

d-cyphaTrade

AEMC – Pre final Rule determination hearing

Futures Offset Arrangements

Sydney, 12 February 2009

Discussion topics



- A. Resolution of risk issues raised in Draft Determination
- B. How Futures Offsets will contribute to NEM Objective
- C. How to proceed

Resolution of Risk Issues



- Risks can be readily addressed
- Once risks are addressed, prudential framework will be significantly improved
- d-cyphaTrade will provide a detailed written submission in addition to this presentation

Legal Rights and Obligations of FOA parties and dispute resolution

- > Practically identical to NEMMCO's existing reliance on contracts not governed by NER:
 - MCL "Bank guarantee" contract with a bank (Credit Support s.3.3.2(b))
 - "Letter of Agreement" contract between NEMMCO and reallocating parties (see NEMMCO's Reallocation Procedures).

Implications of “non-firmness”

- > Risk of termination is lower and results are less severe than under the existing reallocation mechanism:
 - > FOAs cannot be terminated by force majeure, ie they are “firm”, unlike Reallocations which are practically terminated if the generating unit trips, ie they are “non-firm”.
 - > FOA termination has better worst-case MCL protection and SDA deposit protection than reallocation termination because the SFE Clearing Participant has kept NEMMCO whole up until the date of termination
- > MCL bank guarantees are regularly inadequate during high prices

Clawback risk

- > Likely to be no worse (and potentially better) than NEMMCO exposure under existing arrangements

NEM Participants might not understand FOAs

- > Participants already consider current prudential arrangements to be non-robust (regular shortfalls)
- > Universal understanding of FOA not critical to contribution to NEO – only 1 FOA user needs to understand
- > Extensive market consultation has taken place and wider understanding will be achieved if Rule approved

SFE Clearing Participant support?

- > SFE Clearers are very supportive of increasing electricity futures services to clients, remain available to assist AEMC and are awaiting final Rule.
- > Keenness of SFE Clearing Participants was demonstrated when 5 Clearers asked AEMC (via d-cyphaTrade) to attend FOA Workshop

How Futures Offsets will contribute to NEM Objective



1. NEO more likely to be achieved via Rule Change rather than NEMMCO procedures
 - a. Removes barriers to competition from SFE market and limiting of potential efficiency gains (SFE can't compete because can't agree procedures with NEMMCO)
 - b. Avoids compliance risk/costs for NEM Participants
 - SFE is a licensed financial market (Corps Law Ch7)
2. Increased competition and less compliance cost/risk leads to more efficient pricing

How Futures Offsets will contribute to NEM Objective



FOAs achieve the NEM Objective (detail at Appendix 1)

1. Efficient investment in the NEM is achieved by:
 - a. Reduced counterparty credit risk/cost and Diversity of credit support providers
 - b. Prudential support during high price periods and competitive interregional as well as international supply of offsets
2. The long term interest of consumers with respect to price is achieved by
 - a. Efficiency for new and existing retailers achieved by unlimited supply of offsets (not energy constrained)
 - b. Support for unbundling or retail and generation as well as market transparency

How Futures Offsets will contribute to NEM Objective



FOAs achieve the NEM Objective (detail at Appendix 1)

3. Long term quality of the market is achieved by:
 - a. Regulatory integrity of offset arrangements
 - b. 100% improved market transparency
4. Long term security of supply and financial reliability of the market is achieved by
 - a. Removing the effective exclusion of peaking generation from participating in offset arrangements
 - b. Counterparty anonymity

- > AEMC should draft a Preferred Rule (s.91A)
- > Since the AEMC has already recognised some of the benefits of FOAs, a Preferred Rule would be more beneficial to the market than a s.45 Review to avoid further delays to cost savings for NEM retailers
- > Market Participants have been extensively consulted on this initiative over several years

- > If AEMC decides that a review is necessary, d-cyphaTrade will provide support where required
- > If AEMC decides that additional independent risk analysis is needed, d-cyphaTrade suggests engaging a new risk consultant, to maximise independence

Appendix 1. Summary of FOA Benefits and Compliance with the NEM Objective



Economic benefits	Futures Offset Arrangements	NEM Objective
1. Reduced counterparty credit risk	Daily margining significantly improves the prudential framework of the NEM and reduces the NEM's direct and indirect current credit risk exposure to reallocators	<ul style="list-style-type: none"> ➤ Less credit risk makes the market more efficient ➤ Positive impact on price for consumers of electricity
2. Diversity of Credit Support Providers	SFE Clearing Participant support in addition to existing MCL guarantee providers as opposed to non-rated or below investment grade generators	<ul style="list-style-type: none"> ➤ Promotes efficient investment in the NEM because financial integrity of the market is increased
3. Prudential support coverage during high pool prices	Daily futures cash flows are price-following unlike current MCL guarantees whose "protection level" is based on historic prices.	<ul style="list-style-type: none"> ➤ Promotes efficient investment in the NEM because financial integrity of the market is increased
4. Regulatory Integrity	SFE and SFECC operate a licensed market under Corps Law and are supervised by regulator (ASIC) with expertise in financial markets	<ul style="list-style-type: none"> ➤ Increases the attractiveness of the market to new investors ➤ Improved long term quality of the market and lower cost of compliance

Summary of FOA Benefits and Compliance with the NEM Objective



Economic benefits	Futures Offset Arrangements	NEM Objective
<p>5. Efficiency for new entrant retailers and existing retailers</p>	<p>Improves collateral funding costs of retailers due to efficiency of daily margining</p>	<ul style="list-style-type: none"> ➤ Promotes long term efficient investment by retailers in the NEM ➤ Increased retail competition and lower cost for retailers results in most efficient price for electricity consumers
<p>6. Competitive Financial Instrument</p>	<p>Higher liquidity in futures for any given NEM region because contracts are traded by interstate and international sellers including banks and trading houses, not just intraregional reallocators</p>	<ul style="list-style-type: none"> ➤ Promotes long term efficient investment by retailers in the NEM ➤ Increased retail competition and lower cost for retailers results in most efficient price for electricity consumers
<p>7. Unlimited supply of off-set instruments</p>	<p>Futures market depth and number of market participants is unlimited as it is not limited by energy commitment</p>	<ul style="list-style-type: none"> ➤ Long term readily available offset instruments leads to reduction in collateral funding costs and leads to long term more efficient retail pricing

Summary of FOA Benefits and Compliance with the NEM Objective



Economic benefits	Futures Offset Arrangements	NEM Objective
<p>8. Supports effective unbundling of retailers and generators</p>	<p>Use of futures as hedging instrument as well as a prudential tool vis a vis NEMMCO is more cost effective for a retailer than investment in a generation asset</p>	<ul style="list-style-type: none"> ➤ Increased retail competition due to less vertical integration results long term in most efficient price for electricity consumers
<p>9. Market Transparency</p>	<p>Futures market is fully transparent as opposed to reallocation contracts which is a non-disclosed, bi-lateral agreements whose terms vary significantly</p>	<ul style="list-style-type: none"> ➤ Transparent markets promote long term efficient pricing in the NEM
<p>10. Anonymity of counterparty</p>	<p>Retailers buy futures anonymously and lodge FOA's anonymously encourages retailers to use the instrument as they do not have to reveal their position to a reallocator who may also have a competing retail interest</p>	<ul style="list-style-type: none"> ➤ Long term use of an anonymous prudential instrument leads to increased financial reliability of the NEM ➤ Market quality is improved as it levels the playing field and increases access for all participants
<p>11. Promotes peak as well as base load generation technology</p>	<p>Peakers can readily participate in the futures market</p>	<ul style="list-style-type: none"> ➤ Promotes long term security of supply in the NEM as peaking plants are not excluded from an attractive market segment