



13 March 2009

Dr John Tamblyn (Chairman)
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear John

**Futures Offset Arrangement Rule Change Proposal 2008
Submission to Draft Rule Determination (22nd January 2009)**

Ref: ERC0056

As foreshadowed in our submission dated 6 March 2009, d-cyphaTrade is pleased to have the opportunity to provide the AEMC with an alternative to the Futures Offset Arrangements (**FOAs**) Rule Change Proposal which includes the attached Draft Rule for implementing the alternative in the National Electricity Rules (**Rules**). The alternative, the Direct Retailer FOAs:

- allows for the use of futures offset arrangements in the NEM within the existing regulatory structure whereby the FOA would be between the Market Participant (a Registered Participant) and NEMMCO;
- addresses the concerns raised by the AEMC in its draft Rule determination on the Futures Offset Arrangement Proposal;
- in comparison to the current arrangements in the NEM and the FOA Rule change proposal, better contributes to the achievement of the national electricity objective (NEO); and
- is within the AEMC's powers to make a more preferable Rule.

We address each of these points below

How the Direct Retailer Futures Offset Arrangement would operate

The Direct Retailer FOAs would be implemented in a similar way to which reallocation transactions have been implemented in the Rules, thus providing market participants with a prudential offset alternative to reallocations. The administration of a Direct Retailer FOA under the Rules involves the following:

1. A Market Participant (normally a retailer) will lodge a FOA Request with NEMMCO. If a FOA Request is lodged with NEMMCO in the appropriate form;
2. NEMMCO will register a FOA at the "Futures Lodgement Price";
3. As a condition of the FOA, the Market Participant must procure and provide to NEMMCO from the Market Participant's SFE Clearing Participant a confirmation of the Market Participant's futures position in writing each morning during the term of the FOA;
4. NEMMCO will recalculate the Maximum Credit Limit (MCL) for the Market Participant in consideration of the FOA such that taking into account the FOA the new MCL (measured in \$/MWh) should be equal to the maximum of (i) the Futures Lodgement Price at inception of the FOA and (ii) the Prudential Margin (in \$/MWh), adjusted for GST and Loss Factor. A formula for calculating the MCL with regards to the FOA is specified such that the MCL will not exceed the MCL prior to the FOA;

5. NEMMCO will calculate the FOA payment on a daily basis during the term of the FOA using a defined formula which references price movements of defined futures contracts above the "Futures Lodgement Price" registered at the inception of the FOA;
6. If the calculated FOA payment is a positive amount (due to a futures price increase), the Market Participant is then obligated to make a cash payment to NEMMCO via their existing Security Deposit Arrangement. If the FOA payment calculation results in a nil amount (from a futures price decrease or unchanged futures price) the Market Participant is not required to do anything;
7. A Market Participant cannot terminate a FOA without NEMMCO's consent;
8. NEMMCO may terminate a FOA at the request of the Market Participant but may determine a new MCL and Trading Limit for the Market Participant as a condition of termination;
9. Interregional offsets are not allowed under FOAs; and
10. NEMMCO may need to apply for a Ministerial Exemption from holding an Australian Financial Services License (AFSL) to deal in FOAs, on similar grounds to those used to obtain NEMMCO's exemption to hold an AFSL to auction SRA derivatives.

Please see the attached Draft Rule regarding the implementation of the above Direct Retailer FOA in the Rules.

How the Direct Retailer FOA alternative addresses the concerns raised by the AEMC regarding FOAs

The Direct Retailer FOA addresses the concerns raised by the AEMC in its draft Rule determination on the FOA Rule change proposal. We demonstrate below how the Direct Retailer FOA will address the AEMC's concerns by reference to the subject matters identified in the draft Rule determination:

- *MCL offset methodology:* Our analysis (see previous submission) demonstrates that Direct Retailer FOAs would have retained a much higher retailer MCL credit support for NEMMCO than under reallocation since 2005 (an average \$50.08/MWh of FOA bank guarantee support compared to \$17.35/MWh under reallocation) plus FOAs would have contributed additional Security Deposit protection which has been ignored in the analysis. The increased competition in the supply of FOAs and elimination (via daily margining of FOAs) of off market bilateral credit default risks between NEM Participants required under reallocation will however regularly yield operating cost savings to retailers under FOAs despite the larger credit support retained with NEMMCO;
- *Legal rights and obligations of FOA parties:* SFE Clearing Participants would not be a party to the FOA. Hence legal rights and obligations of the FOA parties (NEM Participants) are governed by the Rules. The obligation is on the Market Participant to ensure its SFE Clearing Participant provides NEMMCO with a confirmation of the Market Participant's relevant futures position daily;
- *Non-firmness of FOA payments:* the Direct Retailer FOA is between the Market Participant and NEMMCO and only NEMMCO can terminate an FOA. NEMMCO will not terminate an FOA at the Market Participant's request unless the Market Participant provides sufficient alternative credit support under the Rules. Therefore, the uncertainty regarding FOA payments under the initial proposal is removed.
- *clawback risks of security deposits:* the Direct Retailer FOA arrangements utilise existing payment arrangements and will not change the status quo regarding legal clawback risk.

The risk of clawback would be at the same level that currently exists in relation to security deposit payments that are used for billing purposes. Similarly the risks would be the same as those risks associated with a bank guarantee relating to credit support. The frequency and size of FOA payments are less when compared with ex-ante reallocations as under a Direct Retailer FOA the Retailer only has to pay NEMMCO amounts that are greater than the "Futures Lodgement Price" whereas reallocation transactions include the gross pool price;

- *Lack of clear dispute resolution procedure:* both parties to the Direct Retailer FOA (Market Participant and NEMMCO) are governed by the Rules, hence the dispute resolution process is governed by the Rules as well;
- *Inter-regional FOA offset:* the Direct Retailer FOA does not (and nor did the original FOA proposal) permit interregional MCL offsets; and
- *Counterparty default risk:* under Direct Retailer FOAs, counterparty default risk is reduced through daily margining of the retailer's futures hedge contracts, thereby reducing costs. In comparison, ex-ante reallocation merely transfers the risk of a retailer's default from NEMMCO to a generator via an opposing (and very large) over-the-counter counterparty exposure.

How the Direct Retailer FOA alternative contributes to the NEO

d-cyphaTrade shares the Commission's view that it is important to balance the prudential needs of generators and retailers whilst maintaining a sound and efficient prudential regime in line with the NEO. d-cyphaTrade considers that Direct Retailer FOA best meets the NEO in comparison to the alternatives as:

- there is currently no complementary offset mechanism to reallocations in the Rules that contributes to the effectiveness and efficiency of the current prudential regime;
- it supports the prudential regime of the NEM whilst reducing the working capital cost to retailers and generators alike which is in the long term interests of consumers of electricity;
- the reduction of working capital costs:
 - lowers barriers to entry and thus promotes the efficient investment in electricity services; and
 - leads to increased competition which in turn promotes efficient operation and use of electricity services.
- addresses the concerns and issues that resulted in the AEMC determining that the FOA Rule change proposal did not satisfy the NEO.

The AEMC's power to make the Direct Retailer FOA Rule

d-cyphaTrade submit that the AEMC should make the Direct Retailer FOA as an alternative to the Initial Rule proposed (and which was rejected) as part of the FOA Rule change proposal rather than considering this alternative as part of the market review that has recently commenced on the same issue.

Section 91B of the National Electricity Law gives the AEMC the power to make the Direct Retailer FOA instead of the Rule proposed by the FOA Rule change proposal. In addition, if the AEMC considers further consultation is required, section 102A of the National Electricity Law empowers the AEMC to issue another draft Rule determination and conduct another round of consultation to give stakeholders the opportunity to comment on the Direct Retailer FOA prior to AEMC determining to make the Rule.



We therefore urge the AEMC to consider the Direct Retailer FOA alternative in making its final Rule determination on the FOA Rule Change Proposal.

Yours sincerely,

A handwritten signature in black ink that reads "Dean Price".

Dean Price
General Manager