

9 May 2017

Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney, NSW, 2000

Dear Sir/Madam

Westpac welcomes the AEMC's consultation paper on our proposed rule change relating to secondary trading of Settlement Residue Distribution Agreement (SRDA) units¹ at settlement residue auctions.

However, the majority of the consultation paper focuses on unrelated issues and represents a significant expansion of scope, which may not be consistent with the AEMC's limited powers to modify rule change proposals under section 91A of the National Energy Law. Sections of the consultation paper that focus on the impact of secondary trading on default risk faced by TNSPs are important and relevant, but we ultimately believe that those issues are either immaterial or misconceived.

The AEMC does possess the power to initiate a formal market review of the SRA market if broader topics related to settlements residue are of interest to them. Westpac in general is supportive of properly functioning competitive markets and would support a review if market efficiency and function could be improved. Such a review would likely take several years, whereas we believe our rule change proposal is narrow and well-specified enough that it can be evaluated within a timeframe of a few months.

There appears to be no efficiency gain to discussing larger settlements residue issues in parallel to our proposal. Further, we believe that any financial product that is intended to manage inter-regional price risk would benefit from enabling market participants to sell those financial products (if needed) through a centralized, standardized, liquid and transparent facility. Therefore we do not believe that consideration of the value of secondary trading of SRDA units needs to wait for a larger review of the definition and purpose of SRDAs.

Separation of powers between the AEMC and the SRC

While the intent of our national energy rule change is relatively simply, the rule change process has been complicated by the delegation of auction rule changes to the SRC.

The design of the settlements residue auction is detailed in National Energy Rule 3.18 which provides AEMO and the Settlements Residue Committee with the powers to make and modify auction rules. Any auction rule change is subject to a public consultation and must be found to further the NEO and satisfy the requirements of National Energy Rule 3.18.3(b).

The SRC consists of representatives from all stakeholder groups including consumers and has successfully implemented significant reforms to the auction rules in a timely manner.

In our rule change submission we explicitly stated our confidence in the Settlements Residue Committee and their ability to oversee an **auction** rule change request. Our proposal to the AEMC concerns a related **National Energy** rule change which has the effect of enabling (but not requiring), the SRC to consider and potentially implement new auction rules relating to secondary trading of SRDA units.

¹ While the rules refer to SRDA units, market participants typically use term SRAs to refer to the same financial product.

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The AEMC's rule-making powers

The inclusions of questions on the functions of the broader SRA market do not appear relevant to the specific issues raised in our rule change request. If it is the AEMC's intention to consider making a more preferable rule than the rule we submitted, we would ask that the AEMC explain how an expanded scope is consistent with part 91A of the National Energy Law.

*The AEMC may make a Rule that is different (including materially different) from a market initiated proposed Rule (a more preferable Rule) if the AEMC is satisfied that, **having regard to the issue or issues that were raised by the market initiated proposed Rule** (to which the more preferable Rule relates), the more preferable Rule will or is likely to better contribute to the achievement of the national electricity objective.*

The specific issue with the National Energy Rules raised in our rule change proposal was the ability of the SRC committee to consider secondary trading, given the wording of the national energy rules relating to the distribution of auction proceeds.

Our rule change proposal would not have made sense if we did not also include a discussion on the possible implementations of secondary trading of SRDA units at auction. That discussion was provided as in an appendix as context only and does not form part of the specific **National Energy Rule** change proposal.

We also did not raise any issues with the definition of the SRDA units, or the lack of collateralization in the SRDA market at any time, so we are unclear as to why questions on those topics are relevant to any possible rule that the AEMC would have the power to consider.

Comments on the AEMC's Proposed Assessment Framework

The design of units and whether those units are efficiently allocating risk are broader questions than are necessary to assess our proposed rule change. Our proposed rule change should be assessed under a framework that assumes the SRDA market functions as it currently does. Improvements to the SRDA market could be discussed in a separate review initiated by the AEMC. If that review found that SRDA units should be re-designed, we would still argue that net market efficiency is higher if secondary trading of those units at auction is allowed.

It is appropriate and desirable to include in the framework an assessment of whether secondary trading of SRDA units would promote competition, efficient trade across interconnectors, and value maximisation for consumers. We note that the AEMC has asked comparatively few consultation questions relating to these relevant parts of the assessment framework.

Costs and benefits are normally assessed as part of any rule change and we accept that they should rightly be included in the assessment framework. In this case, we would highlight that there will be no cost to our proposed National Energy Rule change other than the cost of participants engaging in the consultation process. We therefore submit that total implementation costs would be lower if the AEMC assessment framework only focused on issues related to our rule change proposal. For any monetary costs to be incurred, AEMO and the SRC must also make changes to **auction** rules which could only occur after another public consultation that would also be tested against the National Energy Objective.

Specific consultation questions

1. Does the current design of units remain appropriate for its original purpose (providing a means for inter-regional hedging and facilitating inter-regional trade)?

We are not sure what relevance this question has to our proposed rule. If it is the AEMC's intention to make some more preferable rule, we are not sure how this question relates to the issues raised in our rule change request, which is a requirement under part 91A of the National Energy Law.

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If the AEMC wished to re-design SRDA units as part of a separate review, we would still argue that financial markets would function more effectively given the ability to both buy and sell.

2. If the current design of the units and auction process is no longer appropriate, what improvements would be necessary for them to serve the original purpose?

This question conflates the design of units with the design of the auction. As per our response to question 1, we did not raise any issue with the design of units and therefore consideration of the design of units appears to be out of scope.

If the AEMC wished to re-design the SRA auction as part of a separate review, we would still argue that financial markets would function more effectively given the ability to both buy and sell.

3. Has the underlying purpose of the units and auction process changed over time from the original purpose as set out by the ACCC in its 1999 determination?

This question is unrelated to the issues raised in in our rule change request, which is a requirement under part 91A of the National Energy Law if the AEMC intends to make a more preferable rule related to this question.

4. How accurately can the value of units be forecasted at the time of the auction process? What factors influence trading strategy decisions when units are procured?

This question appears unrelated to the issues raised in in our rule change request, which is a requirement under part 91A of the National Energy Law if the AEMC intends to make a more preferable rule related to this question.

5. Are units considered akin to a type of insurance from inter-regional price differences? If so, would market participants expect the unit price for units to reflect a premium over the expected payout from the units?

This question appears unrelated to the issues raised in in our rule change request, which is a requirement under part 91A of the National Energy Law if the AEMC intends to make a more preferable rule related to this question.

The questions also demonstrates that the AEMC has mis-understood the relevant risk factors in relation to pricing SRDA units. If it helped the AEMC we would be able to provide an explanation of the relevant risk factors when pricing SRAs if there was a relevant review of the topic.

6. What process and considerations does a market participant examine in relation to corporate strategy and risk management structures in determining how it will participate in the auction process?

We evaluate all physical market conditions as well as our existing and expected financial positions, when determining how we will participate in an auction. Given the lack of liquidity in SRDA units, we must evaluate all factors that might affect the value of the units that might occur before the liquidation quarter.

7. Where a market participant participates in the current bilateral secondary trading of units, are there any other processes or consideration that it takes into account besides those outlined in (6) above?

We very rarely are able to find a counter-party willing to trade secondary SRAs. When we do find a willing counter-party, it occurs near to an auction date and the same processes apply as when we buy units at auction.

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8. How are units addressed by a market participant in relation to its financial accounts, i.e. are these units treated the same or differently to other hedging instruments for accounting purposes?

We can disclose our accounting treatment confidentially to the AEMC, but do not consider it relevant to evaluating the proposed rule change. We do not anticipate that secondary trading of SRDA units will require changes to our accounting treatment.

9. Does the current design of the settlements residue auctions inhibit the development of market based solutions, that is the lack of a requirement for collateral in the AEMO auction process versus the requirement for collateral or credit limits in bilateral and market based transactions?

We are not sure we understand the premise of this question.

The settlement residue auction is the primary source of settlements residue. Without a primary market, a secondary market cannot exist by definition. If the TNSPs (through AEMO) did not auction the residues in the first place, no contracts would be written using settlements residue as a basis.

The ASX is currently proposing to introduce a new product which would be a \$0 price cap on the half-hourly inter-regional spread. Such a product would be similar to an SRDA unit in that it transfers inter-regional price risk. So the current design of the auction is not inhibiting development of market-based pricing solutions.

10. Would the increased liquidity of units increase the efficiency of inter-regional hedging?

We would reiterate that this is a case of going from effectively no liquidity on the sell side to at least quarterly liquidity. As a by-product of that, liquidity will increase on the buy side, but the main advantage of the proposed rule change is giving participants the ability to reduce a position size if needed at a fair market price. The ability to adjust positions sizes both up and down will allow participants to better achieve their desired inter-regional hedging strategy.

General comments on questions about default risk

The questions the AEMC raise about default risk are all valuable questions, as are the potential solutions provided.

Our position is that secondary trading does not materially increase the default risk faced by TNSPs.

Given that it is the SRC (as part of a public consultation) that will determine the exact implementation of secondary trading, it is hard to definitively give an answer to how default risk could be handled. Nevertheless, we can make some comments on default risk and whether secondary trading would increase TNSPs' exposure to participant default risk.

In our preferred implementation, there would be no distinction between primary and secondary SRA units for buyers. It would not be relevant to talk about "secondary" buyers as all buyers are buying SRDAs with AEMO as the counter-party and are therefore buying primary units. However the exact implementation details would be determined in public consultation by AEMO, highlighting our preference to discuss default issues in detail as part of the **auction** rule change proposal.

Comments on AEMC's default scenario

We believe that the AEMC has incorrectly identified the relevant base case when assessing whether secondary trading would increase default risk borne by TNSPs.

The AEMC shows participant 1 buying in auction number 6 in the base case (Figure 5.5), but buying in auction number 7 in the case with secondary trading (Figure 5.6). As such, the two scenarios are not a like for like comparison.

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The correct base case is that auction participant 1 buys at \$120 in auction 7 (the same as the case with secondary trading). In that case, the TNSP is exposed to a \$40 loss of revenue due to the default of participant 1, which is the same as the case with secondary trading. Given that participant 1 has not engaged in any secondary trading in the given examples it makes sense that there is no change to the TNSP default exposures.

There are other potential default scenarios that might be considered.

If a participant buys low, sells high, and then defaults, the TNSP would realize a net benefit. The TNSP need not be under any obligation to make future dated payments to a defaulting counterparty.

If a participant buys high, sells low, and then defaults, there would be a potential residual exposure to the TNSP. The relevant question is whether the size of that default is greater than would have been the case without secondary trading. If a participant defaults, the TNSP is at least exposed to the difference between the buy price and the final auction price. If a participant sells before the final auction price, the sale price could only be lower than the final auction price **on average** if auction prices were mean reverting. Mean reverting prices would be inconsistent with an efficient market. In fact, allowing secondary trading would help the market avoid limits to arbitrage that might create inefficient outcomes such as mean reversion.

The other way to think about default risk is that a secondary seller must have been a buyer first. Therefore the TNSP was already taking default risk on that buyer. Under the current rules, the size of a TNSP's default risk is unknown because the next auction price is unknown. If secondary trading was allowed and a participant sold their unit (at a lower price) before defaulting, the default risk would at least be known and not able to increase further.

Finally it is worth considering the special case where a participant buys high **because** they now have the ability to sell later. If the participant later sells below their purchase price and then defaults, then it could be said that the allowing secondary trading has increased the default risk faced by TNSPs. However, we still believe that behavior such as that would be rare and the resulting increase in default risk would be orders of magnitude smaller than the default risk already present in the SRDA market.

The AEMC's proposed solutions to mitigate default risk to TNSPs incurred by buyers are all workable and would potentially be found to further the NEO if subject to a rule change proposal. Our preference would be to evaluate the costs and benefits of controlling SRA defaults as a separate rule change given that the issue does not appear to be materially related to secondary trading of SRAs, even in the AEMC's given example.

Further responses to specific questions

11. Do auction participants have better information, ability and incentives to manage the risk of default in comparison to TNSPs?

No.

12. How would default risk be best managed in the auction process in relation to secondary units?

We submit that there should be no distinction between primary and secondary units for buyers. As explained in question 10 we do not believe the existence of secondary trading materially raises the default risk faced by TNSPs.

13. Is it appropriate to have different parties or mechanisms to manage the risk of default in relation to primary units and secondary units?

Creating a distinction between primary and secondary units for buyers would prevent many of the identified benefits from being achieved. If a primary SRA bore no default risk but a secondary SRA did, then they would be two separate financial products. The secondary SRAs would be less preferable to

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hold than the primary SRAs and would therefore have to trade at a discount to the primary SRAs, if they traded at all.

14. Would the introduction of secondary trading at AEMO facilitated auction increase the value of units to market participants and/or TNSPs?

The value of SRDA units to TNSPs is irrelevant to the TNSP as the revenue stream is ultimately passed through to the consumer.

If the value of SRDA units to market participants rises, then they will bid higher prices, resulting in a net benefit to consumers.

The final payoff of an SRDA unit as it relates to spot market outcomes would be unchanged by secondary trading, so it is not possible for the change to decrease the value of SRDAs to market participants in the spot market.

Secondary trading provides participants with an additional optional action (to sell). In general, an increase in optionality increases value so there could be a theoretical decrease in the discount SRDAs trade at relative to spot.

15. Would the addition of secondary trading increase supply and therefore, lead to lower auction prices?

No. In our preferred implementation, short sales would not be allowed. Every seller is first a buyer, so the net number of buyers and sellers do not change. The changes may increase demand for longer dated units if participants value to flexibility of being able to sell those units before spot liquidation if needed. In that case there would therefore be an equivalent increase in sellers of shorter dated units. The net change in buyers/sellers across all units is necessarily zero.

Any potential change to the average price of SRDA units would result from the value participants place on the option to sell, not on a volumetric change to buyers/sellers.

16. Are there any other costs that would need to be considered?

The proposed change to the **National Energy Rules**, to be determined by the AEMC has no cost other than the effort of participants responding to the consultation. Other costs could only be incurred if a change is made to the **auction** rules, if AEMO (in public consultation) finds that the changes advance the NEO.

17. Are the benefits of secondary trading likely to outweigh the costs indicated by AEMO and any other indirect costs?

As per our original submission, the costs indicated by AEMO are trivial in percentage terms and are much smaller than market participants typically pay in brokerage, which is a proxy for the value the market places on liquidity for financial products.

We leave it open to the SRC's consultation on the necessary auction rule changes to determine how their costs could be recovered. One option could be to recover the implementation costs only from sellers of SRDA units. In that case, only those who valued the change would pay for the implementation.

Responding to rule change consultations also has a time cost to participants, with broader consultations being more costly. We therefore submit that it would be less costly for the market as a whole if the AEMC restricted their scope and assessment framework to focus on the original question of the SRC's ability to consider implementation of secondary trading given the wording of national energy rules relating distribution of auction proceeds to TNSPs. Should any stakeholder deem there to

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be value in reforming other aspects of the settlements residue distribution process, at least one stakeholder would find it in their interests to submit a separate rule change.

18. Should the facilitation of secondary trading be managed by an entity other than AEMO?

Secondary trading needs to be implemented by the same entity that facilitates the primary issue of units if benefits relative to the status quo are to be achieved.

Conclusion

The proposed assessment framework is larger than necessary to evaluate our proposed rule change. Several items raised are worthwhile question to ask, but are related to the concept of enabling secondary trading of SRDA only to the extent that SRDA units are involved. The AEMC could pursue unrelated issues in a separate review.

A major point of assessment is default implications. Participant default scenarios are important to consider, but we believe that our proposed rule change does not materially increase default risk compared to the status quo. It also appears that the AEMC has mis-interpreted the relevant base case when evaluating a default scenario involving a secondary seller of SRDA units. With the correct base-case identified, the TNSP suffers no additional loss due to default.

Yours Sincerely,

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