



The Chairman
The Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

Dear Sir

Re: Review into the role of hedging contracts in the existing NEM prudential framework

Seed Advisory Pty Ltd (Seed) and Taylor Fry Actuaries Pty Ltd (Taylor Fry) attach the following submission relating to the Australian Energy Markets Commission's (AEMC) Draft Report, *Review into the Role of Hedging Contracts in the Existing NEM Prudential Framework*, released on 19 March 2010. This submission reflects Seed's and Taylor Fry's own views on the issues raised by the AEMC's Draft Report relating to Futures Offset Arrangements. Seed and Taylor Fry have not been commissioned by a client to undertake this work or prepare this response.

If you have any questions about any element of this response, please do not hesitate to contact Patricia Boyce or Peter Eben on 03 9653 9460.

Yours sincerely

Patricia Boyce
Director



Submission

The assessment criteria

In preparing its Draft Report, the Australian Energy Markets Commission (AEMC) considered that:

The options for enhancement of the operation and efficiency of the [National Electricity Market (NEM)] prudential framework [should]:

- Promote the National Electricity Objective (NEO);
- Have regard to relevant [Ministerial Council on Energy] statements of policy principles; and
- Are consistent with the assessment criteria established for the Review following stakeholder consultation:
 - Prudential quality of the NEM
 - Cost of capital to trade in the NEM wholesale market; and
 - Operational effectiveness¹.

In the light of the AEMC's conclusion that the modified Futures Offset Arrangements (FOAs) present only a marginal benefit to a participating retailer depending on the quarter modelled when considered under the Reduced Maximum Credit Limit², we believe that the most significant of these criteria is that relating to the prudential quality of the NEM. If the reduction in the prudential quality of the NEM has the potential to be significant and the benefits to retailers are small, then, in our view, the proposal fails the NEO test.

The need to consider the potential effects of a participant failure

To understand the potential effects on the prudential quality of the NEM, the AEMC should give detailed consideration to the issues arising from the potential failure of a retailer using FOAs in the event of a default in the electricity spot market operated by the Australian Energy Markets Operator (AEMO). The practical effects of the introduction of the FOA should be clearly understood before the implementation of the recommendations of the Draft Report.

- As the AEMC acknowledges, a strong prudential regime is a necessary requirement for confidence in the NEM wholesale market and in ensuring that electricity spot market prices do not price in credit risk, to maximise the economic efficiency of the current market design³.
- The experience of other electricity wholesale markets, where the market operator has had to manage substantial participant failures, is relevant. In those markets, the size and nature of acceptable securities required from market participants is a significant issue for market operators and the relevant regulator.
 - In the USA, where a number of the wholesale electricity markets similar to the NEM have experienced significant participant failures, a significantly greater focus on the robustness of the prudential regime in the light of participant failure is emerging. The extent of unsecured credit, the length of billing and settlement periods, the nature of security and the legal arrangements related to reallocations required to ensure the market's position is protected in

¹ Australian Energy Markets Commission, *Review into the role of hedging contracts in the existing NEM prudential framework: Draft Report*, 19 March 2010

² AEMC, 2010, pg 98

³ AEMC, 2010, pg vi; pg 7



the event of default are all currently under discussion in the US by the Federal Energy Regulatory Commission (FERC) and market participants^{4, 5}.

- Again in the US, until relatively recently, prudential requirements for market participants in wholesale electricity markets have been considered in the light of the desirability of encouraging maximum possible participation to increase competition in the wholesale electricity markets. FERC is reconsidering its stance on prudential requirements for market participants in the light of the equity issues involved where, in the event of a material market failure, the costs are socialised across other market participants, as they are in the NEM⁶.

The performance of the FOA proposal in the event of a participant failure

Against this background, the proposed FOAs involve:

- A reduction in the prudential quality of the NEM, both through a reduction in the RMCL and in a reduction in the quality of the security held by AEMO. AEMO currently holds bank guarantees and/or Security Deposit Accounts lodged with AEMO, but under the FOA proposal these securities would be replaced by unsecured commitments by the retailer to deliver funds in the event that further funds are required to meet the RMCL substituted.
- The retailer pays no direct compensation to the affected generators (all generators in the relevant regional pool) for this reduction. Reallocation Agreements, in contrast, generally attract a fee from the participating generator in compensation for assuming a higher loss in the event of the retailer's default than that the generator would face if the Reallocation Agreement was not in place and the generators in the relevant regional pool face a reduced risk of loss in the event of default.
- An increase in the uncertainty of AEMO's position in the event of default or failure by the retailer, with the AEMC acknowledging that "it is not possible to determine with certainty that a Client's obligations to AEMO under an FOA will always be backed by margin payments from [Sydney Futures Exchanges Clearing Participants(SFECs)]"⁷. In addition, no potential security arrangements are identified over other potential sources for payment of the retailer's obligations in the event of the failure of margin payments to meet the retailer's obligations to AEMO.

⁴ See the discussion by FERC and various market participants at the January 2009 *Technical Conference on Credit and Capital Issues Affecting the Electric Power Industry*, <http://www.ferc.gov/EventCalendar/EventDetails.aspx?ID=4383&CalType=&CalendarID=116&Date=01/13/2009&View=Listview>

⁵ There is some international experience that suggests that the Market Operator's standing in the event of default in reallocations involving Swaps and Options may be unclear, resulting in the potential for unanticipated losses by Market Participants. In addition to the regulatory issues associated with AEMO using Swaps and Options in this way, the AEMC and AEMO should consider the Australian legal position. See FERC, above, as well as submissions in response to FERC, 18 CFR Part 35, Docket No. RM10-13-000, *Credit Reforms in Organized Wholesale Electric Markets*, January 21, 2010

⁶ FERC Docket No RM10-13-000, 2010; PJM, *PJM Credit and Clearing Analysis Project: Findings and Recommendations*, June 2008.

⁷ AEMC, 2010, p 72



- AEMO's submission in response to the draft PwC Report⁸ suggests that other sources of funding are significant in meeting the retailer's obligations to AEMO under the FOA proposal AEMO modelled.
- A proposed increase in the Prudential Margin that has not been tested for its performance in preventing a loss in the event of default.
 - The AEMC proposes requiring an additional 7 days of the difference between the price used for the calculation of the standard Maximum Credit Limit less the FLP multiplied by the energy under the FOA.
 - The presentation by d-cypha Trade at the AEMC's public forum suggested that the proposed increase represented a significant increase in the overall prudential requirements relating to an FOA compared to Reallocation Agreements⁹. Although we believe the comparison with Reallocation Agreements is inappropriate¹⁰, we believe that this is an issue that could be assessed by modelling the proposed increased Prudential Margin for its adequacy in the event of retailer default.

Responses to issues raised by the AEMC

In the light of the above, our views on specific areas where the AEMC sought stakeholders' responses are given below.

The Commission seeks views from retailers, SFECs and AEMO on the feasibility of SFECs becoming a party to FOAs, agreeing to "hold" margins arising from futures contracts underpinning FOAs in a separate client sub account and agreeing not to net off those margins against a retailer's other positions.

The proposal that the SFECs become a party to the FOAs appears to us unlikely to succeed. The proposal in its current form transfers security from the SFEC to the NEM, reducing the quantity and effectiveness of the security held by the SFEC against its exposure to the default of its client, with no benefit to the SFEC. If, in response to the reduction in its security, the SFEC was to increase its client's required security arrangements (deposits, margin requirements, etc), then the net benefit to the client/retailer of the FOA, is unclear.

The Commission seeks views from retailers, SFECs and AEMO on the proposal for AEMO to hold an irrevocable power of attorney over the retailer's right to receive funds in the CSA.

The Commission's own finding that there is no guarantee that the funds in the CSA will match the client's obligations to AEMO suggests that the proposed power of attorney provides no additional security to AEMO and market participants should a default occur. Further, the AEMC's summary of its legal advice does not address the rights, if any, that AEMO would have under a power of attorney following an event of bankruptcy or the appointment of an administrator to the client/retailer.

⁸ Australian Energy Market Operator, *Response to PwC Draft Report*, 20 November 2009, pps 23-25, <http://www.aemc.gov.au/Media/docs/Australian%20Energy%20Market%20Operator%20Received%206%20November%202009-abbcefc2-758f-4686-9bc4-051f09015546-0.PDF>

⁹ d-cypha Trade, *Review into the role of hedging contracts in the existing NEM prudential framework*, April 2010, <http://www.aemc.gov.au/Media/docs/d-cyphaTrade%20presentation-bb2e4d31-b44f-4615-bc9a-b0c5fa962bde-0.PDF>

¹⁰ Because, among other issues, the effect of Reallocation Agreements and the proposed FOAs on the exposure of Market Participants to a loss given default are not the same.



The Commission seeks views from stakeholders on whether the additional PM and the power of attorney as proposed would adequately mitigate FOA termination risk and whether there are any other options that may help increase the surety of margin payments.

The AEMC's summary of its legal advice does not address the rights, if any, that AEMO would have under a power of attorney following an event of bankruptcy or the appointment of an administrator to the client/retailer. Additional legal advice should be sought. The adequacy of the additional Prudential Margin in mitigating FOA termination risk should be tested by modelling. Other mechanisms, where such mechanisms can be identified, for increasing the surety of margin payments should be assessed by comparing the risks and uncertainties of the security provided with those of the security foregone in introducing the FOAs.