13th April 2006

Dr John Tamblyn, Chairman
Australian Energy Market Commission
1 Margaret Street
Sydney NSW 2000

Congestion Management Review

1. Westpac Energy is a registered market trader and financial intermediary in the National Electricity Market. Westpac Energy operates within the Financial Markets group of Westpac Institutional Bank and is considered among the most active market risk management participants in the OTC, Futures and SRA derivatives markets. Within its wider operations, Westpac has significant debt and equity interests in the Australian energy market. The following response represents the views of the Westpac Energy group (Westpac).

2. Westpac notes that the MCE has stated that both the "financial" and "physical" trading risks are to be addressed in the review which is a pleasing acknowledgement of the role of the financial market in the NEM.

3. Westpac is mindful that the AEMC has been directed by the MCE to perform this Review under the set Terms of Reference[1] (ToR). Westpac would comment that the ToR themselves have an objective that appears extremely difficult to fulfil viz.

> *"this review will identify and develop improved arrangements ….with the objective of maximising net economic benefit to* ***all*** *[*emphasis added*] those who produce, consume and transport electricity in the market*"[2].

It is not possible that any change can create a "net economic benefit" to all those who produce, consume and transport electricity. Any changes to the current arrangements must by definition create "winners" and "losers" amongst the various generators, transmission companies, retailers and end-consumers in the NEM. We note further that, despite the prominent reference to financial risk, the financial market stakeholders are not considered in the ToR objective.

4. To this end, the wide ranging scope of this review coupled with the density of information sought in the question blocks (numbering a total of 40 separate question blocks some of which contain several sub-sections) only allows those NEM participants who have the largest amount of self-interest at risk (or gain) to promote their preferred solutions and outcomes so as to ensure that they are in the group of "winners".

As a consequence, this review under the ToR as established by the MCE is unlikely to achieve its objective. Ideally, an independent expert report on the issues raised in the

[1] Pages 53-55 of the AUSTRALIAN ENERGY MARKET COMMISSION: Congestion Management Review - Issues Paper 3 March 2006
[2] Section 3.1 Terms of Reference, MCE Letter to AEMC dated 5 October 2005.

40 question blocks before the first round of submissions would have provided a framework for discussion and assessment. However, it is still possible that an independent expert can be used after the close of submissions on 13 April 2006 to provide commentary to accompany the draft report by the AEMC on Congestion Management alternatives. Market participants can then make submissions on the draft report with the information from the independent expert report also being available.

5. As Westpac is the largest and most active of the non-physical NEM participants we are best placed to provide a market-informed and independent viewpoint to the AEMC. Such view is best delivered on the balance of submissions received and Westpac welcomes the opportunity to discuss these matters with the AEMC after the closing date for submissions.

6. Westpac has some general comments concerning principles that SRA mechanics should follow in response to the following questions:

> *24. To what extent will firming-up IRSRs facilitate inter-regional trade? What is the best approach to firming up IRSRs and how would this work?*
>
> *26. What would be the effect of ceasing NEMMCO intervention to manage counter price flows? To what degree does this depend on other factors such as the region boundary criteria and process?*
>
> *27. How should negative settlements residues be funded? Should the current process of offsetting negative residues with positive residues within the current billing week be continued or changed?*

Physical capacity between NEM regions is dynamic and affected by weather, bushfire, generation and demand levels and other factors which are difficult to hedge. Most of these factors are best managed by participants themselves who can manage physical generation, demand levels, or purchase structured hedge products. It follows logically that neither NEMMCO nor TNSPs should be compelled to underwrite these risks; these physical risks should be accepted and managed by participants.

NEMMCO, nor any other regulatory body, should be tasked to attempt to determine a level at which to offer SRA's "with NEMMCO retaining any excess of positive settlements residues to fund firmer inter-regional products[3]". Any error in setting the level will result in either too few units being offered with a corresponding reduction in inter-regional trade or too many units being offered creating a shortfall. There is no evidence to suggest that NEMMCO can "on average" determine the correct level, and even so being correct "on average" still creates distortions since generators with market power can ensure that the shortfall fund is always at or below zero. Such

[3] Page 40 of the AUSTRALIAN ENERGY MARKET COMMISSION: Congestion Management Review - Issues Paper 3 March 2006

shortfalls, if funded by a participant levy[4], will only create an uncertain financial exposure for which there does not exist any hedging instrument.

There is a well proven alternative to the creation of a firm product that does not require underwriting or creation of a top up fund. Securitisation of credit risk in debt markets is a case in point. The residue stream is split into multiple, different priced tranches and auctioned independently. At settlement, the funds available are then allocated on a cascading waterfall basis between tranches until the available funds are exhausted. The senior (most expensive) tranche will receive the maximum of 100% notional value or the funds available. The second tranche can then receive up to 100% of the notional value but with greater risk that a shortfall may result in the payout of the remaining funds after the senior tranche has been paid etc. Since multiple tranches can be created with each tranche less firm than the previous, they will attract lower bids and participants with different hedge requirements.

7. Westpac has some general comments concerning principles that CSC and CSPs should operate in response to the following questions:

> *34. Is the allocation of CSCs a necessary element of a CSP/CSC regime, or would it be practical to introduce CSPs without simultaneously allocating CSCs?*
>
> *35. If CSCs are a necessary component, what is the optimal way to allocate CSCs? What effect will this have on the ability to introduce CSPs rapidly and flexibly?*
>
> *36. Is it important to the design of a congestion management regime whether or not CSCs are firm? If so, what issues should the AEMC consider in reaching a view on the appropriate nature of CSCs?*
>
> *37. How should the process of region boundary change be coordinated with the allocation of CSCs under a staged approach to congestion management?*
>
> *38. How can the Commission best draw on the partial Snowy CSP/CSC trial to evaluate the costs and benefits of the use of CSP/CSCs? How can the Commission best draw on the Snowy CSP/CSC trial to consider modifications to the proposed design of CSPs and CSCs?*

The SRA unit is simply a way of packaging the residue generated by the **inter-**regional limits on each NEM interconnector into a floating payment stream that is exchanged for a fixed payment.
The CSC product is another way of calculating the floating payment stream which is generated by binding **intra**-regional constraint. It would be advantageous if both products were replaced with a single auctioned instrument where an upfront fixed payment is exchanged for the variable payment stream generated by the congestion.

[4] Page 42 of the AUSTRALIAN ENERGY MARKET COMMISSION: Congestion Management Review - Issues Paper 3 March 2006

Any allocation of CSC's should be avoided. They should be auctioned just like SRA's. It makes little sense to introduce a complex CSP system just to retain the status quo with a CSC allocation. If there is any vesting of CSC's it should be of very short tenor as a pre-cursor to an auction based allocation.

> *27. How should negative settlements residues be funded? Should the current process of offsetting negative residues with positive residues within the current billing week be continued or changed ?*

8. Negative residue should only be managed when there is no other option. Negative residue in a regional market occurs because the (transient) constraint does not align directly with the regional boundary. If the negative residue is prevented, it will impose a direct cost and distortion since higher priced generation must be dispatched to maintain strictly positive residue, and cheaper priced generation will be shut out of a now fragmented market. Potentially, the issue is how to fund the negative residue. Negative residue occurs because the binding constraint is (or can be re-formulated as) an option 4 formulation. There are then two cases to consider:

i) The first is when the constraint LHS only contains interconnector terms. In this case, the total residue stream is strictly positive even if the residue generated by one of the interconnectors is negative.

ii) The second is when the constraint LHS contains a mix of interconnector and generator terms. In this case, the total residue stream will be strictly positive if, and only if, the CSP scheme is employed.

In both of these cases, although there could be multiple interconnectors involved as well as generators from multiple locations, there is only a single floating revenue stream generated by the single source of congestion. Rather than attempt to assign portions of this single source to multiple interconnectors, it would be better if it were auctioned as a single stream[5]. To make this model manageable, constraints should be grouped according to ANTS congestion zones and hedgers would purchase residue from all constraints between nominated zones in a package.

Westpac welcomes the opportunity to meet and discuss our submission in more detail. Feel free to contact me at (02) 8254 9130.

Regards

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[5] Dr D Biggar, "Management of Negative Settlement Residues in the Snowy Region: Comments On The Proposal By LYMMCO and Other Generators" [point 68], 9 February 2006.