

13 August 2009

Manager
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Dear Sir

Survey of Second Tier Retailers – Submission

Thank you for the opportunity to provide feedback on the attached paper. The comments below represent those of Victoria Electricity Pty Ltd (and its related/subsidiary relating businesses) and Infratil Energy Australia Pty Ltd which manages all wholesale procurement on behalf of Victoria Electricity. Throughout, these businesses are referred to as VE/IEA.

GENERAL COMMENTS

1. Futures Contracts

Firstly, it is necessary to correct an error made a number of times throughout the paper:

Futures are NOT fully paid at the start of the contract (as stated in sections 6.1.3, 7.1.3, 7.3.1 & 7.3.2) so do not carry “nil settlement risk”. Rather, an Initial Margin payment is made when entering the contract. Ongoing credit risk is managed through paying/receiving Variation Margins which match the movement in the contract value.

Furthermore, referring to comments in section 7.3.2, there is no guarantee that a futures clearing participant will accept the credit risk of a small retailer and, if it does, may well require multiple margining.

2. Generation Ownership & Physical Asset as Ultimate Hedge

VE/IEA does not agree with the various statements made in a number of sections regarding the ownership of generation assets. It is true that a generation asset may provide prudential off set, and hence capital savings for credit support to AEMO, however:

- Owning a generation asset does not, of itself, confer a credit rating. Indeed, many businesses that do own large generation assets have arguably the poorest of credit ratings. (This may primarily be due to the high level of gearing but if the alternative is to solely equity fund, then one might as well retain the equivalent capital on the balance sheet and achieve credit quality that way.)
- A physical asset does not guarantee a shaped OTC hedge. A 100MW generator provides a flat 100MW of cover, just as a 100MW swap (or cap) does. Operating the plant to match load would be grossly inefficient and provide a very poor return on capital invested.

VE/IEA strongly contends that, “for the same capital outlay”, ownership of generation does not provide benefits greater than an OTC or futures hedge contract – it is indeed a very poor use of capital. Furthermore, the generation owner inherits a swathe of additional risks including operational, FM, fuel, transmission, OHS, labour, environmental....which requires far greater resource than managing a portfolio of financial contracts.

This statement is of course only correct where the option to hedge through financial contracts is available. The real risk being addressed here is that industry consolidation (through vertical and horizontal integration) leads to illiquidity in wholesale contracts and the resulting market power.

This then raises barriers to entry such that investment in generation, and the large capital outlay required, becomes essential to establishing a retail business. Ultimately, this is the same outcome as the paper concludes but for very different reasons.

Further, that the larger retailers have been “increasingly acquiring physical generation” in no way makes the situation “self-evident” (section 7.2). It is in fact this more subtle strategy of influencing market structure, and raising barriers to entry, being dressed up as a requirement to hedge – this should be the major concern of regulators.

3. Contracting with Generators

Referring to comments in sections 7.1.2 & 7.1.5.

Relationship Management - no matter how good a relationship might be, it is naïve to believe this will overcome objective assessments of credit capacity and risk. It is not unreasonable that a generator should require reasonable levels of credit support, having reasonably assessed the credit risk exposure.

However, this argument is muddled by the issue of industry consolidation, where generators are in a position to insist on onerous credit support due to their market power and the retailer has little ability to “shop around” (as is the case with DNSPs, discussed below).

Reallocation - what continues to astound VE/IEA is the continued disinterest of (and/or the level of premium required by) generators in reallocation agreements. This remains a mystery given that it is as close to “money for nothing” that a business can achieve (for consistent levels of credit risk).

The point that generators require retailers “to lodge a prudential guarantee with them to manage the re-allocation agreement risk in addition to that lodged by the retailer to manage its OTC hedge payment default risk” does not make sense (section 7.1.5). Generators will require parties to a reallocation agreement to lodge security for the face value of the transaction only, there are no difference payments (if this is what an “OTC hedge payment” is referring to).

Futures Offset Arrangements (FOA) – to provide an alternative to contracting with generators, and to address the associated market power and re-allocation cost issues, the regulators and market operator are strongly encouraged by VE/IEA to ensure a workable FOA product, currently being assessed by the AEMC, is implemented.

4. Basis of Prudential Calculations

Referring to comments in section 9.7.

VE/IEA does not agree that the formula should not consider a worst case outcome. The retailer itself has to consider such a scenario and ensure it is adequately capitalised (or has access to adequate short-term capital) to manage such a scenario. Whether this capital sits with AEMO or in the retailers’ bank account should be of little concern.

When considering the “Methodology to Calculate Future Price”, this in itself is misleading. There is no way to calculate a future price, only forecast, and futures are not a “predictor” of the future spot price as is seemingly implied. What we are really seeking is a methodology to calculate the range of possible future settlement payments.

5. Retailers as Collection Agents for DNSPs

VE/IEA accepts that, for small customers, part of the value added by retailers is packaging up all costs associated with energy supply. We do not object to collecting money that then has to be paid to DNSPs. However, we do believe current arrangements could be improved in a manner that reduces barriers to entry and growth. DNSPs do not only deliver network infrastructure but also other services. Where they fail, or make errors, this increases the risk of credit defaults by customers, e.g.:

- Failure to provide timely and accurate meter data;
- Failure to correctly identify meter characteristics;
- Failure to execute disconnection or de-energisations in a timely manner;
- Failure to energise in a timely manner;
- Systems that do not adequately recognise meters that are not active (leading to charges levied on retailers and customers for inactive meters).

DNSPs should be required to meet strict performance criteria for delivery of services or bear the cost of any associated losses - not only overcharged network charges but energy consumption by those customers who have not been adequately billed or have continued to be supplied when they should have been disconnected.

6. Bank Guarantees

Maybe a minor point but worthwhile clarifying. The cost of bank guarantees is not really the issue. It is their availability without requiring cash collateral; hence, for smaller retailers, prudentials are actually supported by equity (not debt) finance. This is the true cost to be considering.

SPECIFIC ISSUES & QUESTIONS

6.1.2 DNSP Prudentials

Issue: Should the AEMC investigate a rule change to require networks to negotiate prudential arrangements consistent with the next period expectation of customer load for each small retailer and be prevented from imposing high fixed-minimum-level prudential guarantee requirements?

Current arrangements provide DNSPs with high degrees of discretion and power with very little responsibility for reasonably assessing credit risk and appropriate credit risk actions. In VE/IEA's recent experience, DNSPs have become more insistent on pursuing prudentials during the recent credit crisis and in most cases only because they can do so. In some cases, DNSPs have acknowledged that established retailers present very little credit risk but say that as they have the power to impose prudential requirements they will do so.

At present, coordination agreements do tend to be binary in nature – credit rated companies do not need to lodge prudentials and those with no investment grade rating are increasingly being asked to lodge the maximum cash or bank guarantee. VE/IEA believes that this is an abuse of market power by DNSPs and that DNSPs should be required to act reasonably in assessing the credit risk of individual retailers, including considering the operational and financial performance of those retailers, their history of payments and the nature of their shareholders. DNSPs should also be required to consider reasonable alternatives to cash or bank guarantees.

6.1.3 Generator Prudentials

Issue: Does there need to be regulation of the level of prudential guarantee imposed by a generator on a retailer associated with an OTC hedge to mitigate discrimination against small retailers? OR Is this an area solely for negotiation between the parties as the OTC hedge is a negotiated instrument developed under the conditions imposed through the ISDA Master Agreement and so outside the field of jurisdictional or national competition regulator?

VE/IEA does not believe there should be regulation of the security required by a generator when entering an OTC contract with as retailer. These are bilateral negotiations between two private parties and outside the jurisdiction of NEM regulators.

However, where onerous requirements for security are a result of market power, and a limited choice of counterparties for the retailer, then other forms of regulation are clearly required. This includes strong regulator and market operator support for the FOA initiative currently being reviewed by the AEMC.

6.4.1 NEMMCO Call Notices

Issue: Should prudential margin calls on retailers, given the timing involved, result in market suspension of the retailer for non-compliance by the retailer?

Issue: Should NEMMCO (AEMO) be obliged to consider the payment performance of a retailer when it considers suspension? Particularly given the “loss of customer-base” consequences of suspension?

VE/IEA considers that non-compliance by any market participant in meeting its payment obligation to AEMO should result in market suspension. VE/IEA concurs with AEMO’s position (note 2, page 5) - it does not see the payment timetable as onerous on the retailer and considers daily monitoring of credit exposure and liquidity requirements a normal part of a retailing operation.

However, where there is a reliance on a third party (i.e. a bank) to respond in such a short time-frame this introduces unmanageable operational risk to the retailer. Even where lines are available, there is a risk that the bank may not release funds within the time required; consideration needs therefore to be given to this exposure where it is of no fault of the retailer.

VE/IEA does not agree that payment performance history should be a consideration. This position differs from that with respect to DNSPs as AEMO is a (non-profit making) collection agent on behalf of market participants and should not, therefore, have discretion in this regard. (DNSPs, on the other hand, receive a regulated rate of return to, among other things, manage normal business risks, including credit risk.)

6.4.2 AEMO's Powers of Suspension

Issue: Are the suspension powers of NEMMCO (AEMO) associated with cash flow and prudential issues appropriate given the consequences to the small retailer's business that flow from market suspension?

Issue: Should jurisdictional cancellation of a retail licence occur as a consequence of suspension by NEMMCO (AEMO) from the market? Should consideration be given to having a more-graded response by both NEMMCO (AEMO) and jurisdictional regulators to a failure by a retailer to respond in a timely manner to a call to lodge an increased prudential guarantee?

VE/IEA considers suspension powers to be appropriate. With reference to the statement in section 2.2.13, VE/IEA would argue that a failure to make payment when it is due is "a material, rather than a technical, breach".

While retail licences are jurisdictional specific (and not under the jurisdiction of AEMO), cancellation should not be automatic in the event of suspension by AEMO; though it should trigger a review. A more-graded response is therefore recommended with respect to (state based) retail licenses but not to market suspension.

We trust this submission will provide assistance to the MCE in addressing the issues raised by Second Tier Retailers. We would be pleased to discuss further and can be contacted by telephone on 03 8680 6402 or email: darryl.flukes@infratilenenergy.com.au.

Yours faithfully

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Dear Sir

Shorter NEM Settlement Cycle – Submission

Thank you for the opportunity to provide feedback on the attached paper. As background information, Infratil Energy Australia Pty Ltd (IEA) manages all wholesale procurement activities on behalf of its related retail business, Victoria Electricity Pty Ltd (and its subsidiary retailing businesses). The comments below are the views of both companies.

1. Reduced MCL

A fundamental point that appears to be missing in all the analysis is that **reducing prudential (MCL) requirements does nothing to reduce the capital required by a prudent retailer to operate in the NEM.**

A prudent retailer is required to carry sufficient liquid capital (or callable lines of credit) to meet a margin call from AEMO in the event of high prices. Whether this capital sits with AEMO, in the retailer's bank or as an uncalled line of credit makes little difference. Reducing the settlement cycle should not therefore "give rise to any cash flow issues for retailers" (section 3.1, pg9).

Consequently, a reduced MCL does not reduce the barrier to entry for retailers, it merely increases the risk of retailer default in the event of a high price (and the consequent margin call from AEMO).

2. Reducing the Capital Required

The amount of liquid capital required to be carried by a retailer is that which may be called by AEMO, as security deposit in the event of high prices, until OTC contract difference payments are received.

In theory, there could be up to four Cumulative Price Threshold (CPT) events within the current settlement cycle of four weeks. A case can therefore be made for carrying enough capital to meet the margin calls resulting from four CPT events.

Shortening the settlement cycle would commensurately reduce the number of CPT events which can occur before OTC difference payments are received (see Settlement of OTC Contracts below).

This is the real saving in working capital realised by a retailer through a reduced settlement cycle.

3. "Cost" of a Bank Guarantee

IEA contends that the analysis of the "cost" of a bank guarantee is flawed. The 1% "cost of credit support" (section 3.1 pg 10) is just the cost of the bank providing the service of issuing a bank guarantee. The real cost of credit support is the opportunity cost of the capital associated with the bank guarantee.

In the case of a start-up retailer, this is easily observable as the guarantee provider will require full cash collateral (this comes at the cost of shareholder equity). For more established retailers it is less evident as it represents the opportunity cost of this capital (line of credit) being available to alternative uses.

4. Transfer of Wealth

Care should be taken in concluding that, on the face of it, a transfer of wealth results from a shorter settlement cycle.

For a generator, a receivable is simply swapped for cash (which may be used to pay down debt or return to shareholders); there is no net increase in net asset value.

For an established retailer, undrawn lines of credit become drawn. This does not diminish the capital available to be business.

For a smaller retailer, cash used to support a bank guarantee to AEMO is instead used to pay AEMO (in which case it may be argued any transfer of wealth is from the guaranteeing bank to the generator).

In the particular circumstances currently prevailing in the NEM, the re-payment of (expensive) debt by the generators being replaced by drawn lines of (much cheaper) credit by established retailers may result in a net gain to the industry (at the expense of the banks). Further, in the current low interest environment, IEA would question the materiality of any wealth transfer. (IEA would not of course argue this as a point of principle as these are situations peculiar to a point in time, but it may be worth some consideration during deliberations.)

5. “Circular” Cash-flows

It is not clear to IEA how a shorter settlement cycle addresses this issue (as is implied in section 2.1).

6. Reduced Generator Risk Premiums

It is not at all clear to IEA how a shorter settlement cycle would reduce “risk premiums generators price into OTC contracts”, indeed it is not clear what is being priced in any such risk premium.

The risk of default in OTC contracts is more likely to fall on the retailer where a generator is unable to make large difference payments following a high price event (for example, if the generator suffered an outage at that time).

7. Settlement of OTC Contracts

IEA can confirm that it is standard industry practise for the settlement of difference payments under ISDA contracts to be linked to the NEM settlement cycle. We refer you to the AFMA Guide to OTC Transactions and Electricity Market Conventions.

8. Re-allocation Agreements

IEA has long been concerned about the risk of de-registration of a reallocation agreement. This would immediately trigger a call from AEMO on a retailer to top-up its MCL to the extent that the reallocation agreement had reduced it. An advantage therefore of a shorter settlement cycle is the reduced stress placed on a retailer in the event of a reallocation agreement being de-registered.

9. Daily Settlement Cycle

IEA is of the view that the additional savings from daily (T+2) settlement do not sufficiently justify the additional resources required and the operational risk introduced, especially where there are numerous difference payments being made under OTC contracts.

SUMMARY

- A shorter settlement cycle substantially reduces the capital required by a retailer to enter the NEM. This, however, is not due to the reduction in the prudential (MCL) requirements, as the paper suggests. Rather, it is as a result of the reduced risk of successive high price event, triggering AEMO margin calls payable prior to difference payments being received under OTC hedge contracts.
- Cost savings from reduced prudentials need to consider the opportunity cost of alternative uses of capital, not just the cost of issuing of a bank guarantee.
- Daily settlement, in IEA's view, introduces operational risk and cost in excess of the potential savings.

I trust this will assist the MCE in considering a shorter settlement cycle.

Should you wish to discuss any of the above issues further, please call on 03 8680 6402 or email darryl.flukes@infratilenenergy.com.au.

Yours faithfully

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