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Mr Murray Chapman
Senior Manager, Market Policy
Australian Energy Market Operator

via email: murray.chapman@aemo.com.au

Dear Mr Chapman

Re: Energy Markets Prudential Readiness Review: Consultation

The National Generators Forum (NGF) welcomes the opportunity to make a further submission to the Energy Market Prudential Readiness Review.

This submission outlines our positions on AEMO's draft recommendations and actions contained in the draft report as follows.

NEM Prudential Standard

The NGF supports revisions to the prudential standard to clarify requirements, end the uncertainty created pursuant to the use of the RMCL, and reduce the overall risk of loss given default.

It is apparent that a revision of the current MCL/RMCL approach is required. This includes: the development and implementation of a more precise expression of the NEM prudential standard to provide confidence in the surety of payment to generators; and a clear expression of the probability of loss facing the market. We believe the issues identified in the Seed Report have been effectively captured in the revised approach.

New process for calculating Maximum Credit Limits

The NGF supports the use of an improved calculation approach.

Given the impact of seasonality and load factor deterioration there is a strong case for improving the calculation approach to account for these relationships. This new approach should be supported by continual monitoring.

NEM Settlement Cycle

The NGF is extremely disappointed with AEMO's recommendation. The NGF supports the adoption of a shorter settlement cycle given associated benefits outlined in the Seed Report and the Competition Economics Group Report. The NGF recommends a Rule Change be lodged by AEMO and the market benefits then assessed by the Australian Energy Market Commission.

The NGF is extremely disappointed at AEMO's current position on this issue.

The issue of a shorter settlement cycle was first considered in 2008; over two years later the issue remains unresolved and with AEMO's guidance will be subsumed within an investigation of alternative settlement processes and hence further delayed.

The Seed Report effectively demonstrates that the adoption of a shorter settlement cycle has the effect of reducing the prudential requirements across all regions of between 30 and 50 per cent. In that regard, while it arguably satisfies the National Electricity Objective in its own right, it also forms an integral part of a new prudential framework for the NEM.

As indicated by Competition Economics Group the current settlement cycle determines the allocation of working capital between generators and retailers, provides retailers with an effective interest free loan from generators, and exposes generators to a degree of credit risk. A change to the settlement cycle would need to result in an improvement in efficiency. We are convinced that the change will improve efficiency by:

- reducing systemic risk to generators and industry risk overall;
- reducing administrative and financing costs for generators;
- reducing requirements for bank guarantees and participant reliance on banking institutions;
- reducing the cost of security for retailers as less cash will be required to manage trading limits;
- reducing administration costs as the integration of settlement with OTC will reduce administration costs for generators; and
- increasing competition in the retail sector, due to the lower prudential burden.

These outcomes will improve competitive efficiency as generators will be exposed to lower levels of default risk. This will be factored into their trading and hedging activities, where the benefits of a highly competitive market will flow through to customers in the form of lower prices. This will also bring NEM settlement cycle in line with international best practice.

The main concern relates to the transfer of wealth from retailers to generators. As AEMO would be aware, including through submissions and respective representations, the primary opponents of the shorter settlement cycle are major retailers, with some small retailers supporting the proposal. It is this issue which appears to be unduly influencing the debate and consideration of this issue by AEMO.

Further, that the arguments expressed by the opponents of the shorter settlement cycle are not evidenced and are not sufficient to delay the progress of a Rule Change application.

The ERAA opposed the proposals for a shorter settlement cycle, cited a wealth transfer between generators and retailers inhibiting competition in the retail sector. They also stated the extra working capital from the shorter settlement cycle should be valued at the company's hurdle rate reflective of the opportunity cost rather than the cash rate, stating this was higher than the savings in collateral/guarantees. This discounted or ignored the possibility of generators passing through any savings in working capital in prices of financial contracts. The key theme was that retailers would face a net cost from a shorter settlement cycle as the increase in working capital would not be offset by savings from smaller bank guarantees. This implicitly discounts any reduction in price of financial contracts when generators would pass savings in working capital from the shorter settlement cycle.

The NGF contends these comments are misleading as the increases in working capital to retailers will be offset by lower prices in financial contracts. The savings from smaller security deposits and bank guarantees will be a direct gain for retailers. We disagree with the argument that retailers will perversely be worse off with the shorter settlement cycle. Stretching this argument further to conclude that lowering retailers' prudential burden will impede competition is incongruous.

Firstly, generators do factor in financing and settlement periods into contracts. The assertions that they do not is not evidenced. This occurs generally through contract prices and especially for contract products that are tailored to individual customers. While market conditions mean it is not always feasible to recover costs in every circumstance, it is necessary to note that generators do factor in these costs in their trading decisions and hence a reduction in these costs will directly impact upon trading and product offerings.

Second, meter data accuracy has been of a high standard, and based on its experiences and AEMO's advice the NGF does not hold any strong concerns regarding metering data integrity under a shorter settlement cycle (this is on the basis that a robust process to "true-up" such data through settlement adjustments would remain). We suggest this issue is a smokescreen.

Third, the argument that as retailers need to undertake multifaceted promotional campaigns generators should carry the additional working capital costs so that new retailer can more readily enter the market is a stretch. The NGF would prefer to note that retail competition will continue to thrive if new retailers get cheaper contracts, including load following products that are tailored to start-up and small retailers.

As for the argument that asset owners are better placed to carry working capital costs we suggest that ownership of assets, particularly older coal fired power stations, has its own inherent commercial problems and access to cheap capital is not something most generators experience in the current climate. Hence, generators are no better placed to access capital, and are possibly less adept at doing so, than many of the large sophisticated retailers.

Finally, one could conclude that aside from the wealth transfer the mechanics of moving to a shorter settlement cycle may be practically difficult for some of the larger retailers. Nevertheless, these practical impediments are implementation issues and are hardly cause for delaying the shorter settlement cycle given the likely net market benefit.

Alternative forms of collateral in the NEM

Subject to the management of clawback risk, supported by authoritative legal advice, the NGF does not oppose the lodgement of cash as an alternative for bank guarantees.

The NGF notes the potential benefits of using cash as an alternative for bank guarantees as it may: be timelier; increase flexibility; reduce administrative costs; and not rely on subsequent action to be taken by the nominated bank. However, the NGF remains concerned by clawback risk and would need to be appropriately assured that the lodgement of cash was of equal or higher standard to a bank guarantee. This has been the NGF position for some time and we look forward to AEMO providing appropriate assurances.

Integration of NEM with contract markets

We note AEMO's ongoing intention regarding reallocation arrangements subject to granting of the relevant exemption by the Australian Securities and Investment Commission.

Single Guarantee for Related Entities

The NGF supports AEMO's proposal for further development of single guarantees within single markets with affected parties on the basis of ensuring that such an arrangement does not weaken credit quality in the NEM and provided sufficient cross-guarantees between entities can be provided.

The NGF has a number of concerns regarding this proposal but agrees that there is potential for increased efficiencies from an appropriately structured arrangement operating within a single market. On this basis, the NGF's support is conditional on finalised arrangements not weakening credit quality or increasing the risk of cascading default between related bodies.

The NGF looks forward to working with AEMO on these developments.

Reduction in the NEM Reaction Period

The NGF supports further work being undertaken by AEMO on the implications of a shortened reaction period and will review its position once AEMO's modelling is released.

The NGF understands the arguments that for some participants a shortened reaction period may be beneficial. However, in the absence of clear evidence that a voluntary change to a individual participants prudential monitoring arrangements will not have wider market implications or give rise to selection bias the NGF supports further analysis.

Calculation of Initial MCLs for new NEM entrants

The NGF supports the proposed approach.

The NGF notes the rationale for reviewing the determination of MCLs for new participants. If the determination of MCLs for new participants is revised, and it ensures that the amount of security provided by a new entrant is based on an accurate estimation of each new entrants pool exposure, such a proposal would appear beneficial to the market.

Management of payment shortfalls to NEM Generators

The NGF supports AEMO's intention to undertake further work in this area.

The risk of short payment, while present, would come as a surprise to market participants if realised given the relatively stable operation of the NEM to date and the historical surety of payment. As such, the NGF supports investigating methods to better cushion the impact of any significant short payments should they arise to minimise the risk of cascading default.

Inconsistencies between energy market legislation and Corporations Act

The NGF notes the MCE initiated changes in this area.

Alternative settlement and prudential arrangements (and link with shorter settlement cycle)

The NGF supports AEMO's ongoing work in this area but notes that any developments in this area should be progressed cautiously and will present unique challenges and risks.

The NGF does not support this conceptual proposal being used to not progress the shorter settlement cycle Rule Change.

The draft report discusses further developments being pursued by AEMO to lower the prudential costs without increasing the risks to participants, most notably the possibility of a Securitised Receivables Fund. We support AEMO's work but are extremely disappointed that this concept has been used as a reason to not progress the shorter settlement cycle.

Although the NGF requested AEMO consider ways to "close the gap" from the 2% probability of loss given default to zero, we do not believe this relinquishes AEMO from implementing change that supports the National Electricity Objective in other areas, specifically the shorter settlement cycle. We would prefer AEMO progress obvious improvements now rather than delay progress further.

There is scant information provided in the draft report on how a Securitised Receivables Fund will work, or be superior to a collateral based regime with a shorter settlement cycle. Leaving aside the broader issues with securitisation of risky assets that has played out in other markets globally, the use of this conceptual proposal to delay the lodgement of a Rule Change raises concerns with this consultation process.

Regardless of how it can be characterised, the primary reasoning for AEMO baulking at its previous strong position on the shorter settlement cycle is the existence of opposition amongst a small group of AEMO stakeholders due to alternative private interests, whereas it can be clearly argued clear public benefits exist in progressing the proposal. On this basis, it is the Australian Energy Market Commission, as the appropriate rule making body, which should be charged with assessing the proposal on its merits during the Rule Change process.

We urge AEMO to reconsider its position on the shorter settlements cycle as the possibility of a Securitised Receivables Funds remains in its infancy, is untested and is not yet supported.

Future Offset Arrangements (FOAs)

The NGF supports further modelling of the implications of FOAs in the context of the revised NEM Prudential Standard.

The NGF supports further work in this area and notes that there are a number of issues with the implementation of FOAs that require consideration in the context of a Rule Change. With a change to the prudential standard to remove the weaknesses created by the existing RMCL arrangements, it is likely the FOA proposal may no longer pass the NEO assessment performed by the AEMC in its recent rule review on this matter. The change in credit risk created by the FOA remains of concern to the NGF and further assessment of the costs and benefits of the proposal post MCL clarification should be performed prior to any implementation.

Settlement Day

In relation to the settlement day, the NGF is comfortable with moving the settlement day to a Wednesday.

The NGF is pleased to continue to provide advice to the AEMO in the consideration of these issues.

Yours faithfully,

M. Roberts

Malcolm Roberts
Executive Director