

d-cyphaTrade

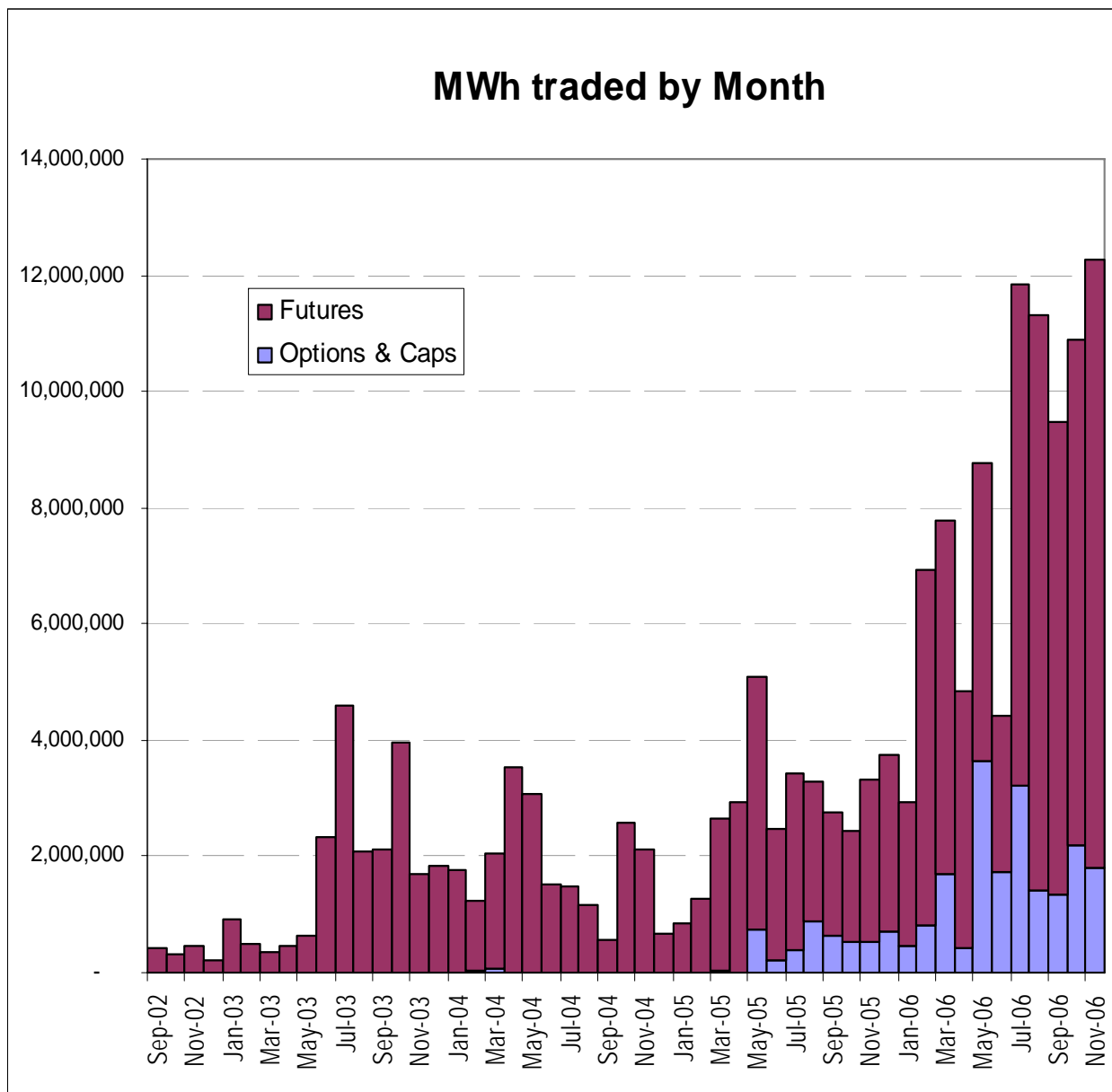
Australian Energy Markets Commission

Reallocation/Futures MCL offsets

December 2006

1. Importance of Futures
2. SCOPE – Direct Futures MCL Offsets
 - Why AEMC should consider Futures Offsets in current workflow
3. NEM Objective
 - New entrant retailer perspective
4. Summary of efficiency improvements

Importance of Futures

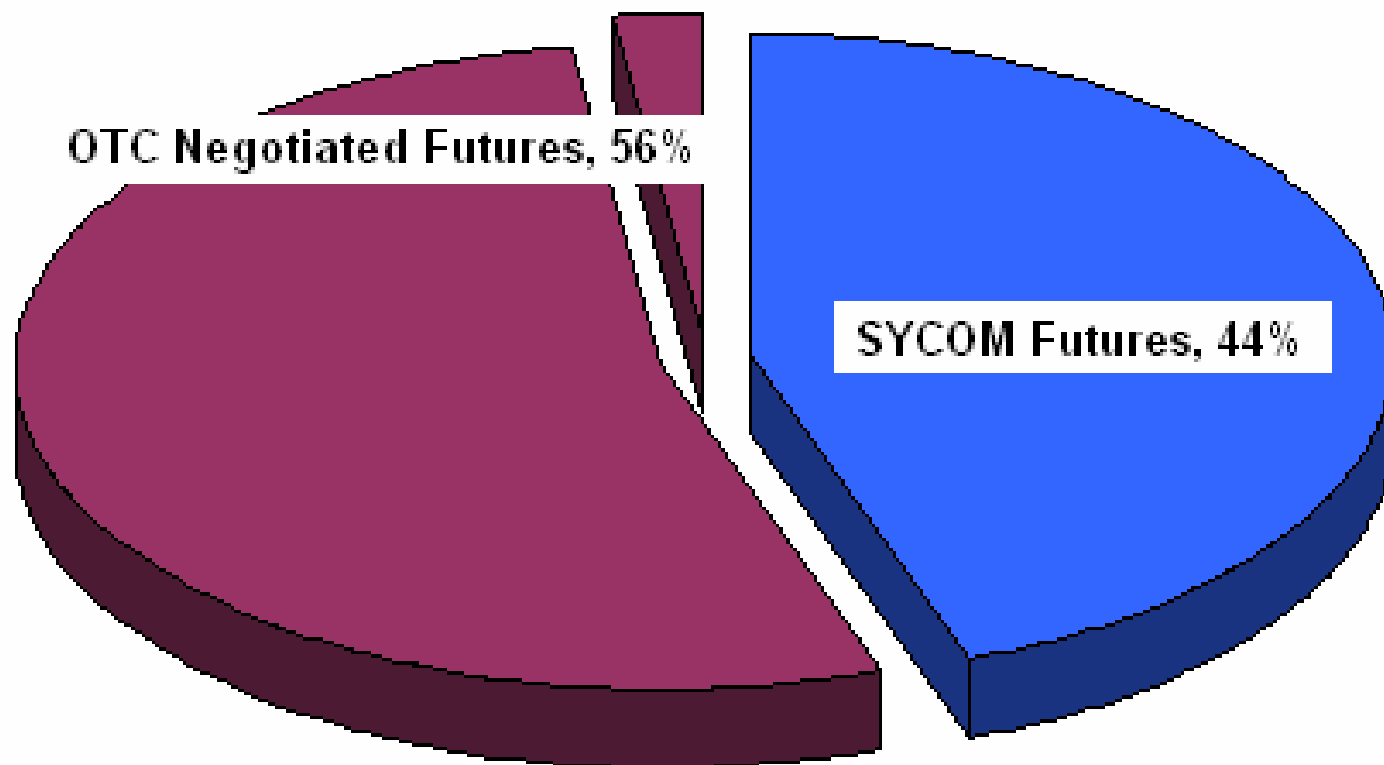


12.3 million
MWh during
November-06

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78% of NEM
demand (ex
Tas)

Futures Traded Volume (OTC Negotiated Futures & SYCOM Traded Futures) 12 months to Nov 2006



Futures based MCL offsets are relevant to reallocations workstream because:

1. Futures Offsets and NEMMCO reallocations are complimentary and apply similar MCL offset formulas
2. AEMC asked d-cyphaTrade (20 participant) submission to be a *response* to NEMMCO proposal

3. Efficiency objectives cited by NEMMCO proposal and Draft Rule can only be achieved if complimented with efficiency and popularity of Futures
4. AEMC determination cites desire to incorporate futures-based offsets but:
 1. ignored ASX submission; and
 2. did not consult with SFE Clearers....

5. SFE Clearers will not participate as “Reallocators”

- NEMMCO proposal asks SFE Clearers (as Reallocators) to bear unacceptable risk
- Unacceptable risk created by shortcomings and “non-firmness” in NEMMCO reallocation derivative market

6. NEMMCO has been unable or unwilling to deliver Futures based reallocations, despite written industry requests dating back to **Feb 2005**
 - Written requests from **AFMA, ERAA, 10 industry participants**
 - Meetings between NEMMCO and d-cyphaTrade/SFE since **Sep 2004**

7. Hence, “NEMMCO consultation with Industry Participants” **will not deliver** workable futures reallocations
8. Moving reallocation rules to procedures enables NEMMCO to exclude futures from reallocations indefinitely

hence Draft Rule will not achieve cited objectives *unless* AEMC also incorporates Futures Offsets

- > Credit risk creates barrier to entry to New Entrant Retailers and energy consumers
 - > See names of J20 submitters
- > MCL guarantee costs much higher than NEMMCO quoted – project financing costs for new entrants (e.g. 15% effective cost)

- > Working capital constraints limit the growth of New Entrant retailers – unless Futures Offsets implemented
- > Reallocations merely *transfer* credit risk to New Entrant retailers and gens – increasing reallocation costs
- > Direct Futures MCL offsets *reduce* credit risks (and inefficiency of OTC) via SFE Clearing Participants, Clearing House, Contract Netting and daily margining

- > Base Load Generators retain absolute market power – unless Futures Offsets incorporated
 - > New entrant retailers forced to buy reallocations from incumbent base load generators
 - > New entrant retailers cannot buy from interstate gens or non-bank financial traders

- > Base Load Generators retain absolute market power – unless Futures Offsets incorporated
 - > Non-bank, non NEM Participant trading > 28% NEM demand and excluded from supplying MCL Offsets as “Reallocators”
 - > Vertically Integrated entities (Base Load) are preferentially treated by NEMMCO reallocations
 - i.e. No consolidated loss upon default of related entity
 - > New Entrant and independent retailers must bear and pay for credit risk created by reallocation

- Lack of popularity of NEMMCO reallocations limits potential efficiency gains – energy constrained market and lack of competition

SFE “Exchange for Physical” = Unlimited supply of MCL Offsets for New Entrants

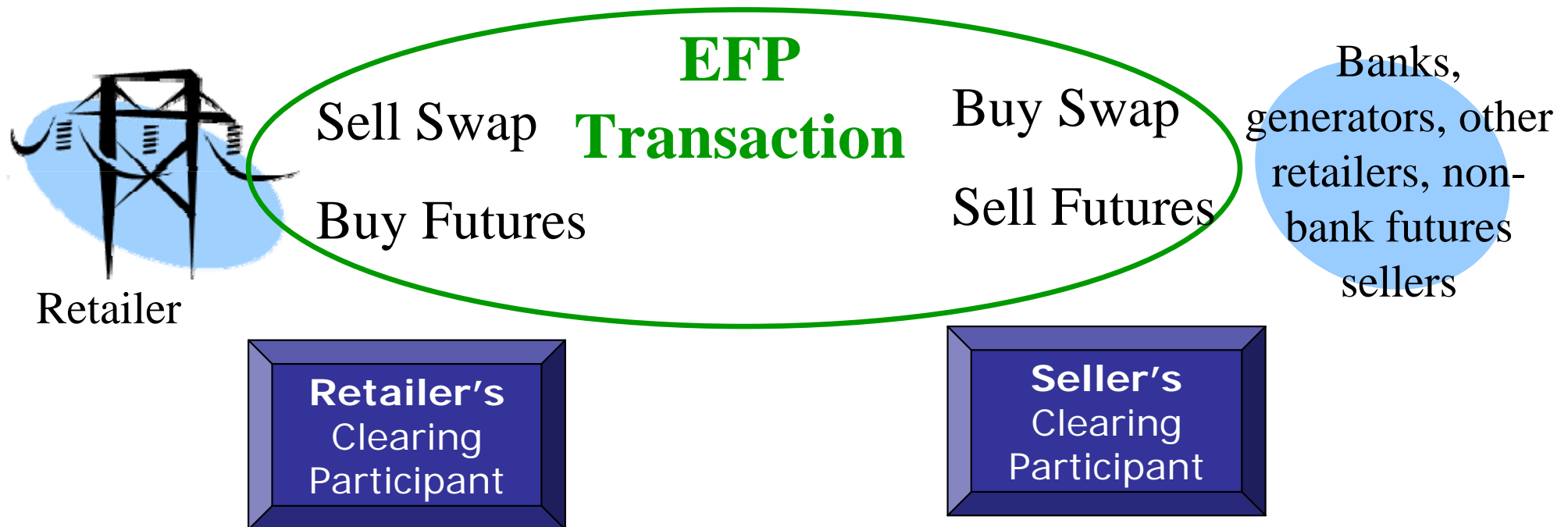
1. EFP enables Retailers to create unlimited futures positions to achieve MCL cost reductions
2. EFP Market Size is independent of retailer hedges - **the entire NEM demand load could be EFP’d**

Exchange for Physical (EFP) example



Retailer wishes to enter into EFP, to create a bought futures position to create an MCL Futures Offset.

*Retailer buys spot futures, sells swap. On matching, the SFE Clearing Participant of each party registers the EFP.



Direct Futures – Reductions in MCL credit costs for New Entrants













New Entrant Retailer reduction in MCL guarantees from Direct Futures MCL Offsets – historical observations only

Region	Qtr2 2005	Qtr3 2005	Qtr4 2005	Qtr1 2006	Qtr2 2006	Qtr3 2006	Qtr4 2006
SA	50%	47%	43%	14%	69%	60%	55%
QLD	54%	45%	30%	0%	59%	49%	41%
VIC	35%	30%	32%	0%	57%	56%	53%
NSW	68%	66%	65%	57%	69%	57%	54%

Summary of Efficiency

(see JS20 submission for more efficiencies)













Efficiency Improvements (NEM Objective)	Direct Futures MCL Offsets	NEMMCO reallocations without Direct Futures
Clearing Bank support	 Strong	 Negligible
Market Transparency	 Total	 Nil
Inter-state trading	 Full	 Nil
Competition for supply of offsets	 Banks, funds, non-bank traders, inter-state gens, retailers	 Same Region base load gens only
Peaking generation participation	 Included	 Excluded (practically)

Summary of Efficiency

(see JS20 submission for more efficiencies)



Efficiency Improvements (NEM Objective)	Direct Futures MCL Offsets	NEMMCO reallocations without Futures
Flexibility of Entry and Reversal of offset	 Retailer's unilateral decision	 Need gen's permission
Anonymity	 Yes	 No
Preferential treatment for Vertical Integration	 None	 Substantial
Reduction of credit default risk (and costs)	 Strong	 Weak
Avoidance of systemic default risk from generator outage	 Effective	 Ineffective

- > AEMC asked to advise if 20 industry participants should immediately submit an additional Rule Change Request

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