

21 November 2024

Ms Anna Collyer
Chair
Australian Energy Market Commission
Level 15, 60 Castlereagh St
Sydney NSW 2000

Reference: ERC0403

Dear Ms Collyer,

AEMO submission to consultation paper – cash as credit support

Thank you for the opportunity to make a submission on the proposed change to the National Electricity Rules (NER) to allow AEMO to accept cash as credit support.

AEMO supports the evolution of the NEM credit support arrangements to remain efficient, effective and fit-for-purpose through the energy transition. We acknowledge the potential for administrative benefits and cost reductions for participants from allowing cash to be provided in lieu of bank guarantees, and welcome further analysis of an appropriate path to facilitate this option.

The provision of cash as credit support has been previously considered but not progressed in the NEM, primarily due to the elevated risk of exposure to potential ‘clawback’ of cash transactions made by a market participant in the event of its insolvency. In AEMO’s view, the existing NEM regulatory framework still does not fully address this risk, and changes to the NER alone cannot eliminate it.

In the absence of a legislated solution to fully remove clawback risk, any NER change allowing for cash as credit support will need a clear mechanism for AEMO to fully recover any related liabilities if they are incurred, at the time they are incurred. As the independent non-profit market operator who facilitates the settlement and prudentials framework on behalf of market participants, exposure to potentially significant unfunded liabilities presents a serious threat to AEMO’s solvency and the ongoing orderly operation of energy systems and markets.

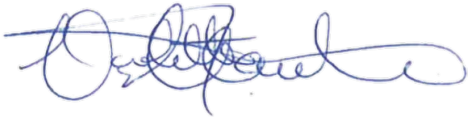
AEMO is committed to working with the AEMC and market participants to progress this rule change, noting the importance of designing a robust cash collateral capability that appropriately assesses and allocates potential liabilities. As a result, the rule change is more complicated than Delta’s proposal envisaged. Detailed analysis and informed consultation on possible solution designs is critical to ensure that market participants understand the extent of clawback liability, and that workable cost recovery mechanisms are in place to cover this eventuality.

In the context of the immediate concerns identified by Delta, our submission highlights aspects of the existing prudential process that support the continued safe, secure and reliable operation of the power system if a major generator were to default for non-provision of credit support. In AEMO’s view, these existing processes and the need to carefully address other matters raised, are relevant considerations with respect to the time frames for progressing this rule change.



The attached detailed submission expands on these issues and others identified in the AEMC's consultation paper questions. Should you wish to discuss any aspect of our submission, please contact Hannah Heath, Group Manager, Strategic Market Reform (Hannah.Heath@aemo.com.au).

Yours sincerely,



Violette Mouchaileh
Executive General Manager, Reform Delivery

ATTACHMENT – Detailed submission

1. Do the current available options for credit support create problems in the NEM?

Consultation questions:

- How likely is it that other participants may face issues in the future obtaining bank guarantees or letters of credit, similar to the issues currently faced by Delta or otherwise?
- Could the current options for credit support create risks to the supply of electricity? Are these short term risks or longer term risks to the broader NEM?
- Are there any other issues faced by market participants due to the current options to provide credit support?

Market participants are best placed to comment on questions about the availability of options or other issues in obtaining credit support from financial institutions to meet their NEM prudential requirements. As a general observation, to date AEMO has not been made aware that any other market generators would be unable to provide sufficient bank guarantees as credit support if they were required to do so. However, AEMO periodically receives enquiries from other market participants (typically smaller market customers/retailers) about the possibility of providing cash to cover all or part of their maximum credit limit (MCL), particularly where there may be a delay in securing replacement or additional bank guarantees.

With regard to any electricity supply risks presented by the current credit support requirements, AEMO notes that the AEMC assessed the rule change as urgent based on the security and reliability implications of a sudden unplanned withdrawal of Vales Point B Power station from December 2024 if Delta Electricity is unable to meet its prudential obligations. As described below, AEMO considers that the existing prudential framework in the NER incorporates controls that are sufficient to manage the continued safe, secure and reliable operation of the power system and are relevant with respect to the associated urgency of the rule change.

Prudential framework

AEMO is required to hold credit support from market participants that are net debtors in the NEM at the level of the participant's current MCL¹. Credit support is provided to collateralise market participant credit risk such that in the event of default, all outstanding settlement amounts can be met in each cycle with only a 2% probability of loss to the market².

A market participant will be a net debtor if its expected trading activity may result in it owing money to the market in a billing period, accounting for the participant's anticipated production, consumption, reallocation transactions, market prices and other risk factors detailed in the NER and AEMO's credit limit procedures. Consequently, most market generators or gentailers, whose production or reallocations are expected to fully offset any consumption, do not have an MCL on an ongoing basis. For established generators, an MCL would typically only be calculated for periods such as plant outages of sufficient scale that their total adjusted market generation is unlikely to exceed their total connection point load in a billing period. If this does occur and a market generator's consumption is likely to exceed their production for a sustained period, they may look to consider unwinding retail load or reallocation positions to reduce risk of introducing credit support requirements.

¹ Participant MCLs are calculated in accordance with NER 3.3.8 and as set out in AEMO's credit limit procedures. https://aemo.com.au/-/media/files/electricity/nem/settlements_and_payments/prudentials/credit-limit-procedures.pdf?la=en

² This is referred to in the NER as the 'prudential standard'

Default and suspension process

NER 3.15.21 sets out the process for default and market suspension of a market participant. NER 3.15.21(a) defines 15 default events, including, in NER 3.15.21(a)(3): *the Market Participant fails to provide credit support required to be supplied under the Rules by the appointed time on the due date*. If a default event does occur, the NER prescribe a range of actions AEMO can take in response to that default. Importantly, AEMO is given discretion to exercise these powers in most cases, for example:

- If a default event occurs, AEMO may issue a default notice or make a claim on credit support – **NER 3.15.21(b)**.
- If a default event is not remedied by the appointed time, AEMO may issue a suspension notice – **NER 3.15.21(c) or (c1)**³.

In exercising these discretions, AEMO will consider the relevant circumstances, including the power system implications and broader market impacts of any suspension decision, as well as the financial risk posed to the market by the defaulting participant.

Further, AEMO is not required to suspend all activities or registration categories of a market participant when making a suspension decision. A suspension notice will identify the registration categories and the activities of the market participant that are suspended, as per the **NER glossary**:

suspension notice

A notice issued by AEMO to a *defaulting Market Participant* pursuant to clause 3.15.21(c) or (c1) under which AEMO notifies the *defaulting Market participant*:

- (a) of the date and time from which it is suspended from specified activities;
- (b) the *registration categories* of the *defaulting Market Participant* to which the suspension relates; and
- (c) in respect of the *registration categories* referred to in paragraph (b), the activities (or subset of activities) of the *Market Participant* that have been suspended.

As an example, if a market participant is both a creditor (generator) and debtor (market customer), the NER would allow AEMO to suspend only the market customer registration and related activities if AEMO deems that to be the most appropriate action in the circumstances. In practice, AEMO could take this course of action if it were considered necessary to keep a generator operating in the market for system security or reliability reasons, while restricting participant spot market purchases to minimise any potential financial risk to the market. AEMO acknowledges, however, (as the AEMC flagged in a 2016 determination⁴) that partial suspension could be challenging to operationalise due to the complexity of ring-fencing different market registrations, especially with respect to their financial obligations. These considerations would need to be worked through with the market participant in a relevant default scenario.

In the context of the immediate concerns raised by Delta, these aspects of the existing prudential framework and default processes provide options to minimise or mitigate any risk to system security should a major generator default due to non-provision of credit support (where required). AEMO's view is that these are relevant factors when considering the time needed to investigate and address the implications of the rule change highlighted in the consultation paper and discussed in this submission.

³ NER 3.15.21(c) refers to a default event that is not an external administration default event, while NER 3.15.21(c1) refers to a default event that is an external administration default event.

⁴ AEMC, 2016, Market Suspension rule change Final Determination, page 17 - <https://www.aemc.gov.au/sites/default/files/content/2f2c5e7c-41e9-4013-9c6b-0f640881af21/Market-Participant-Suspension-Framework-Final-Determination.pdf>

2. What are the potential benefits of allowing cash to be provided as credit support?

Consultation questions:

- What benefits do you consider there to be from allowing cash to be provided as credit support?
- If there are benefits, how material could they be?

AEMO supports efficient enhancements of the prudential regime and acknowledges the ongoing challenges market participants may face in managing prudential exposure through the energy transition. Market participants will be best placed to advise on the benefits of allowing cash to be provided as credit support for participant MCLs, but AEMO observes that the potential benefits identified in AEMO's 2011 Energy Market Prudential Readiness Review⁵ remain valid. These include increased flexibility for participants to access the least cost option for provision of collateral, and reductions in administrative costs for both participants and AEMO.

If the provision of cash as credit support is more accessible for market participants, they may be able to better respond to changes in MCL requirements at short notice. This in turn would reduce administrative processes chasing up bank guarantees and mitigate participant risk of default due to the time taken to obtain additional or replacement guarantees.

3. What are the potential costs of allowing cash to be provided as credit support?

Consultation questions:

- What are your views on risks to AEMO and market participants from insolvencies if cash is provided as credit support? Are these risks sufficiently material to outweigh any benefits of the proposal?
- What do you consider would be the likely impact on emissions by allowing cash to be provided as credit support?
- Are there any other potential costs from allowing cash to be provided as credit support?
- If there are costs, how material are they?

Clawback risk

AEMO agrees with the consultation paper that the primary risk (and therefore potential cost) of allowing cash to be provided as credit support is associated with the cost of funding cash deposits in the event of a successful liquidator clawback. This section discusses clawback risk at a high level. It should be acknowledged at the outset that both the prospect of a successful clawback claim, and the potential magnitude of any clawback liability, are highly uncertain in the context of NEM transactions. While that uncertainty may lead to the probability of successful clawback being assessed as low, introducing cash deposits as credit support in the NEM significantly increases the potential amount of any exposure.

Clawback is the term commonly used to refer to mechanisms in the *Corporations Act 2001* (Cth), permitting a liquidator to seek to have certain transactions set aside in a winding up. As the NER are made under state legislation (the National Electricity Law (NEL) as applied in each participating jurisdiction), the federal Corporations Act provisions will apply to NEM transactions unless clearly 'displaced' in the state laws. Although the NEL does include displacement provisions, AEMO is of the view that these are not comprehensive enough to fully address residual clawback risk (discussed further under question 4).

AEMO's role is to administer the prudential framework as set out in the NER, which covers the receipt of credit support in the form defined in NER 3.3.2. If the proposed rule extends the meaning of credit support to include

⁵ See AEMC, Cash as credit support consultation paper, page 16 - <https://www.aemc.gov.au/sites/default/files/2024-10/Consultation%20paper%20-%20ERC0403%20Allowing%20AEMO%20to%20accept%20cash%20as%20credit%20support.pdf>

cash, AEMO may have to accept cash deposits in circumstances where a market participant is insolvent, or nearing insolvency – creating conditions in which those transactions might be unfair preferences. As noted in the consultation paper, to the extent that the payment and/or application of a cash deposit in the NEM is determined to be an unfair preference, it may be subject to clawback by a liquidator of the participant who provided it. If this occurs, AEMO could be ordered to pay back those amounts long after they have been applied in final and revised settlements.

AEMO's settlement and prudential functions facilitate the secure and reliable delivery of energy, by providing confidence in the process of collection and payment for energy received and supplied respectively. As the independent market operator and the facilitator of the settlements and prudentials framework, AEMO cannot take on financial exposure associated with executing its market operations. It performs this role on the basis that any settlement shortfall, however small the possibility of occurrence, is fully funded such that AEMO is never obliged to pay out any more than it receives, and there is no gap during which AEMO would need to fund a shortfall. Market participants (and ultimately consumers) would therefore need to bear the potential clawback risk associated with accepting cash as credit support.

Other risks and costs

Another risk of allowing cash to be provided in lieu of bank guarantees arises from removing the additional credit risk screening provided as part of the financing process. In determining whether to guarantee a market participant's NEM obligations, lenders assess financial risk in a way that neither AEMO nor retail regulators can do. If a market participant can access a bank guarantee, typically this would provide an additional layer of credit risk assurance to the market. Allowing cash to be provided as credit support lowers barriers to participation for entities who may have difficulty in accessing bank guarantees, but in some cases this could also indicate an increased credit risk and a higher risk of default and market suspension.

There would be upfront costs associated with the necessary system and procedural changes to allow AEMO to accept cash as NEM credit support in addition to bank guarantees. AEMO is not yet in a position to estimate the amount of those costs but considers that, over time, the administrative effort to AEMO in receiving cash as credit support may be comparable to that of handling bank guarantees. If applicable and appropriate, AEMO may look to leverage existing WEM processes for handing cash as credit support.⁶

4. Are there any provisions that could enable AEMO to sufficiently manage insolvency risk when accepting cash as credit support?

Consultation questions:

- If cash is accepted as a form of credit support, do insolvency risks to AEMO and the market need to be managed? If so, could risks be satisfactorily managed by:
 - socialising costs from cash clawbacks among market participants, instead of AEMO bearing the costs?
 - guidance to AEMO on conditions for which cash could be provided as credit support?
 - AEMO registering a security interest in the cash on the Personal Property Securities Register?

As discussed above, AEMO as the independent non-profit market operator cannot be exposed to unfunded liabilities in exercising its statutory functions. In AEMO's view, the probability of clawback risk in the present regulatory framework cannot be readily quantified. However, even if the residual risk is assessed as very

⁶ AEMO, 2023, WEM Prudential Requirements Procedure - <https://aemo.com.au/-/media/files/electricity/wem/procedures/2023/wem-procedure---prudential-requirements---v100---final---external.pdf?la=en&hash=B88A2EAF045E928872FA4A66CA47CA73>

small, AEMO must still be kept whole for any liability that does eventuate. To assure AEMO's solvency and protect the ongoing secure and reliable operation of the NEM, it will be critical for any rule to include clear provisions for AEMO to fully recover any liabilities from market participants at the time they are incurred. The remainder of this section discusses AEMO's view of existing prudential requirements, limitations and mitigations in the NEM and WEM,

Displacement provisions

With the introduction of the National Energy Customer Framework (NECF), Corporations Act displacement provisions were included in section 10A of the NEL, as further specified in regulation 5A of the National Electricity (South Australia) Regulations. In relation to NEM prudential obligations, section 10A allows the regulations to declare only two types of 'relevant provisions' as displacement provisions, namely:

- The application by AEMO of money in any security deposit fund (declared provision **NER 3.3.13A**).
- The functions of AEMO under procedures relating to defaults by retailers (declared provision **NER 3.15.21**, but likely to be limited to the exercise of those functions in relation to market participants who are authorised retailers).

Section 10A and regulation 5A were originally inapplicable to jurisdictions that did not initially adopt the NECF but have since been incorporated in the national electricity legislation of all NEM participating jurisdictions. Where a displacement provision applies to a transaction that may otherwise be an unfair preference under the Corporations Act, it will have the effect of removing clawback risk entirely, with no need for NER mechanisms to recover any liability associated with that transaction.

AEMO is of the view that the existing NEL displacement provisions do not eliminate clawback risk, because they are explicitly limited to the *application* of security deposits and the default process (in which AEMO is entitled to *apply* both security deposits and credit support). Although open to interpretation, it remains arguable that the *provision* of cash amounts to AEMO by an insolvent participant is a distinct transaction, which is still capable of being an unfair preference. The provision of cash as credit support increases the potential market exposure to this risk.

AEMO suggests that the most straightforward means of eliminating clawback risk from the NEM settlement and prudential process is to broaden the displacement provisions to cover all AEMO settlement and prudential transactions. This would require amendments to NEL section 10A and regulation 5A to effectively include most or all of NER 3.3 and NER 3.15. AEMO would strongly support these legislative amendments if recommended by the AEMC, to provide certainty and improve investor confidence.

In the absence of those legislative changes, any rule amendments to allow cash as credit support must account for this risk and structure a solution for AEMO to fully recover any related costs at the time they are incurred (as further discussed below).

Existing NEM provisions for cash security deposit amounts

NER 3.3.8A currently allows a market participant to provide at any time cash as a security deposit to AEMO to secure payment which may become payable in respect of a billing period. While it may be tempting to consider this existing provision as analogous to the provision of cash as credit support against participant MCLs, AEMO cautions against any comparison.

Cash security deposits under NER 3.3.8A are permitted to secure liabilities above a trading limit and are typically provided by market participants in response to call notices – when a participant’s outstandings exceed its trading limit, AEMO may issue a call notice requiring a participant to respond by 11am on the next business day. Call notices are more frequent during periods of high price volatility where the credit support provided could become insufficient to cover participant outstandings. Given their function, security deposits are typically significantly lower in value than credit support amounts. They are also temporary in nature, generally removed quickly by being credited against an upcoming participant final statement. The process of receipt and application of security deposits by AEMO is set out in AEMO’s Security Deposit Arrangement procedure.⁷

The amount of credit support required for participant MCLs is much more significant. It is based on a 42-day⁸ credit period to address both expected liabilities from normal trading activities, and liabilities that may accrue following a default event. The quantum of credit support held by AEMO to collateralise credit risk across the market is significant – over the last two years AEMO has typically held between \$2- \$2.5 billion in bank guarantees⁹ to secure credit risk in the NEM, and ensure that in almost all circumstances, AEMO will be able to settle the market without shortfall.

In contrast to the security deposits framework, participant credit support is required to mitigate enduring and systemic credit risk of the NEM. The robustness of participant credit support underpins the prudential framework, and the potential for clawback could give rise to very significant exposure.

WEM credit support arrangements

AEMO has been required to accept cash in the form of security deposits to meet participant credit support obligations in the WEM, under WEM Rule 2.38.4, since commencement of the WEM. As mentioned in the consultation paper and set out in the *WEM Prudential Requirements Procedure*¹⁰, following receipt of security deposit deeds, AEMO currently registers them as security interests on the Personal Property Securities Register in accordance with the *Personal Property Securities Act 2009* (Cth) (PPSA). This may assist in preserving AEMO’s interest as a secured creditor on the basis that these cash securities may be considered to fall within the application of the PPSA. Registration does not mitigate all clawback risk, however, in a situation where the transaction providing that security is itself an unfair preference. Noting the relative size of the NEM and the associated administrative and legal complexity of PPSA registrations and priorities, AEMO suggests consideration be given to drafting any rule in a way that clearly puts NEM cash securities outside the scope of the PPSA¹¹.

Mechanism to recover any clawback liability

As discussed above, to accept cash as credit support in the NEM in the absence of more comprehensive Corporations Act displacement provisions in the NEL and National Electricity Regulations, the NER must allow

⁷ AEMO, Security Deposit Arrangements, https://www.aemo.com.au/-/media/Files/Electricity/NEM/Settlements_and_Payments/Prudentials/2018/Security-Deposit-Arrangements-v13.pdf

⁸ This will decrease under a shorter settlement cycle

⁹ AEMO, Effectiveness of the NEM Prudential Settings Methodology, p7 - https://aemo.com.au/-/media/files/electricity/nem/settlements_and_payments/prudentials/2023/report-on-effectiveness-of-the-nem-prudential-settings-methodology-2023.pdf?la=en

¹⁰ AEMO, 2023, WEM Prudential Requirements Procedure - <https://aemo.com.au/-/media/files/electricity/wem/procedures/2023/wem-procedure---prudential-requirements---v100---final---external.pdf?la=en&hash=B88A2EAF045E928872FA4A66CA47CA73>

¹¹ Consideration could be given to explicitly providing that AEMO acquires a security interest in cash deposited as collateral by operation of and in accordance with the NER, for the purposes of section 8(1)(b) of the PPSA.

AEMO to appropriately recover any clawback liabilities, at the time they are incurred. This will protect AEMO solvency and ensure its ability to operate the market is not impaired or exposed to any additional risk.

A mechanism in the NER to allocate the costs of clawback to participants aligns with existing provisions that require AEMO, in the event of insufficient payments and participant collateral to settle the market, to spread the shortfall across suppliers in the NEM. Under NER 3.15.22(c), where the maximum total payment¹² will not cover the amounts payable by AEMO to market participants for a billing period, AEMO will reduce payments to each market participant in proportion to their net amount payable. AEMO is then able to continue to settle final statements¹³, with the cost and impact of shortfall to any one market participant being minimised by spreading the cost amongst all NEM creditors.

AEMO considers the application of a similar mechanism to socialise any clawback liability amongst NEM creditors is fundamental to the ability to accept cash as credit support in the NEM. As the timing of clawback liability would only arise following court proceedings, it will not align with settlement cycles and may only be known many months or even years after a participant suspension. Funds would need to be recovered from market participants at the time any liability is incurred, to mitigate solvency risk to AEMO from a lag in the timing of cash flows from the time payment is due to liquidators. How the recovery mechanism will work in practice and interact with existing settlement shortfall provisions will require careful consideration as part of detailed design and implementation of the proposed rule.

Given the uncertainty and potential materiality associated with liquidator clawback, AEMO reiterates the importance of stakeholders having appropriate time to review and consider proposed amendments and solution design. Detailed analysis and informed consultation will be needed to ensure market participants appreciate the possible risk of extended clawback liability and are able to make an informed judgement on what is an acceptable level of exposure.

This may include consideration of rules to minimise the amount of credit support risk borne by the market. For example, the consultation paper suggests cash could be provided up to a dollar limit. While this would reduce the quantum of potential exposure in the event of liquidator clawback, it may also require market participants to provide a combination of both cash and bank guarantees to meet their credit support requirements, potentially at higher cost. If this approach is accepted by the AEMC and market participants, the cash limit should be clearly prescribed in the Rules. AEMO does not consider it appropriate for the NER to give AEMO discretion on the amount of cash as credit support as AEMO is not positioned to decide on appropriate levels of credit exposure to be accepted by the market in different circumstances.

5. Would transitional rules be needed?

Consultation questions:

- If a rule was made to allow AEMO to accept cash as credit support, would transitional rules be needed to enable Delta or other participants to provide cash as credit support during an interim period? If so, what would be an appropriate form of transitional rules?

As the AEMC identified in section 3.2.2 of the consultation paper, AEMO would need to change its NEM prudentials systems and procedures to accept cash as security for MCL amounts. The necessary change processes will need to be scheduled into AEMO's IT change program and consider possible disruption of

¹² As defined in NER 3.15.22(a)

¹³ Currently 20 business days following the end of the billing period but under consultation as part of the *Shortening the settlement cycle* rule change.

other projects. Further assessments are required to determine how long the implementation process will take, but it could take between 6 and 18 months if given priority following final determination of the Rule.

Given the complexity and potential materiality of clawback risk, AEMO does not support any transitional rule or process that would require AEMO to accept cash as credit support prior to the establishment of clear rule-based provisions for immediate recovery of clawback liability from the market. AEMO considers the existing provisions and discretions in the prudential framework, as discussed earlier in this submission, are relevant to the assessment of any transitional requirements for this rule change.

6. Are there any additional variations or alternative options to Delta's proposal?

Consultation questions:

- Do you have any additional variations or alternative options to Delta's proposal that may address problems associated with the available options for providing credit support in the NEM?

As discussed in question 4 above, AEMO supports the acceptance of cash as security for MCL amounts, provided market participants and AEMC accept the associated risks. Comprehensive provisions are required to either to fully remove any clawback risk, or to allow AEMO to recover any liabilities at the time they are incurred. AEMO has no objection to a proposal for cash to be provided up to a dollar limit, however any such limit should be defined in detail in the NER and reflect the amount of risk the market is willing to bear. As noted, AEMO does not support any discretion to set monetary limits or other conditions for accepting cash as credit support.

Finally, AEMO observes that the amendment proposed by Delta, to insert 'cash or' in NER 3.3.2(b), may not work from a drafting perspective with the introductory words of clause 3.3.2, which require credit support to be an obligation in writing.