Australian Energy Market Commission

NEM Prudentials Review
Advice on Futures Offset Arrangements

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Introduction

The Australian Energy Market Commission (***AEMC***) has requested advice on aspects of a proposed futures offset arrangement (***FOA***) being considered by the AEMC in a review of the National Electricity Market (***NEM***) prudentials framework. A proposed model for the FOA has been prepared by an AEMC working group and reviewed by Pricewaterhouse Coopers (***PwC***).

The FOA would allow a NEM participant to reduce the amount of credit support otherwise required under Chapter 3 of the National Electricity Rules (***NER***), using the margins due to it under a Sydney Futures Exchange (***SFE***) traded contract that has been registered with the Australian Energy Market Operator (***AEMO***). The NEM participants who would use an FOA are most likely to be retailers (as Market Customers). For convenience in this advice we have referred to these participants as ***retailers***.

Existing reallocation arrangements (***RAs***) contemplated in the NER already establish the principle of using derivative contract payment streams to reduce a participant's maximum credit limit (***MCL***), thereby reducing the required credit support amount. AEMO is currently seeking exemption from the Corporations Act requirement to hold a clearing and settlement (***C&S***) facility licence in respect of proposed 'swap and option' RAs, which would extend AEMO's existing reallocation procedures.

Unlike the current and proposed RAs, the contract counterparty under an FOA would be an SFE full clearing participant (***SFECP***), not a NEM participant. The margin payments would therefore be settled normally by the retailer and the SFE clearing participant, but the margins due to the retailer would be deposited with AEMO in a security deposit account (***SDA***).

AEMC Questions

The AEMC has sought advice on specific questions on both the reallocation arrangements and the FOA, under three broad headings or risk categories:

- 'clawback' risks (liquidator claims and uncommercial transactions) under the *Corporations Act 2001* (Cth) (***CA***) in the event of retailer insolvency;
- surety of payment under the FOA model; and
- AEMO immunities.

Subsequently, having reviewed a draft of this advice, the AEMC has asked further questions about specific aspects of the SFE regime and the possible options available to provide increased surety of payment for AEMO. The AEMC also put forward a modified FOA model for consideration, which is addressed as a separate question.

The questions and our responses are set out below.

Advice

Clawback risks

1. With reference to clause 3.3.13A of the NER and AEMO's procedures, review the current legal structure of the SDAs held by AEMO under the NER and AEMO procedures, and provide advice on the materiality of clawback risk as it relates to those existing arrangements

Summary

We do not consider that there is a material risk that a liquidator of an insolvent retailer would successfully be able to claw back any funds paid into an AEMO SDA. In our view, the payment would not constitute an unfair preference under the CA if made in the normal course of market operations as contemplated by the NER.

Analysis

1.1 Existing legal structure of Security Deposit Accounts

Clause 3.3.8A of the NER contemplates the payment of funds into an SDA by a Market Participant:

> 3.3.8A Security Deposits
>
> At any time, a Market Participant may provide a security deposit to AEMO to secure payment of any amount which may become payable in respect of a billing period.

It is noted here that funds are said to be paid into the SDA by a Market Participant in respect of amounts 'which may become payable' as opposed to amounts already due and payable. As explained below, this is important because one of the criteria for 'unfair preferences' at risk of being clawed back by a liquidator is that the payment must be received from an insolvent company in respect of an existing unsecured debt.

Clause 3.3.13A of the NER sets out how AEMO may apply funds received into an SDA. Although it is lengthy, for ease of reference we have reproduced the clause here:

> 3.3.13A Application of monies in the security deposit fund
>
> (a) Subject to clauses 3.3.13A(b) and (e), AEMO may apply money from the security deposit fund recorded as a credit balance in the name of a Market Participant in payment of monies owing by that Market Participant to AEMO:
>
> (1) in respect of any final statement previously given to that Market Participant which has not been fully paid by the appointed time on the due date and remains unpaid; or
>
> (2) at the time of issuing any final statement,
>
> in which case AEMO may set off all, or part of, any amount by which a Market Participant is in credit in the security deposit fund at that time against any amounts owing to AEMO under the final statement.
>
> (b) Subject to clause 3.3.13A(c):

(1) a Market Participant may, by giving notice at least one business day prior to the due time for the issue of a final statement, seek agreement with AEMO on the arrangements to apply to the application of security deposits paid by that Market Participant under clause 3.3.8A against amounts owing to AEMO under a particular final statement or final statements; and

(2) AEMO must apply the security deposits in accordance with an agreement reached under clause 3.3.13A(b)(1).

If agreement is not reached between AEMO and the Market Participant under this clause, then AEMO has a discretion to apply the security deposit funds of that Market Participant in payment of moneys that the Market Participant owes AEMO as set out in clauses 3.3.13A(a)(1) and (2).

(c) Despite any agreement under clause 3.3.13A(b), if a default event occurs in relation to a Market Participant, then AEMO has a discretion as to which amounts owing to AEMO under final statements it applies or partially applies security deposits paid by that Market Participant under clause 3.3.8A.

(d) In the case of security deposits paid by a Market Participant in the security deposit fund under clause 3.3.13, AEMO has a discretion as to which final statements it applies or partially applies those monies against.

(e) However, in exercising its discretion in clauses 3.3.13A(b), (c) or (d), if a Market Participant pays AEMO a security deposit, then AEMO must apply any remaining portion of the security deposit (taking into account deductions for any liabilities or expenses of the security deposit fund) against the longest outstanding amounts owing to AEMO under final statements issued not later than the final statement for the billing period in which the security deposit was paid to AEMO. If, for any reason, AEMO has not fully applied such security deposit within this time, then AEMO must apply the remainder to amounts owing to AEMO under the next final statement or statements until it has been fully applied.

(f) If:

(1) a Market Participant has a credit balance in the security deposit fund and ceases, or intends to cease, being a Market Participant; and

(2) that Market Participant has paid all money owing to AEMO and AEMO reasonably considers that the Market Participant will not owe any money to AEMO in the future arising from that person's activities as a Market Participant,

then AEMO must return any credit balance for that Market Participant in the security deposit fund to that Market Participant (subject to deduction for any liabilities and expenses of the security deposit fund).

(g) If, for any reason, there is a debit balance in the security deposit fund for a Market Participant, then the Market Participant must pay that amount to AEMO. For this purpose, AEMO may:

(1) include that amount in the next final statement; or

(2) issue an account to that Market Participant for payment of that debit balance and the Market Participant must pay that amount within 2 business days.

Based on clause 3.3.13A, it does not appear that AEMO holds funds in an SDA on trust for the Market Participant that has deposited those funds. Once deposited, the Market Participant has no control over the use of those funds by AEMO. It may request that

AEMO apply the funds in a certain manner (clause 3.3.13A(b)(1)), but AEMO is under no obligation to agree to such a request, and would presumably only do so if satisfied that it retains sufficient alternative security (or funds remaining in the SDA) to meet the prudential requirements. It is only on the Market Participant ceasing to be a Market Participant – and then only if AEMO is satisfied that there will be no future liability of the Market Participant to AEMO – that the NER requires AEMO to refund to the Market Participant any credit balance in the SDA. In that respect, the Market Participant will be a creditor of AEMO for that amount, rather than a beneficiary having a claim against trust funds.

1.2 What is an 'unfair preference'?

Unfair preferences are transactions that are potentially voidable by a liquidator (and only a liquidator) pursuant to CA s.588FF. In order for a transaction to be an unfair preference it must:

(a) be between a company and an unsecured creditor in respect of an unsecured debt;

(b) be entered into at a time when the company is insolvent (or an act is done for the purpose of giving effect to the transaction at such a time, or the company becomes insolvent as a result of the transaction) and within 6 months prior to the commencement of the winding up; and

(c) result in the unsecured creditor receiving from the company in respect of that unsecured debt more than it would have received if the transaction were set aside and the creditor were to prove in the winding up of the company.

A 'transaction' is broadly defined and includes:

- a conveyance, transfer or other disposition of property;
- a charge created by a body over its property;
- a guarantee given by a body;
- a payment made by a body;
- an obligation incurred by a body;
- a release or waiver by a body; and
- a loan to the body.

Where the transaction is voidable, the court has wide powers to make orders to avoid the transaction, including orders directing payment of money to the company equivalent to the amount paid by the company under the transaction, and orders declaring the transaction to be unenforceable.[1]

1.3 Defences to unfair preferences

If a transaction is an unfair preference, a Court may not make an order voiding the transaction if one of the positive defences set out in CA s.588FG can be established. The defences under that section generally rely on the counterparty to the transaction (for present purposes, AEMO) having received the benefit in good faith at a time when it did not

[1] CA s.588FF(1)

suspect, and a reasonable person in its circumstances would not have suspected, that the company was insolvent.

The risk of reallocation transactions being deemed to be unfair preferences was recognised by AEMO (as NEMMCO) in its document – *Reallocation Information Paper and Examples*, May 2004, version 2 – where it stated [at section 3.6]:

> The risks from insolvency relate to unfair preference payments. These are payments made by an insolvent company to a creditor in the period of 6 months prior to the date of commencement of winding up the company and have the effect of preferring that creditor to other creditors. NEMMCO has the view that the risks arising from insolvency of either of the Market Participants are the same for ex post reallocations as they are for ex ante. The risks from insolvency are considered to be small for transactions completed prior to winding up of an insolvent participant, because NEMMCO would be able to demonstrate that it made the transaction in good faith, for valuable consideration and without notice of the insolvency being declared.
>
> The same insolvency risk considerations apply to all of NEMMCO's settlement transactions.

We agree with this analysis and do not consider there to be any material difference in the clawback risk as between the different types of RAs contemplated by the NER.

The potential impact of those clawback risks is minimised in the current system by the prudential and credit support obligations on Market Participants as well as the provisions of the NER that:

- for reallocation transactions - allow the deregistration by AEMO of any reallocations associated with trading intervals that have not yet occurred where a default event occurs in relation to either Market Participant[2]; and
- generally – require AEMO to undertake prudential monitoring daily, although AEMO's monitoring obligations may mean that it is more difficult for AEMO to establish that it should not have known or suspected that a retailer was insolvent than it would be for a normal commercial counterparty.

Accordingly it will be important for AEMO to maintain a high level of enforcement in respect of prudential requirements.

1.4 Set-off

Once funds are deposited by a Market Participant in the SDA, AEMO must deal with the money in the account in accordance with the NER[3]. The NER explicitly allow AEMO to set-off money held in the SDA against debts owed to it by a Market Participant[4]. Any such set-off will not be an unfair preference even if it occurs during the 6 months prior to the commencement of the winding up of a Market Participant. This is because, on the liquidation of the insolvent Market Participant, the mandatory insolvency set-off provisions of CA s.553C would have applied in any case to net out the obligations between AEMO and the Market Participant[5]. Hence the third requirement of an unfair preference as set out

[2] Clause 3.15.11(l) and (m)

[3] see NER clause 3.3.13A

[4] NER clause 3.3.13A(a)

[5] see *Jetaway Logistics Pty Ltd v DCT* [2008] VSC 397

at section 1.2(c) above is not met, since the original set-off will not have resulted in AEMO receiving more than it would have received if AEMO had proved in the Market Participant's liquidation. A Court would therefore not grant a liquidator's application to set aside any set-off by AEMO.

1.5 Materiality of unfair preference risk as it relates to existing SDA arrangements

Under existing arrangements, payments made into the SDA pursuant to clause 3.3.8A or clause 3.3.13 of the NER are not at risk of being found to be unfair preferences provided that those payments are not:

- made at a time when the Market Participant is already insolvent; or
- used by AEMO to discharge a pre-existing unsecured debt owed by the Market Participant to AEMO.

In respect of the first point, a transaction may only be found to be an unfair preference if it is entered into (or given effect to) at a time when the Market Participant is actually insolvent. If AEMO determines that a Market Participant is likely to be insolvent (unable to pay its debts as and when they fall due) at any given time, funds received into the SDA after that time may be at risk.

In respect of the second point, even if the payment was made at a time when the Market Participant was insolvent, it will not be an unfair preference unless it results in AEMO receiving from the Market Participant, **in respect of an unsecured debt that the Market Participant owes to AEMO**, more than AEMO would receive from the Market Participant if the transaction were set aside and AEMO were to prove in the Market Participant's winding up[6]. If the payment into the SDA is not made or used to discharge an existing unsecured debt owed by the Market Participant to AEMO, it will not be an unfair preference.

In that regard, we note the paper published by AEMO entitled *Security Deposit Arrangements* (version 9, 8 October 2009) which states at section 1.2 that:

> GST implications have meant that Security Deposit Amounts should be distinguished from early payment or partial satisfaction of settlement statements. Rather, the monies represent a deposit to AEMO to secure payments of future Settlement statements.

The paper states that if deposits into the SDA were deemed to be early payments of a final statement settlement amount, then AEMO's GST liability in relation to those supplies would be triggered even if a final statement had not been issued yet. Therefore, AEMO has concluded in section 4 of that paper that deposits into the SDA (including the payments of call amounts under clause 3.3.13 of the NER):

> … are held as security for the performance of an obligation of Market Participants. That obligation is payment to AEMO of amounts owing for the supply of electricity and other services as set out in the final statements.
>
> The security deposit becomes consideration for a supply only at the point it is offset by AEMO against amounts owing under a final statement (unless it is forfeited at an earlier point). At the point it is offset, it will form part of the consideration for the taxable supply of electricity by AEMO. Up until that point, it will not be consideration for any supply by AEMO. AEMO does not

[6] CA s.588FA(1)(b)

make a separate supply (financial or otherwise) related to receiving the security deposit from the Market Participant.

AEMO sought and obtained a private ruling from the ATO confirming, among other things, that amounts paid by Market Participants into the SDA are security deposits pursuant to the relevant division of the GST Act and do not trigger attribution of the GST payable on the supply of electricity to those Market Participants[7].

It appears clear that payments by Market Participants into the SDA are received by AEMO as security and not as payment for pre-existing unsecured debts owing by the Market Participant. On this basis, the deposit of those payments would not meet the first requirement for an unfair preference as set out at section 1.2(a) above – ie. payments into the SDA do not represent a transaction between the Market Participant and AEMO in respect of an unsecured debt.

Finally, notwithstanding our conclusions above, if an amount paid into an SDA were found to be an unfair preference given to AEMO, it will be protected from clawback:

- if AEMO is able to establish the positive defence described in section 1.3 above; or
- by AEMO's ability to set-off the security deposit against any amount owing to it by the Market Participant (or the application of mandatory insolvency set off under CA s.553C), described in section 1.4 above.

Accordingly, we believe that under the existing arrangements contemplated by the NER, there is no material risk that payments made by a Market Participant into an SDA could be clawed back by a liquidator of that Market Participant as unfair preferences.

2. Having regard to the current structure of the SDA under the NER and with reference to AEMO's procedures, advise on possible changes to the legal structure or operation of SDAs held by AEMO that may mitigate or eliminate clawback risk as it relates to money in those accounts

As discussed in response to question 1 above, we do not believe that the current structure and operation of the SDAs attracts material risk of unfair preference clawback from the liquidator of a Market Participant who deposits funds into an SDA. Accordingly we do not consider that any changes to the NER or the operation of the SDAs are required.

[7] ATO Private Ruling: Security Deposits, 1 October 2001, authorisation number 6969

3. Review the manner in which the security deposits are to be obtained and applied under the FOA model and PwC FOA model and advise if these arrangements would adversely affect the clawback risk to the NEM, compared to existing arrangements. In considering this matter, consider whether the proposed structure of the SDA under the FOA model and PwC FOA model could constitute AEMO as a trustee or custodian in respect of the funds held in a SDA (ie. the money in the account is held by AEMO on the retailer's behalf and at the retailer's control and direction)

Summary

In our view there is no material difference in clawback risk under either FOA model compared with existing SDA arrangements. Funds would still be paid into SDA as a security deposit, not in payment of any pre-existing unsecured debt owed by the Market Participant to AEMO[8]*. Our analysis in question 1 above will apply to both FOA models.*

Analysis

We do not believe that the proposed operation of the SDAs under the FOA model or the PwC FOA model would result in funds held in the SDA being deemed to be held by AEMO on trust for the Market Participant (or any other party). In much the same way as a bank does not hold deposits made by its customers on trust (but rather the customer becomes a creditor of the bank for the value of its deposits plus interest), a Market Participant will be a creditor of AEMO in respect of the money that it deposits in an SDA. Based on the description of the FOA provided to us, it does not appear accurate to say that the SDA funds are under the retailer's control and direction. While AEMO must administer and apply the funds in the SDAs pursuant to the imposed legislative regime[9], which in certain circumstances may oblige AEMO to direct those security deposit funds in certain ways (including potential refunds to the Market Participant), AEMO is not obliged to pay funds from the SDA at the direction of the Market Participant.

[8] see clauses 6.5 and 6.11.1 of the FOA models

[9] eg. pursuant to clause 3.3.13A of the NER and, for the FOA model, under the rules or other instruments implementing the FOA

4. Advise on possible changes to the legal structure or operation of SDAs for FOA model and PwC FOA model that may mitigate or eliminate clawback risk as it relates to FOA model and PwC FOA model (or make the risk no higher than under existing arrangements), including whether the clawback risk under FOA model 2 would be lower if:

(i) security deposits were paid directly to AEMO by the SFECP; and/or

(ii) the retailer's discretion with respect to the use of the funds in the security SDA is removed and the discretion on the application of funds is transferred to AEMO?

As we do not consider that there is any significant difference in the clawback risk inherent in the operation of the SDAs under the FOA model and the PwC FOA model compared to the current operation of the SDAs, no changes are proposed.

There will be no difference in any clawback risk if the security deposits were paid directly to AEMO by the SFECP rather than by the Market Participant.

We do not believe that either proposed FOA model gives control over the funds held in the SDAs to the Market Participant, notwithstanding that AEMO may be obliged to refund amounts held in the SDAs to a Market Participant in certain defined circumstances. Similar obligations to refund monies to Market Participants exist in the current regime, albeit more limited in scope[10]*.*

5. Provide advice on the circumstances (if any) in which a liquidator for an insolvent retailer or generator could seek to have a RA set aside on the basis that it is an uncommercial transaction within the meaning of the Corporations Act, thereby reinstating as amounts for NEM settlement the settlement credits and debits made by AEMO under the RA[11]

Summary

A reallocation arrangement per se would not be an uncommercial transaction, as it only involves the netting of equal and opposite payments and receipts by AEMO. It is possible (though unlikely) that, if the underlying transaction between the two Market Participants is found to be uncommercial, the reallocation process might be taken to be a part of that transaction and therefore also held to be uncommercial. Even if these circumstances were to arise, AEMO should be able to take advantage of a CA defence that would prevent the Court from making any order that would materially prejudice AEMO's interests.

[10] see for example clause 3.3.13A(f)

[11] E.g. In the event of generator failure, the liquidator might seek to recover difference payments where pool prices were high; in the case of retailer failure the liquidator might seek to recover difference payments where pool prices were low.

Analysis

5.1 What is an 'uncommercial transaction'?

Pursuant to CA s.588FB(1), a transaction of a company is an uncommercial transaction if:

> '… it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction …'.

Where a Court considers that no benefit or advantage was obtained by the company from the transaction or if the transaction caused some detriment to the company that cannot be explained by normal commercial practice, the Court may declare, on the application of the company's liquidator, that the transaction is an uncommercial transaction. The Court may also take into account other relevant factors in considering whether a transaction is uncommercial.

If an uncommercial transaction is entered into or given effect to when the company is insolvent or which itself causes the company to become insolvent (an 'insolvent transaction' – see CA s.588FC) and if it was entered into during the 2 year period before the commencement of the winding up of a company, a Court may declare, on the application of the company's liquidator, that the transaction is voidable (CA ss.588FC, 588FE).

Where the Court declares the transaction to be voidable, it has wide powers to make orders for the benefit of the company's creditors, including directing a person to pay money or transfer property to the company (clawback), discharging a debt incurred by the company in connection with the transaction, or declaring void or unenforceable or varying an agreement relating to the transaction (CA s.588FF).

5.2 What makes a transaction uncommercial?

Section 588FB of the CA provides that a transaction of a company is an uncommercial transaction of the company if, and only if, it may be expected that a *reasonable person in the company's circumstances* would not have entered into the transaction, having regard to:

(a) the benefits (if any) to the company of entering into the transaction;

(b) the detriment to the company of entering into the transaction;

(c) the respective benefits to other parties to the transaction of entering into it; and

(d) any other relevant matter.

These factors require that the nature and effect of the transaction be examined. 'Transaction' is very broadly defined in CA s.9 by way of example (but without limitation) as including a payment by the company, an obligation incurred, a loan to the company, a transfer of property of the company, a charge created on property of the company, a guarantee, a release, a waiver or a loan. Respected insolvency expert, Professor Keay, considers that among those transactions which may be challenged successfully as uncommercial include those where the company:

- makes gifts;
- agrees to perform tasks for no consideration;

- purchases property which has a market value less than the price paid;
- leases an asset for more than its rental value;
- disposes of property for a price less than its market value;
- agrees to pay for services a sum which exceeds their value;
- agrees to provide services for a sum less than their value;
- provides a guarantee for no benefit or a benefit less than the value of the benefit conferred by the guarantee; and
- provides security for a previously unsecured loan.[12]

There are only a few reported cases on the uncommercial transaction sections of the CA, and they adopt a purposive interpretation as directed by s15AA of the *Acts Interpretation Act 1901* (s109H of the former *Corporations Law*).

In *Peter Pan Management Pty Limited (in liquidation) v Capital Finance Corporation (Australia) Pty Limited*[13], in assessing whether the relevant transaction was an uncommercial transaction, the Court considered whether the other party to the transaction

> '… obtain[ed] a bargain of such magnitude that it cannot be explained by normal commercial practice [or] … was [either] nominal [or] trivial [or] lacked commercial quality.'

The Explanatory Memorandum to the *Corporate Law Reform Bill 1992*, which introduced CA s.588FB, stated:

> The provision is specifically aimed at preventing companies disposing of assets or other resources through transactions which resulted in the recipient receiving a gift or obtaining a bargain of such magnitude that it cannot be explained by normal commercial practice. Where consideration is given by the other party to the transaction but the consideration is nominal or trivial or lacks 'a commercial quality' then, provided it occurs within the time period set out in proposed section 588FE, the liquidator may apply to a court to have the transaction set aside or another order made under proposed section 588FF so that the body of unsecured creditors is not prejudiced by this transaction. (Paragraph 1044)

In *Demondrille Nominees Pty Limited v Shirlaw*[14], the Full Court of the Federal Court, adopting the purposive approach in its reading of section 588FB, concluded that:

> [t]he purpose or object of the provisions with which we are concerned is to prevent a depletion of the assets of a company which is being wound up by, relevantly, 'transactions at an under-value' entered into within a specified limited time prior to the commencement of the winding-up. To construe the expression 'uncommercial transaction' to catch the Agreement in the way which we have done promotes the purpose or objects of the provisions to which we have referred.

5.3 Risk of RAs being uncommercial transactions

Whether an RA initiated by two Market Participants to reallocate their obligations to AEMO is uncommercial will depend on the circumstances of the Market Participants involved and

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[12] *Liquidators' Avoidance of Uncommercial Transactions* (1996) 70 ALJ 390 at 398

[13] [2001] VSC 227, unreported 5 July 2001 at paragraph 44

[14] (1997) 25 ACSR 535 at [42]

any underlying relationship between those Market Participants. The structure of RAs under the NER does not require AEMO to inquire into the underlying arrangement between the two Market Participants associated with the reallocation.

The RAs serve the primary purpose of allowing Market Participants to net their financial obligations to AEMO so as to offset their prudential requirements. For AEMO, the RAs have a zero-sum balance in that, when the first Market Participant's account is credited with the specified trading amount, the second Market Participant's account is debited by an identical trading amount. It is highly unlikely that the netting performed as a result of the reallocation arrangement as between each Market Participant and AEMO would be found to be uncommercial. There is of course a possibility that an underlying arrangement between two Market Participants pursuant to which those Market Participants initiate a reallocation arrangement could be found to be uncommercial. In that circumstance, there is a chance that the reallocation arrangement will, as a whole, be considered by a Court to be the relevant 'transaction' for the purposes of the uncommercial transaction provisions of the CA and orders may be sought that could affect AEMO. We think this is unlikely, but should it occur, AEMO would need to look to the positive defence available to parties to an uncommercial transaction as discussed below.

5.4 Defences to an uncommercial transaction claim

Even if a liquidator of a Market Participant were able to successfully establish that a particular reallocation arrangement is an uncommercial transaction and therefore voidable by the Court, section 588FG(2) of the CA establishes a positive defence that should be available to AEMO.

That section provides that a Court is not able to make any order pursuant to a liquidator's application under the clawback provisions that would materially prejudice a right or interest of a person, if it is proved that:

(a) the person became a party to a transaction in good faith;

(b) at that time the person had no reasonable grounds, and a reasonable person in the person's circumstances would have had no such grounds, for suspecting that the company was insolvent or would become insolvent; and

(c) the person provided valuable consideration or changed his, her or its position in reliance on the transaction.

In the normal course, and subject to our earlier comments on the importance of AEMO maintaining the level of its prudential monitoring of Market Participants, we would expect that AEMO would be able to establish this positive defence in respect of an RA.

6. If a risk of clawback is identified in your response to 5 above, advise:

(i) if the risk of clawback differs as between the three different types of RAs;

(ii) whether this risk is higher or lower than that for money held in the SDA;

(iii) if the 'good faith' defence may be used to mitigate this risk; and

(iv) what other measures may be taken to ensure that the risk is mitigated.

As discussed in response to question 5 above, we do not consider that the RAs give rise to material clawback risk on the basis that the RA reallocation arrangement is (or is part of) an uncommercial transaction. We do not consider that this risk is any higher or lower as between different types of RA.

Surety of payment risk

7. Having regard to the legal structure and operation of the SFE margins payment process, provide advice on the potential impediments to the payment of positive margins to AEMO as proposed under FOA model and PwC FOA model (e.g. SFECP's rights to set-off the margins against other amounts owed by the retailer)

Summary

In our view, the nature of the 'positive margins' arising under futures contracts and the relationship between the retailer and the SFECP are likely to create significant legal impediments to implementing the FOA model (see also the discussion in section 8.2). These impediments are substantially addressed by the PwC FOA model. We therefore consider that the PwC FOA model provides the most workable solution and does not reduce the surety of payment that would be available under the FOA model.

We note that there is a continuing risk of non-payment under the PwC FOA model until the 'positive margins' have actually been paid by the SFECP into the client segregated account and are held on trust for the retailer. While the risk of default and insolvency of an SFECP cannot be ruled out, SFECPs are subject to minimum financial requirements, including net assets tests, enforced and monitored by the SFE. If an SFECP is suspended from trading, the open positions of each of its clients will be transferred to another SFECP.

Analysis

7.1 Nature of 'positive margins' paid under electricity futures contracts

This part of our advice has been prepared from the viewpoint of an electricity retailer (***Client***) which enters into long (bought) positions with an SFECP under electricity futures contracts (***Contracts***). As a full SFE participant, the SFECP must comply with both the SFE Operating Rules (***SFEOR***) and the SFE Clearing Corporation Clearing Rules (***SFECR***).

Under the SFEOR and the SFECR, upon registration of a Contract with SFE Clearing Corporation Pty Limited (***SFECC***), that Contract becomes a contract between the SFECP and SFECC (SFECR 31.3). No other person (including the Client) has any rights or obligations under that Contract (SFECR 31.4). SFECC as a market operator is not obliged to recognise the interest of anyone other than the SFECP who may be taken to be a party to the Contract with SFECC.

SFEOR 2.2.25 stipulates minimum terms for the agreement between the SFECP and the Client. These include:

- (para. 2.2.25(c)) – any benefit or right obtained by the SFECP upon registration of a Contract with SFECC is personal to the SFECP and does not pass to the Client; and
- (para. 2.2.25(d)) – the Client has no rights in relation to Contracts registered with SFECC, whether by subrogation or otherwise, against anyone other than the SFECP.

As a result, any rights and obligations of the Client in relation to the Contract are solely contractual rights and obligations as against the SFECP who entered into that Contract on behalf of the Client. Those contractual rights and obligations are partly mandated by the SFEOR and the SFECR (see for example SFEOR 2.2.25 above), but may also include other terms and conditions imposed by the SFECP or negotiated between the SFECP and the Client. Any rights which the SFECP has to payment of 'positive margins' from SFECC do not belong to the Client.

Under SFECR 41.2, a client clearing account (***CCA***) is established for each SFECP, being the account for all money and other property owing to or from the SFECP in respect of Contracts entered into for Clients. In section 7.2 below, we have also considered the possibility that a separate CCA might be opened relating only to a Client's Contracts.

SFECC administers the CCA of each SFECP on an omnibus basis and payments to or from the CCA are net payments in respect of all Contracts entered into by the SFECP from time to time. This is likely to include non-FOA contracts and contracts entered into on behalf of multiple other clients of the SFECP. Net payments to the SFECP will only become referable to particular Contracts registered in the FOA once those payments have been received by the SFECP and paid into the client segregated account (***CSA***) by the SFECP (see section 8 for a discussion of the CSA).

As a result, references to 'positive margins' for the purposes of the FOA can only mean the right of the Client, as a contractual right against the SFECP, to be allocated (out of any net payment received by the SFECP into its CCA) a positive amount in respect of a particular Contract registered in the FOA. If the only contracts entered into by the Client are bought Contracts participating in the FOA, then payments by SFECC to the SFECP in relation to those Contracts should, in aggregate, always equal the 'positive margin' contemplated under the FOA model, except in circumstances where the SFECP has defaulted and SFECC exercises its rights over the CCA (see section 7.3 below). However, the net payment received from SFECC will always be affected by the net position resulting from the contracts of other clients of the SFECP which are accounted for under the same CCA.

7.2 Possibility of a separate CCA for FOA-registered Contracts

SFECR 41.2 contemplates that the SFECC may agree to open one or more additional CCAs for a 'prescribed Group of Contracts' trading on a single exchange, to which all amounts owing to or from the SFECP with respect to that Group of Contracts will be referable. It is important to note that:

- the establishment of a separate CCA is at the discretion of SFECC;
- a Group of Contracts is defined as a group of contracts which, in the opinion of SFECC, have similar characteristics (the given example is contracts denominated in a foreign currency);
- currently the only 'prescribed' Group of Contracts are SFE-listed contracts denominated in NZ dollars; and
- SFECC is not required to recognise any clients of the SFECP, or to be on notice in relation to any matter between the SFECP and a client (SFECR 42).

On this basis we consider it unlikely that the SFECC would prescribe FOA-registered contracts as a Group of Contracts for the purposes of establishing a separate CCA. Even if a separate CCA were to be established for those Contracts, this would not necessarily quarantine the funds in that account from liabilities relating to other client positions for the SFECP, as explained below.

7.3 Rights of SFECC in relation to CCAs

In accordance with SFECR 44, the SFECC conducts a daily settlement of all open contracts, which results in payment obligations as between the SFECP and SFECC.

Under SFECR 47.1, daily settlement is effected by way of a net payment either to or from the SFECP. SFECR 47.3 allows the SFECC to combine or consolidate the balances (whether arising from settlements, margin payments or otherwise) for all or any open contracts designated to the CCA, and may set-off any credit amounts from time to time of any of the SFECP's CCAs towards payment of any of its liabilities to SFECC in respect of open contracts designated to those CCAs.

It is therefore quite clear from the rules that, where multiple CCAs have been established for the SFECP, the SFECC can use funds in any of those accounts to offset any unpaid liabilities of the SFECP that relate to client positions.[15]

Under SFECR 72.1, upon Default of an SFECP (as defined in the SFECR), SFECC may:

- close out all or any open contracts;
- appropriate any excess after applying SFECR 47 and 48;
- apply and set off any money or securities or other property deposited by the SFECP with SFECC; and
- apply proceeds without notice for the above purpose.

As a result, whenever the SFECP has other clients whose contracts are registered with SFECC, the Client has no certainty of receipt of any 'positive margin' until that payment is received into the SFECP's CSA. Moreover, upon default and insolvency of the SFECP, the Client's only claim in respect of its Contracts would be a claim as an unsecured creditor of the SFECP, to the extent a valid claim could be established under the Client's agreement with the SFECP. While the Client would have a priority claim to money held for it on trust in the CSA, that claim will not arise until the money is paid into the CSA.

7.4 Risk of default of SFECP

We have been asked to consider whether it is possible to quantify the risk of default by an SFECP and whether any information could be made available to AEMO for the purposes of monitoring or assessing the likelihood of default by a particular SFECP with whom an FOA agreement is (or may be) registered. The following paragraphs provide a high-level overview of the financial requirements, reporting and default provisions of the SFECR and SFEOR. In summary, we do not consider that it would be possible for AEMO to directly monitor positions of SFECPs. However, an SFECP is subject to minimum financial and

prudential requirements upon admission and is monitored by SFECC on a regular basis to ensure that these requirements continue to be satisfied. These requirements are imposed by SFECC with view to reducing the risk of financial failure by an SFECP and to ensure that SFECC satisfies its own obligations as the licensed operator of a clearing and settlement facility, subject to supervision by ASIC.

Whilst, of course, the possibility of financial failure or default by an SFECP cannot be eliminated entirely, there are a number of safeguards built into the operation of the market. The risk of financial failure is further mitigated because settlements are effected, and margins called, daily and on a net basis. The following is a summary of the primary measures adopted by SFECC to reduce the risk of financial failure by an SFECP.

(a) Financial Requirements for SFECP

Under the SFECR, in order to become an SFECP and to maintain such admission a person must:

- have net tangible assets (***NTA***) of at least $5 million (the current amount prescribed by the Board of SFECC);
- provide a specified financial "Commitment" to the operations of SFE (generally by way of cash or irrevocable letter of credit), consisting of a fixed Commitment and variable Commitments based on the SFECP's aggregate initial margin as a proportion of total Participant initial margin; and
- comply with a capital based open position limit (currently an SFECP's initial margin liability must be no more than 200% of the SFECP's NTA).

(b) Ongoing monitoring and reporting requirements

There are similar reporting requirements applicable to exchange participants under the SFEOR and full clearing participants under the SFEOR. An SFECP must immediately inform SFECC (and the Exchange) on the occurrence of events that may indicate a financial risk, including the following:

- the value of its financial position at any time is less than 150% of the Financial Requirements (see paragraph (a) above) or has decreased by more than 20% since the last advice provided;
- its financial position has varied such that it exceeds prescribed position limits (currently 200% of NTA);
- its financial position has altered in specified prescribed circumstances;
- a relevant licence (including an Australian financial services licence) is suspended or cancelled, or its conditions are varied; or

[15] Funds in a CCA cannot be used to offset liabilities relating to the SFECP's own (house) positions, although its house account could be applied in relation to client positions.

- an event of Default occurs under SFECR 71 (events include failure to pay a margin or to meet obligations under open contracts).

In addition, an SFECP must provide statements of its financial position on a monthly basis (one month in arrears), as well as quarterly and annual (audited) statements. An SFECP must also give the SFECP immediate access to its information and records concerning trading and financial positions.

(c) Suspension

Under the SFEOR, the participant status and trading rights of an SFECP who is a Full Participant will be suspended if (among other things) it fails to provide any financial position statement within 7 days of the due date or fails to maintain the required level of net tangible assets under SFEOR. In addition, SFECR 10.11 provides for the automatic suspension of an SFECP who:

- is in Default under SFECR 71;
- is in breach of the Financial Requirements defined in the SFECR or fails to provide a monthly financial report under SFECR 8.4 and fails to rectify that breach within the time specified by the Board of SFECC; or
- has a liquidator or receiver, or some other form of external management, appointed in respect of its property, or if the SFECP or a partner of the SFECP becomes bankrupt.

Under SFEOR 2.2.7(i), if an SFECP is a Full Participant and its status and rights are suspended or terminated, the SFE will notify all other participants and ASIC. The SFE may also make other public announcements or notify other persons as it sees fit. The AEMC may wish to explore whether the SFE would be willing to notify AEMO if suspension or termination occurs. Generally, however, the SFE and SFECC are obliged to keep participant information confidential unless permitted by the rules or required by law.

7.5 Differences between the FOA model and the PwC FOA model

We understand that the primary differences between the FOA model and the PwC FOA model which are relevant to the question of surety of payment are:

(a) under the FOA model, the SFECP would undertake that positive margins from the Client's Contracts would be held in a client segregated account and would not be netted off against other contracts entered into for that Client, whereas under the PwC FOA model the positive margins would not be quarantined from netting in the event that the Client defaults; and

(b) under the FOA model, the Client would direct the SFECP to pay positive margins directly to AEMO whereas, under the PwC FOA model, the positive margins would be paid by the Client to AEMO by drawing that money from the client segregated account.

In our view the nature of the 'positive margins' arising under Contracts and the relationship between the Client and the SFECP mean that there are likely to be significant legal impediments to implementing the FOA model (see discussion in section 8). These

impediments are substantially addressed in the PwC Model. However, there is a continuing risk of non-payment under the PwC Model until the 'positive margins' have actually been paid by the SFECP into the CSA and are held on trust for the Client (see section 8.5 for a discussion of how the risk of non-payment by the Client to AEMO from the CSA could be reduced).

For the reasons set out above, we would support the PwC FOA model. In our view the FOA model would not achieve greater security of payment rights for AEMO in relation to positive margins than the PwC FOA model, and it presents significant legal difficulties in attempting to bind the SFECP to make the payments directly to AEMO. Having regard to the nature of the 'positive margin' payments received by the SFECP from SFECC and the direct and exclusive relationship between the SFECP and SFECC in relation to Contracts registered with SFECC (see section 7.1 above), AEMO could not obtain any greater right to receive those payments than the Client itself has under its agreement with the SFECP. Also, any attempt to construct an agreement between the SFECP and AEMO which purported to by-pass the Client in relation to payments to AEMO could be a breach of the SFECP's obligation to pay that money into a CSA for the benefit of the Client (see sections 8.1 and 8.2 below).

8. Advise whether, if positive margin payments are received from the SFE Clearing Corporation Pty Ltd in respect of a futures contract to which a retailer is a party and paid into the SFECP's client-segregated trust account, the retailer will have the right to access that money and direct the payment of that money to AEMO

Summary

The retailer's entitlement to the funds in a CSA is reduced by any amount to which the SFECP is entitled under the Client agreement with the retailer, or under the SFEOR. There may also be a shortfall in funds in the CSA due to the activities of other clients or other contract positions. This risk could be reduced if the SFECP established a separate CSA for the Client's Contracts, but this would be at the SFECP's discretion.

Subject to the priority rights of the SFECP, the retailer will have an absolute beneficial entitlement to its share of the money in the CSA, and would have the right to direct payment out of that account to AEMO as contemplated in the PwC FOA model.

We do not consider that the direct arrangement between AEMO and the SFECP contemplated by the FOA model can be implemented.

Security of payment risks still exist under the PwC FOA model if:

- *the SFECP fails to pay the positive margins into the CSA; or*
- *the retailer fails to direct payment to AEMO, or revokes that direction.*

It may be possible for AEMO to reduce the risk of future non payment by the retailer by obtaining an irrevocable power of attorney from the retailer.

Analysis

8.1 Distinction between client clearing account and client segregated account

To clarify the question, it should be noted that positive margins are paid from SFECC into the SFECP's CCA, as described in section 7. Those margins will be netted against payment rights and liabilities of the SFECP in relation to all its open contracts under that CCA. The SFECP would then in turn pay any positive margin under the Client's Contracts into a CSA.

8.2 Nature of the client segregated account

The CSA is maintained by the SFECP in order to satisfy its obligations under:

(a) CA s.981B(1) – under which any money paid to a financial services licensee in connection with a financial service or a financial product held by a person must be paid into an account which satisfies the requirements of the section; and

(b) SFEOR 2.2.26 – under which any money received by an SFECP from the Client or required by the SFEOR to be paid into a CSA (including payments for margin calls, interest on investments, money received from SFECC and realisation of investments) must be paid into an account designated as a CSA.

It is also worth noting that regulation 7.8.01 of the Corporations Regulations (***CR***) allows a single CSA to be used for purposes described in both (a) and (b) above. Section 981B(2) of the CA allows the CSA to be maintained in a single account or in two or more accounts. While this would technically allow the separation of margins relating to FOA-registered Contracts from those relating to other contracts of the Client, in practice, SFECPs generally hold the monies of all clients in a single trust account, and keep their own internal records of the positions of individual clients within that CSA. This means that at any time there may be an overall shortfall in the CSA. A shortfall could be caused by the failure of an individual client to 'top up' the account in relation to its negative margin position, or by the failure of the SFECP to pay positive margins into the CSA.

Under CA s.981B(1)(a), the SFECP must maintain the CSA with an Australian authorised deposit taking institution or other permitted financial institution. If the SFECP is itself an authorised deposit taking institution, it can maintain the CSA as a deposit account with itself (CR 7.8.01).

Under CA s.981H, money in the CSA is taken to be held in trust by the SFECP for the benefit of the Client, except where the CR provide otherwise. CR 7.8.01(5) requires the SFECP to operate the CSA as a trust account and hold all money paid into the account in trust for the Client (other than money paid to the SFECP for the purpose of meeting margin calls under the SFEOR).

Money which is paid into a CSA and investments made with that money by the SFECP cannot be attached or otherwise taken in execution or be made subject to a set-off, charge or charging order against the SFECP (CA s.981E).

Money in the CSA may only be invested in the manner set out in CR 7.8.02, which includes any authorised trustee investments. Interest and other earnings on the investment may be wholly or partly retained by the SFECP, provided this is disclosed to the Client and dealt

with in accordance with a written agreement between the SFECP and the Client (CR 7.8.02(3)(ii), 7.8.02(7) and 7.8.02(8)).

8.3 Can the CSA be used to fund payments to AEMO as required under an FOA?

Under the FOA model, AEMO would enter into an agreement with the SFECP under which the SFECP would undertake to hold 'positive margins' in the CSA and would agree to make payments as required under the FOA directly to AEMO out of the CSA. Under the PwC FOA model, the Client would withdraw money from the CSA and pay it to AEMO to satisfy its obligations to deposit money with AEMO under an FOA.

As discussed above, in our view, it would not be possible from a legal viewpoint for the SFECP to hold the payments for the benefit of AEMO under the CSA. Funds in the CSA are held on trust for the Client (and each other client of the SFECP) to the extent of its entitlement, and money may only be withdrawn from the CSA for the purposes specified in the CA and the SFEOR. Under CR 7.8.02 and CA s.981D, these purposes include:

- payment in accordance with a written direction of the person entitled to the money (usually the Client);
- payment to the SFECP of money which the SFECP is entitled to under the SFEOR; and
- payment for the purpose of meeting obligations incurred by the SFECP in connection with margining, guaranteeing, securing, transferring, adjusting or settling transactions in derivatives (ie. the Contracts).

The purposes do not include payment to a third party in order to satisfy obligations of the Client in accordance with an agreement between the SFECP and the third party.

SFEOR 2.2.26(g) also prohibits the SFECP from making any agreement with a Client that the Client's money is not to be held in the CSA.

Although a written agreement between the SFECP and the Client can provide for the 'investment' of money in the CSA in the manner directed by the Client (SFEOR 2.2.26(h)(vii)), it is unlikely this could be applied to enable direct 'investment' by the SFECP with AEMO for the purposes of satisfying the Client's obligations under an FOA, because:

- such an agreement must also deal with how any losses on investments made with money in the CSA are dealt with (CR 7.8.02(3)(iv) and SFEOR 2.2.26(i)(i)(d)); and
- the 'investment' must be readily realisable and no less than 50% of money invested must be on 24-hour call.

This would not be consistent with the intended treatment of the funds paid to AEMO under the FOA model.

However, in our view the payment of money by the Client to AEMO under the PwC FOA model is consistent with the treatment of money in the CSA. We consider that payments could be made directly from the CSA in accordance with the written direction of the Client and that direction can be a standing direction. Whilst the SFECP would be making the payment to AEMO, it would do so only in accordance with its obligations to the Client and under the CA, and would owe no obligation to AEMO in respect of that payment. In our

view, such an arrangement can still give AEMO reasonable certainty of payment, except in circumstances where:

- the SFECP fails to pay the positive margin into the CSA; or
- the positive margin is paid into the CSA but the insolvency of the Client prevents a payment being made to AEMO, for example, because a controller of the Client revokes the standing direction to SFECP.

If the standing direction from the Client to the SFECP were expressed to be irrevocable, this may reduce the risk of an administrator or liquidator revoking the direction but would not eliminate that risk entirely.

8.4 Rights of the Client in relation to money held in the CSA

The money held in the CSA will be subject to an express trust in favour of the Client, to the extent of its entitlement, on the terms set out in the CA and CR. The Client will have a beneficial entitlement to that money in proportion to its entitlement (CR 7.8.03(6)(d)). There are three main reasons why the Client's entitlement to funds in the CSA may not equal the positive margins referable to its Contracts:

(a) First, the SFECP may have failed to pay those margins into the CSA even though it has received payment from SFECC.

(b) Secondly, as noted above, the Client will only have a proportionate entitlement to the funds that are actually in the CSA. If a separate CSA has not been established for the Contracts and other clients have failed to make payments to the SFECP in respect of their own positions, the client's proportionate share of the moneys in the CSA may be reduced. This risk would be reduced if the SFECP were willing to establish a separate CSA, provided the SFECP had complied with its obligations in relation to that separate CSA and amounts standing to that separate CSA were clearly identifiable on insolvency of the SFECP.

(c) Thirdly, the SFECP will have a priority right to any money in the CSA to which it is entitled under its agreement with the Client or under the SFEOR, in particular its fees, brokerage and other amounts required to cover payments relating to the SFECP's obligations in connection with margining, guaranteeing, securing, transferring, adjusting or settling transactions in derivatives (ie. the Contracts). Typically, a client agreement will entitle the SFECP to use any funds held on behalf of the client in order to offset amounts owed by that client. For example, if a Client held positions in relation to FOA-registered Contracts in CSA1 and other contracts in CSA2, the SFECP would be entitled to withdraw or divert funds from CSA1 in order to meet unpaid fees or margins relating to CSA2 contracts.

It follows that, if there is a shortfall in the CSA, the Client may not always be entitled to receive its full entitlement to the positive margins paid into the CSA. However, whatever entitlement the Client does have would be an absolute beneficial entitlement to its share of the money held in the CSA.

To the extent that 'positive margins' are paid into the CSA and are not required by the SFECP, there is no legal impediment to the Client directing the SFECP to withdraw those amounts and pay them to AEMO to meet the Client's obligations under an FOA.

8.5 Reducing the risk of non-payment by the Client to AEMO

As mentioned above, under the PwC FOA model, it is possible that the Client either:

- simply does not direct the SFECP to pay the money to AEMO; or
- becomes insolvent or enters into voluntary administration, with the result that a controller of the Client revokes any standing direction to the SFECP or otherwise cancels the payment by the Client to AEMO.

One way of potentially reducing the risk to AEMO under the second scenario would be for AEMO or an officer of AEMO to hold an irrevocable power of attorney from the Client (as provided for under the Powers of Attorney Act (NSW) and equivalent legislation in other States). The holder of the power of attorney would be authorised to direct the SFECP, on behalf of the Client, to make the required payments to AEMO and to do anything else which is necessary or desirable in connection with such payments. In accordance with section 16 of the *Powers of Attorney Act* 2003 (NSW), an irrevocable power of attorney should remain effective notwithstanding the insolvency or liquidation of the Client.

The execution requirements for powers of attorney are governed by State legislation and vary between jurisdictions[16]. We would suggest that any power of attorney should be executed by the Client as a deed, and be required to comply with all other legal requirements applicable in the place where it is executed.

The power of attorney could be expressed to relate to all payments from a CSA in respect of which the Client has (or may have) an entitlement to funds relating to Contracts registered under an FOA. We do not consider that a separate power of attorney would be required for each registered FOA Contract. The power may be expressed in terms that:

- authorise AEMO to direct the SFECP, on behalf of the Client, to pay funds out of the CSA to AEMO;
- limit that authority to amounts to which AEMO is entitled under one or more FOA's ; and
- apply only where the Client has not given the SFECP a valid direction to the same effect.

AEMO would not become a party to the agreement between the Client and the SFECP, whether as the Client's agent or otherwise.

The power of attorney would not bind the SFECP, but should generally be recognised by the SFECP and actioned accordingly, particularly if the Client has notified the SFECP of the appointment and given an undertaking to AEMO and the SFECP not to give a direction to the SFECP which is inconsistent with a direction given by AEMO under the irrevocable power of attorney. However, the feasibility of this option will depend on the commercial positions of both parties. The AEMC may wish to canvass this alternative further with retailers and SFECPs.

[16] For example, s.107 of the *Instruments Act 1958* (Vic) requires the document to be signed, sealed and delivered by the donor, but s.8 of the *Powers of Attorney Act 2003* (NSW) only states that an instrument may or may not be under seal.

8.6 SFECP agreement in respect of its priority rights to funds in the CSA

We have been asked to consider whether:

- the form of the Client's agreement with the SFECP might impact on the extent of the SFECP's priority rights to funds in the CSA, and if so whether AEMO should only agree to register an FOA where it is assured that the agreement is in a particular form; and
- the SFECP might 'contract out' of its priority rights by agreement with the Client and/or AEMO.

The SFECR prescribe minimum terms for agreements between SFECPs and their clients (SFECR 4.14(j)). The minimum terms do not contain specific conditions relating to fees and payments, however an SFECP is specifically entitled under CR 7.8.02(1)(b) to withdraw brokerage and other proper charges from a CSA. As noted in section 8.4(c) above, most standard client agreements will include a provision allowing the SFECP to use the proceeds of any financial product held on behalf of the Client to offset any amounts owed by the Client. We consider it unlikely that an SFECP would agree to trade other than on its standard terms unless it receives some consideration for doing so.

9. Advise whether it would it be possible for AEMO to take security over the retailer's beneficial interest in the SFECP's client-segregated trust account under the SFE Rules (e.g. the right to the proceeds in the account to which it is entitled) if the SFECP agreed to such an arrangement

Summary

There is some doubt as to whether a security interest could be granted directly over the funds in the CSA, but a charge could generally be granted over the Client's right to receive funds from the CSA and to those funds in the hands of the Client. A number of possible security options are noted in this section, some of which may not be commercially acceptable to retailers.

It is legally possible (although not common practice) for a CSA to be held in separate accounts, one of which could be designated for the Client's FOA-registered contracts. If SFECPs are willing to implement this structure, with AEMO taking an equitable charge over the Client's beneficial right to receive the proceeds, we consider that the risk of non-payment or short-payment of amounts due to AEMO under the FOA is likely to be reduced.

Analysis

9.1 Client's interest in the CSA as chargeable property

The Client has an equitable interest in its proportionate share of the money held by the SFECP in the CSA. Although a person would usually be able to grant a valid security interest over an equitable proprietary interest, due to the nature of the entitlements to money in the CSA, it is likely that any charge would need to be expressed as a charge over the Client's right to funds received from the CSA and the proceeds of the chose in action which the Client holds as against the SFECP. Such a charge would not operate over the money in the CSA itself, but would instead take effect over both the right to receive these funds and the funds themselves when they enter the hands of the Client. In this sense it would operate like a charge over a book debt and its proceeds.

9.2 Nature of the security interest

Any security over an equitable interest, whether by way of charge or mortgage, is only capable of taking effect as an equitable interest. If AEMO obtains a security interest over the Client's interest in the CSA, in order to ensure priority over later equitable interests (eg. a competing charge), AEMO would need to give notice of its security interest to the SFECP. AEMO could also take other steps (such as obtaining an irrevocable power of attorney) to assert control over the Client's entitlement to money in the CSA.

In most circumstances it is likely that any security interest granted to AEMO would operate as a floating charge because AEMO would not be exercising the level of control required to be exercised by a chargee for a Court to find a fixed charge in this situation (e.g. maintaining a blocked account). With a floating charge (as opposed to a fixed charge), there is a risk that the charge will be void against a liquidator where it is created within 6 months of the 'relation-back day' under CA s.588FJ. A floating charge will also be postponed to certain employee creditors of the company.

If the security interest is a registrable charge under CA s.262, then it should also be registered (see section 9.3 below).

9.3 Registration of a charge where the Client is a corporation

If an equitable mortgage or charge taken by AEMO from the Client consists of any of the following:

- a floating charge on the whole or the part of any property of the Client;
- a charge on a book debt; or
- a charge on the whole or part of the business or undertaking of the Client,

then it will be registrable under Part 2K.2 of the CA. Registration will have the effect of establishing priority of the equitable charge over later registered floating charges or unregistered charges, unless it can be proven that AEMO had notice of the earlier-created charge. In addition, a floating charge will be postponed to a later-registered fixed charge unless the fixed charge was created in breach of a provision of the floating charge and notice of such a provision was given to ASIC.

As indicated above, any security interest taken by AEMO from the Client is likely to be either a floating charge or a charge over book debts and would therefore be a registrable charge. Failure to register a charge which is registrable may result in the charge being void as against a liquidator or administrator of the Client (CA s.266) but will not otherwise invalidate the charge as against the Client and other persons holding unregistered charges.

9.4 Fixed and floating charge over substantially the whole of the Client's assets

We have considered the possibility of AEMO taking a fixed and floating charge over substantially the whole of the Client's assets, in conjunction with a fixed and floating charge over the Client's entitlement under the CSA. This would allow AEMO to take advantage of the exception under CA s.441A to the general standstill on secured creditors commencing enforcement of a charge after the appointment of an administrator. This exception allows the holder of a charge over the whole or substantially the whole of a company's assets to enforce the charge, including appointing a receiver, within a 13-business day decision period after an administrator is appointed.

In practice, we expect that this would not generally be a feasible option. A retailer is unlikely to be willing to grant such a floating charge unless (possibly) it is a standalone entity within the corporate group without any other secured creditors. It may be possible in some circumstances to take a charge which will satisfy the above requirements whilst not disturbing other security interests or financing in respect of its other business which may have been granted by the Client. This is commonly referred to as a 'featherweight' floating charge, which operates as a floating charge over the whole of the Client's assets whilst in practice limiting its scope to a defined amount of the secured money owing.

9.5 Reducing risk by a separate CSA for FOA-registered Contracts and charging that CSA.

As noted above, CA s.981B(2) allows a CSA to be maintained in a single account or in two or more accounts. Accordingly, it would be possible for all money relating to Contracts to which an FOA applied to be held in a separate CSA by the SFECP. This could be a

condition of a retailer participating in the FOA, although we note that, as a practical matter, SFECPs may be unwilling to separate the accounts.

If this option were implemented, it is likely to reduce the risks associated with the Client not receiving full payment because of a shortfall in the CSA arising (for example) as a result of default by other clients of the SFECP. If the Client grants a charge to AEMO over the separate CSA, a liquidator of the Client may be more willing to call for those funds and release them to AEMO, since (subject to the SFECP's priority payment claims) the Client would have a clear beneficial entitlement to all of the monies in the separate CSA.

10. Advise whether the SFECP will have any residual rights to the positive margins already paid to AEMO on the retailer's behalf should the retailer default on arrangements with the SFECP

It follows from what we have said above that money withdrawn from the CSA at the direction of the Client and paid to AEMO will belong to AEMO absolutely, subject only to any claim by the Client to the money as against AEMO.

Any rights of the SFECP against the Client in relation to Contracts are limited to contractual rights under its agreement with the Client, rights of set-off as between money owed to the Client and to the SFECP, and the right to access money in the CSA for certain purposes (eg payment of margins to SFECC).

Once funds have been paid out of the CSA, the SFECP has no further claim against those funds and AEMO should have an absolute right to retain the amount paid to it out of those funds.

11. Having regard to the FOA model and the PwC FOA model (in particular, sections 1.2 and 5 of Annexure 1), advise on the minimum level of contractual or Rules based commitments that would need to be made by the SFECP and the relevant retailer in order to ensure that the legal risks in respect of surety of payment to AEMO and the NEM participants associated with the FOA model and the PwC FOA model are no higher than under RAs

An FOA is likely to involve lesser surety of payment by the Client to AEMO than an RA because, under RAs, AEMO can rely on mandatory insolvency set-off against the Client to minimise its exposure to the amount owed by the Client to AEMO . Under the FOA model and the PwC FOA model, there is no legal right of the retailer to set-off and no legal right to payments owed by the SFECP until those payments have been made by the SFECP into the retailer's CSA.

In our view it is unlikely that this risk could be reduced significantly by any contractual or Rules based commitments by the SFECP other than:

- *'early warning' notifications to AEMO of potential events which could result in non-payment;*
- *acknowledgement of AEMO's interest (including any interest secured by way of charge) in the Client's entitlement to the money in the CSA;*
- *if granted, acknowledgement of AEMO's irrevocable power of attorney; and*

- *if practical, a requirement to open a separate CSA for the Client margins relating to Contracts that are subject to an FOA.*

Any other commitments by the SFECP are likely to exceed what the SFECP can commit to under the provisions of the SFEOR (see section 8.2 above).

Subject to further consultation by the AEMC with regard to the willingness of retailers and SFECPs to implement the relevant arrangements, the NER could include conditions for the establishment of an FOA by a Market Participant, including the grant of security over its beneficial interest in respect of funds received from the CSA, the provision of an irrevocable power of attorney or a separate CSA for FOA-registered contracts.

Immunities in relation to AEMO's role

12. If the model at Annexure 1 is changed whereby AEMO may enter into a contract with an SFECP in relation to the SFECP's obligations under the FOA model or PwC FOA model (in particular, its obligations in sections 1.2, 1.3 and 5 of Annexure 1), advise on the application of s119 of the National Electricity Law in respect of AEMO's liability under that contract

Summary

We consider that the statutory immunity and limitation of liability for AEMO would apply to its liability under any contract with an SFECP entered into for the purposes of the FOA. For certainty, we suggest that, if AEMO will be required to enter into a contract with an SFECP:

- *the contractual arrangements should be specifically contemplated in the FOA rules to be included in the NER; and*
- *the form of contract should include a statement that nothing in the contract varies or excludes the operation of section 119 of the National Electricity Law.*

Analysis

12.1 Potential obligations of the SFECP

Under the FOA model and the PwC FOA model, it is proposed that the SFECP would have obligations in respect of the following matters:

- provision of accurate and timely information to AEMO about contract position and variations and any corrections to published SFE settlement prices (sections 1.2.2.2, 1.2.2.3, 1.2.2.4);
- setting up a separate client sub account for FOA positions, with no netting against non-FOA contract positions (sections 1.2.2.1, 5.1.1, 5.1.3); and
- possibly, facilitating audit of contracts and futures positions by AEMO (section 1.3).

12.2 The only other direct interaction between AEMO and the SFECP contemplated under the FOA model is the possibility of the SFECP undertaking to pay positive cash flows to AEMO. PwC has suggested that this option be removed (ie. only the retailer could make payments, or direct the SFECP to make payments, out of the CSA). As outlined in sections 7 and 8 above, we agree with this approach.

12.3 Nature of potential AEMO obligations

It is unclear whether AEMO would have any material obligations under such a contract. However, we have responded to this question based on a hypothetical alternative structure under which, for example, a tripartite contract might require AEMO to make payments into, or allow it to call on payments from, a fund or account established by the SFECP, for which AEMO may incur liability.

We consider that AEMO would be entering into such a contract, and performing the obligations under that contract, 'in the performance or exercise of a function or power of

AEMO' under the NER (as contemplated in section 119(1) of the National Electricity Law). The purpose of the contract would be to implement the arrangements necessary to perform AEMO's FOA functions (to be provided for in the NER).

12.4 Recommended wording for NER and contracts

If the FOA structure will require AEMO to enter into a contract with the SFECP, the FOA rules in the NER should expressly contemplate that AEMO may (or must) do so. This will provide a clear link between the contract and AEMO's functions or powers.

Section 119(5) of the National Electricity Law contemplates that AEMO can agree to vary or exclude the operation of the immunity under section 119(1). We recommend that any form of contract developed for FOA purposes contain an express statement that nothing in the contract varies or excludes the operation of section 119.

Additional Proposed FOA Model

13. Having reviewed our draft advice in relation to the FOA model and the PwC FOA model, the AEMC asked whether there would be any legal impediments to the implementation of a revised FOA model, under which:

(a) an 'FOA contract' is entered into between the SFECP, Client and AEMO;

(b) SFECP and Client confirm existence and relevant details (eg futures lodgement price) of underlying futures contract ('relevant Contract');

(c) SFECP agrees to establish separate CSA for relevant Contract;

(d) SFECP and Client agree not to deal in or close out the relevant Contract [possibly except on 7 days' notice to AEMO];

(e) Client gives irrevocable standing direction to SFECP to make payments from CSA to AEMO;

(f) Client gives irrevocable power of attorney to AEMO to direct the SFECP to pay monies out of the CSA (to which the Client is entitled) to AEMO [how does this interact with Client direction under (e) if revoked?];

(g) If amounts paid to AEMO from CSA are less than 'positive margins' under the relevant Contract, the Client must pay the shortfall to AEMO within an agreed period (eg 24 hours), but if the Client fails to pay then the SFECP must pay the shortfall to AEMO (effectively a payment guarantee).

Summary

We have addressed this question by way of comparison and exception to our responses in relation to the FOA model and the PwC FOA model. As a preliminary comment, we consider it unlikely that an SFECP would agree to any obligations to AEMO that may limit its ability to recover monies due to the SFECP out of the CSA, unless (possibly) it charges the Client a premium to do so. As a result, an FOA with this type of structure may be unworkable (because the SFECP is unwilling or unable to enter into the required agreement) or commercially unattractive (because the costs eliminate the benefits of the FOA).

Also, an SFECP could not enter into a blanket agreement not to close out a relevant Contract because this would potentially place the SFECP in a position of non-compliance with the SFEOR should the Client fail to make a margin call relating to any contract position with the SFECP (not just FOA-registered contracts). Further, an SFECP is only permitted to advance a line of credit to a client in very limited circumstances.

Analysis

13.1 Agreement not to deal or close out

Under SFEOR 2.2.27(g), the SFECP is required to immediately close out **all** futures positions held on account of a Client if that Client fails to pay a margin call. Although the SFECP has some discretion to 'wait and see' beyond the 24-hour payment period allowed for Australian resident clients, the exercise of that discretion is limited to circumstances in which it is reasonable to expect that payment will arrive (for example where the Client has attempted to pay but has been delayed by third party action or omission). If there is any reasonable doubt that funds will not arrive, the SFECP must close out the positions. Accordingly, an SFECP could only agree not to close out the underlying Contract subject to its obligations under the SFEOR. Such an agreement would prevent the SFECP and the Client from agreeing to closing out a position by mutual agreement, but would still allow closing out if the Client were in default.

In a tripartite agreement with the Client and AEMO, it would be possible for the SFECP to agree to notify AEMO before (or more likely as soon as practicable after) closing out any positions relating to relevant Contracts or terminating its agreement with the Client. However, failure to notify AEMO would not affect the SFECP's right to close out or terminate.

13.2 Standing direction and power of attorney

We proposed the concept of an irrevocable power of attorney from the Client in favour of AEMO to cover circumstances in which the Client or (more likely) its administrators or liquidators attempt to revoke a standing direction to the SFECP to pay AEMO out of the Client's entitlement to funds in the CSA. Therefore we envisage that the power of attorney would take effect in the event that the Client fails to direct the SFECP to make payment to AEMO in accordance with the FOA. The SFECP would not, however, be bound to act in accordance a direction given under the irrevocable power of attorney unless it had entered into an agreement with AEMO to do so. AEMO would therefore need to enter into an arrangement whereby the Client notifies the SFECP of the appointment of AEMO under the irrevocable power of attorney and gives an undertaking to AEMO and the SFECP not to give a direction to the SFECP which is inconsistent with a direction given by AEMO under the irrevocable power of attorney.

13.3 SFECP undertaking to pay shortfall

If a separate CSA were established for relevant Contracts but there were still a shortfall between the amounts owing by the SFECP to the Client and the funds in the CSA then, under normal circumstances (where the SFECP is acting in accordance with its legal obligations), the shortfall should only relate to amounts due to the SFECP itself, which the Client has failed to satisfy under a margin call. In these circumstances an agreement by the SFECP to fund that amount may involve the provision of a credit facility to the Client. The SFE's Business Conduct Committee has only approved the provision of credit by an SFECP where:

- the SFECP is a bank;

- money is lent by a separate credit division of the bank in accordance with its normal credit policies (which the SFE may verify); and
- the credit facility is used to pay obligations under a margin call by direct payment into the CSA.

Allens Arthur Robinson

22 December 2009

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