydro due the inclusion of loads in southern NSW and northern Victoria.

Whilst there may be large number of derivative contracts entered into for the next year, the number of contracts may be significantly lower for subsequent years in a declining fashion. Thus, although it is impossible to totally avoid, it is possible to minimise the number of affected contracts by providing participants with a longer duration between the final determination date and the implementation date.

Eraring Energy suggests that an implementation date of 1st January 2009 would give adequate prior notice provided the AEMC make the determinations as planned. Such implementation date would provide participants approximately 20 months from the date of the final determination to prepare for the regional boundary change implementation.

Conclusion :

Eraring Energy recommends that the implementation of any changes to the Snowy Region boundary commence no earlier than 1st January 2009.

Yours sincerely



Stephan Boras
General Manager Trading

Encl : Copy of the legal advice from Norton Gledhill

Norton Gledhill

COMMERCIAL LAWYERS

ERARING ENERGY REGIONAL BOUNDARY CHANGE EFFECT ON ELECTRICITY DERIVATIVES

Background

1. The Australian Energy Markets Commission (AEMC) is undertaking consultation on two proposals to change the boundaries of the Snowy region. One proposal involves re-assigning Murray load into the Victorian region and re-assigning Tumut load into the New South Wales region, resulting in the disappearance of the Snowy region (**Snowy Proposal**). The other proposal involves re-assigning Murray load and some Victorian load into a new Northern Victoria region and re-assigning Tumut load and some New South Wales load into a new South West New South Wales region, resulting also in the disappearance of the Snowy region (**Macquarie Proposal**).
2. In this paper I consider the effect of any such regional boundary change on electricity derivatives governed by an ISDA Master Agreement.

Market Disruption Event

3. ISDA Master Agreements provide for 'Market Disruption Events.' These are events that, if applicable to a derivative governed by the ISDA Master Agreement, will give rise to an alternative basis for determining the ongoing floating price under the derivative or, possibly, the termination of the derivative.
4. It is very common for ISDA Master Agreements governing electricity derivatives to include the following provisions:

The Market Disruption Events which apply to a Commodity Transaction are:

(A) *Price Source Disruption;*

...

(D) *where a Specified Price for that Commodity Transaction is a spot price (as defined in the National Electricity Rules) at a regional reference node (as defined in the National Electricity Rules), the occurrence after the Trade Date of the Commodity Transaction of a change in the location of that regional reference node or a change in the boundaries or the number of regional reference nodes of the region (as defined in the National Electricity Rules) in which that regional reference node is located.*¹

5. The provisions are difficult to read because they use terminology unique to either the ISDA Master Agreement or to the National Electricity Rules (**Rules**). However, in substance, their effect is that, for any electricity derivative concerned with spot prices at a regional reference node, there will be a Market Disruption Event if, after the electricity derivative is entered into, either:
 - (a) NEMMCO fails to publish such spot prices; or

¹ One reason why these provisions are very commonly included in ISDA Master Agreements governing electricity derivatives is because they are recommended by the Australian Financial Market Association electricity working group.

- (b) there is a change in the location of that node, a change in the boundaries of the region in which the node is located, or a change in the number of nodes in that region.
6. With either the Snowy Proposal or the Macquarie Proposal, there will be Market Disruption Events. That would be the case, for example, for any electricity derivative concerned with spot prices:
- (a) at the Snowy regional reference node. This is because, under both the Snowy Proposal and the Macquarie Proposal, after implementation there will not be a Snowy region nor a Snowy regional reference node, and therefore NEMMCO must fail to publish spot prices at the Snowy regional reference node: this is 'Price Source Disruption.'²
- (b) at the Thomastown or Sydney West regional reference node. This is because one aspect of each of the Snowy Proposal and the Macquarie Proposal is that there will be a change in the boundaries of the Victorian region and of the New South Wales region.
7. If the Snowy Proposal or the Macquarie Proposal is implemented in early November 2007, as I understand NEMMCO has indicated it could be, then this would be an issue for any electricity derivatives entered into before then. Given that it is not uncommon for electricity derivatives to have a term of 3 years, and some electricity derivatives have terms that are even longer than that, there would be Market Disruption Events in respect of many electricity derivatives.

Disruption Fallbacks

8. When a Market Disruption Event occurs in respect of a derivative governed by an ISDA Master Agreement, it is dealt with by way of 'Disruption Fallbacks.'³ These are methods that may give rise to an alternative basis for determining the ongoing floating price under the derivative or, possibly, the termination of the derivative.⁴
9. Under ISDA Master Agreements governing electricity derivatives, it is very common for there to be two Disruption Fallbacks: 'Negotiated Fallback' and 'Calculation Agent Determination.'
10. Negotiated Fallback would require each party to an electricity derivative to negotiate with the other in good faith, promptly following the Market Disruption Event constituted by the implementation of the Snowy Proposal or the Macquarie Proposal. The aim of the negotiations would be to agree on an ongoing spot or other floating price, or a method of determining an ongoing spot or other floating price, which would apply to the electricity derivative after the Market Disruption Event. The negotiations would have to continue for at least 5 business days.

² A contrary view is that, in this scenario, there is no "failure" by NEMMCO, given that the reason no spot prices at the Snowy regional reference node would be published is the disappearance of the Snowy region, brought about deliberately and the result of the AEMC's consultation and changes to the Rules. If that view were correct then, under the common law, an electricity derivative concerned with a spot prices at the Snowy regional reference node may be frustrated: this would terminate the electricity derivative automatically by operation of law and the parties may be excused from further performance of their obligations under the electricity derivative.

³ The role of determining whether a Market Disruption Events has occurred is vested in whichever party (or third party) has been appointed as Calculation Agent for general purposes (as opposed to the expert appointed as Calculation Agent for the specific purpose of Calculation Agent Determination (see point 12 below)). The general purpose Calculation Agent must act in good faith and its determination that a Market Disruption Event has occurred is binding in the absence of manifest error. Under market conventions, floating price payers under electricity derivatives are normally appointed as the general purpose Calculation Agent.

⁴ Disruption Fallbacks aim for a new floating price or method of calculating a floating price. But in effect fixed prices can be changed. For example, the new floating price might be the floating price published by NEMMCO less \$2/MWh. That is effectively the same as an increase in the fixed price of \$2/MWh.

11. If the negotiations were unsuccessful, the second Disruption Fallback, Calculation Agent Determination, would apply.
12. Under ISDA Master Agreements governing electricity derivatives, it is very common for the Calculation Agent for these purposes to be an expert selected by the parties. If the parties are unable to agree on an expert, either party is able to request that the chief executive officer of the Australian Financial Market Association appoint an expert. The Calculation Agent acts as an expert (and not as an arbitrator).
13. Calculation Agent Determination would involve the expert determining an ongoing spot or other floating price, or a method of determining an ongoing spot or other floating price, which would apply to the electricity derivative after the Market Disruption Event.
14. In my view it is not possible to predict with confidence what the outcome of Negotiated Fallback or Calculation Agent Determination might be. In part, this is because the provisions do not provide any concrete indication as to what the result of the negotiations or the determination should be. For example, the provisions do not suggest that each party should be in the same or no worse a financial position vis-à-vis the other after the Disruption Fallback, nor that the outcome of the Disruption Fallback must not materially adversely affect either party. In effect, the matter of the ongoing spot or other floating price under electricity derivatives would be at large.
15. It is possible, therefore, that parties to electricity derivatives might make contentions along the following lines, either in Negotiated Fallback or in Calculation Agent Determination, or that the Calculation Agent will independently identify the following possibilities:
 - (a) for electricity derivatives previously concerned with the spot price at the Snowy regional reference node, the ongoing floating price should be derived somehow from spot prices at the Thomastown and Sydney West regional reference nodes (in the case of the Snowy Proposal) or spot prices at the new Northern Victoria and South West New South Wales regional reference nodes (in the case of the Macquarie Proposal). Different contentions could be made as to how the ongoing floating price should be derived from those spot prices;
 - (b) for electricity derivatives concerned with the spot price at the Sydney West or Thomastown regional reference node:
 - (1) there should be no change to the ongoing spot price if, in the wholesale market, the parties continue to buy and sell electricity at the same ongoing spot price at the Sydney West or Thomastown regional reference node, as the case may be, one as a retailer buying from NEMMCO and the other as a generator selling to NEMMCO, so that their electricity derivative remains in effect an effective hedge in respect of those spot prices;
 - (2) there should be a change to the ongoing spot price, referable to changes to loss factors applicable to each party's load in the wholesale market; and
 - (3) there should be a change to the ongoing spot price, referable to step changes in ongoing spot prices at the Sydney West and Thomastown regional reference node likely to result from either the Snowy Proposal or the Macquarie Proposal.
16. These possibilities highlight that parties to electricity derivatives may face considerable commercial uncertainty as to what their position under those electricity derivatives will be, if the Snowy Proposal or the Macquarie Proposal is implemented before those electricity derivatives expire.

17. I should also mention a final possible Disruption Fallback: 'No Fault Termination.'
18. Under some ISDA Master Agreements, No Fault Termination may be the second Disruption Fallback after Negotiated Fallback, rather than Calculation Agent Determination.
19. Under No Fault Termination, electricity derivatives would be terminated in accordance with the close-out provisions of the ISDA Master Agreement, an outcome I expect parties to electricity derivatives would strongly prefer to resist.
20. Close out essentially would involve a determination of the extent to which, at or soon after the time of the Market Disruption Event, the electricity derivatives were in or out of the money from the viewpoint of each party. A payment would be required of one of the parties, in effect designed to compensate the other for the loss the other party would incur if that other party had to re-enter the market and replace the terminated electricity derivatives.



Peter Nelson
NORTON GLEDHILL
10 October 2006