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Dear Mr Chapman,

0538-0001 – NEM Prudential and Settlement Framework – Consultation Document

As the primary creditors of the NEM, NGF members have a substantial direct interest in the ongoing credit quality of the pool. The issues under review by the Australian Energy Market Operator (AEMO) have the potential to impact on pool credit quality. NGF members are therefore highly interested in the outcomes of this Review.

The review looks at the; Prudential standard; settlement cycle and the reaction period. NGF views on these matters are outlined below.

The Prudential Standard

Q1. Comment is sought from stakeholders on the changes to the NEM prudential arrangements set out in Seed Advisory's report and summarised in section 3.1 of this report.

As creditors we are concerned the proposals reduce the credit quality of the pool from the reasonable worst case defined under the Rules. Our reasoning is as follows:

- The Maximum Credit Limit (MCL) is the reasonable worst case as specified under the Rules, not the Reduced MCL (RMCL);
 - We note historically the existing MCL calculation has failed to provide adequate collateral prior to major price events and then carries too much following them;
 - Seed indicate the MCL will hold enough collateral to cover losses in the event of 98% of defaults;
- With significant losses arising from default, the MCL may not adequately reflect a reasonable worst case;
- We do not accept the current practice, where retailers opt-out of the MCL via the RMCL as satisfying the reasonable worst case in the Rules;
 - Seed indicate the RMCL will hold enough collateral to cover losses in the event of 96% of defaults;

- The proposal reflects an improvement against the RMCL, not the Reasonable Worst Case in the Rules:
 - The proposal covers losses in the event of 98% of defaults;
 - It appears to halve probability of loss given default in the pool, whilst utilising the level of collateral required under the RMCL;
 - It would enshrine the reasonable worst case at the MCL and change the way retailers provide credit support (less security deposits).
- In simple terms, the proposal looks good because it is being compared against the MCL which may not adequately satisfy a reasonable worst case in the first instance.
- In summary we believe the proposal is a dilution of the Prudential Standard intended in the Rules (even if it is an improvement to that used in practice):
 - The Seed report did not provide a cost benefit analysis for its rationale for choosing a standard of 2% probability of loss given default;
 - Seed provide an estimate that a 1.5% probability of loss given default would increase credit requirements by 17% (compared to 2% loss given default);
 - Seed expressly state the 2% probability does not protect creditors the instance of large losses arising from the default of a retailer;
 - We request a sensitivity analysis when reducing the probability of loss given default to 1% or 0.5%;
 - Should evidence prove credit support is an inefficient in dealing with low probability high value defaults, as per Schedule 3.3.1(b)(8) of the Rules, then we request AEMO consider alternative mechanisms to strengthen the standard.
- We have a further caveat regarding the revised approach to the prudential standard as expressed by Seed:
 - In Seed’s revised prudential standard of clause 3.3.8(b) of the NER (see 6.1.4 of the Seed Report) we are concerned with the effect of: "(after reallocation)";
 - It appears that the preceding analysis used to set the loss given default probability did not account for the use of reallocations in determining the probability of loss;
 - We seek clarification from AEMO that the proposed definition does not weaken the operation of the prudential standard by eliminating the reduced probability of default.
- We are also concerned about the inclusion of a “stable and predictable” criterion in the assessment of alternative prudential requirements (section 6.1.1 of the Seed Report):
 - Seed describe it as a desire to “remove the need to make significant adjustments in the level of prudential holdings at short notice”;
 - We believe this criterion is at odds with the underlying volatile nature of the spot market combined with a requirement to hold credit support;
 - For instance, this criterion would only be satisfied with the lodgement of very large upfront collateral.
- Notwithstanding the preceding comments, we acknowledge efficiency gains from the proposal and believe the analysis has proven the need for reform.

Settlement Cycle

Q2 Comment is invited from stakeholders on whether businesses are likely to be financially disadvantaged by a move to a shorter settlement cycle. Noting that the primary decision criterion for change is the National Electricity Objective, stakeholders are requested to provide details of any issues identified, and any suggestions for mitigation.

Q4 Stakeholder comment is sought in the benefits and the costs discussed in section 4.7, including the implementation costs, of moving to a shorter settlement cycle. Any views should be evidence based wherever possible.

The NGF believes shortening of the settlement cycle will provide a benefit, both to generators and retailers in the NEM. We accept AEMO and Seed Taylor Fry's conclusions as to efficiency improvements and the satisfaction of National Electricity Objective.

- It will reduce systemic default risk in the NEM, reduce participation costs and improve counterparty credit exposure, thus improving the competitive dynamics of the NEM;
- Competitive markets will ensure that working capital savings for generators from shortening settlement will be passed through to retailers in contract prices;
- Reallocations will be less important with a shortened settlement cycle but should remain relevant if participants want to bilaterally manage credit risk:
 - Counterparties of an OTC contract can still bilaterally negotiate credit terms and to transfer NEM outstandings via the process of reallocation.

Q3 Comment is sought on whether meter data quality is considered to be an issue in moving to a shorter settlement cycle, including sufficient detail for AEMO to investigate any concerns that are raised

- Analysis performed by AEMO has demonstrated there is no systemic metering data quality concern arising from a shorter settlement cycle:
 - No case has been made that meter data quality is a material consideration in moving to a shorter settlement cycle;
 - The NGF doubts that additional analysis would uncover any systemic metering concerns and proposes that further work in this area is not required;
 - Metering issues are not a valid barrier to moving to a shorter settlement cycle.

Q5 Stakeholder comment is sought in the merits of changing the nominal NEM settlement day from Fridays to another day in the week such as Wednesdays.

- NGF members have expressed no concern over changing the NEM settlement day.
- If changing the settlement day will improve the ability for retailers to arrange credit support, rather than incur greater outstandings, then we support such a move.

Q6 Input is sought from stakeholders on transitional measures that should be considered if the transition to a shorter settlement cycle is progressed.

- We wish for AEMO to consider magnitude of the problem retailers will face in funding the transition to a shorter settlement cycle;
- We support transitional arrangements if it can be proved for a prudent retailer that working capital demands result in insurmountably deleterious cash-flow problems;
- The NGF notes that some early analysis (based on the existing MCL) in this area indicated that increases in working capital required to fund increasing time periods between collections from customers and pool settlements will be somewhat offset by reductions in pool credit support required from retailers:
 - This is particularly the case under the existing MCL regime which inflates pool credit support requirements significantly (compared to pure outstandings) due to application of the volatility factor.

Reaction period

Q7 AEMO is seeking stakeholder views on whether stakeholders support the consideration of options to reduce the reaction period while maintaining adherence to the prudential standard. In particular:

- Whether participants would use the options outlined if they were available; and
- Other options for reduction of the reaction period.
- We cannot comment as to the likelihood of retailers using the options to shorten the reaction period;
- We believe it would be prudent to delay any changes to the reaction period until other changes to the Prudential Standard and settlement cycle have been implemented;
- Shortening the reaction period may increase the likelihood of default (even if it reduces the value of default) as it gives a disincentive for prudence by retailers;
- The NGF does not support voluntary approaches to allow weakening of the standard, as all the weaker parties will immediately adopt it.
 - The NEM prudential regime should outline a minimum credit quality that all retailers must satisfy – any option must only allow for increases in credit support above the minimum acceptable standard – not allowing opting out of the minimum – which by implication would reduce pool credit quality.

Other questions

Q8 Subject to the mitigation of clawback risk, AEMO is seeking stakeholder views on the merits of allowing cash to be fully or partially interchangeable with bank guarantees in the NEM.

- On the proviso of definitive legal advice on clawback risk, the NGF has no aversion to cash being interchangeable with bank guarantees.
- The NGF does not support developments that would ultimately expose electricity generators to risk of default arising in the gas market, a market that those generators may not be actively engaged in.

- Therefore, the NGF does not support the introduction of cross-guarantees between electricity and gas markets in any form.
- The NGF also has a number of concerns regarding the use of guarantees from related entities within the same market. Therefore, as the NGF believes the findings on the use of cross-guarantees within the same market are inconclusive, and may expose generators to additional risk, we cannot support any changes in this area at this time but wish to further engage with AEMO on this matter, including through the SPRG.

Q9 Comment is sought from stakeholders on the risk of follow-on or cascade default, taking into account obligations to contract counterparties if AEMO should invoke the short payment Rule 3.15.22 with the timelines discussed in section 7.

- Seed's analysis has shown that the MCL and RMCL provisions carry a 2% to 4% probability of large losses given the default of a retailer;
- Maintaining a level creditworthiness that aims to eradicate the chance of short payment is the intention of the Rules;
- Any arrangements to mitigate the impact of short payments are welcomed by the NGF, but in no way indicate our acceptance of lapse creditworthiness of the pool;
- To this end we support AEMO's proposal for deferral of short payment.

Q10 Stakeholder views are sought on the proposals relating to initial MCLs.

- The proposals relating to initial MCLs for new entrant retailers are in response findings that these new parties are required to post greater collateral than is necessary;
- The NGF supports the proposal as it is inefficient to require these parties to provide excessive collateral.

Concluding remarks

The NGF is pleased AEMO is completing a review of the prudential standard. The AEMC review of hedging contracts exposed the discrepancy of the reasonable worst case MCL and the reduced MCL. Seed's work has identified the real possibility of large losses given default, under the MCL, the RMCL and even the new proposals. We wish for the reasonable worst case to be clarified and a new standard be established that ensures the creditworthiness of the pool. Addressing these concerns will be critical to ensuring the NEM can support the levels of generation investment that will be required in coming years.

We recognise the weaknesses in both the current MCL calculation and the opt-out to the reduced MCL (which requires the constant posting of additional collateral). Therefore we endorse reforms in this area.

The shortening of the settlement cycle appears a win-win for both creditors and debtors and ameliorates some of our concerns with proposals to change the Prudential Standard. To supplement these reforms the NGF supports further work on approaches to cover low probability high value losses from default. It is important to close the gap between the proposed standard of 2% to no probability of loss given default.

For these reasons, the NGF believes, subject to proving the probability of loss given default cannot be tightened further than 2% (in conjunction with the shorter settlement cycle), the proposals promote the NEO.

Please contact the NGF SPRG representative Malcolm Roberts on telephone 02 6232 7789 or 0419 835 218 to clarify any of the matters raised above.

Yours sincerely



Malcolm Roberts
Executive Director