



Australian Energy Market Commission
PO Box A2449 Sydney South
NSW 1235

7 July 2016

Dear Sir/Madam

In re: National Electricity Amendment (Market Participant Suspension Framework) Rule 2016

Thank you for the opportunity of providing comments on the issues raised in the Consultation Paper, *National Electricity Amendment (Market Participant Suspension Framework) Rule 2016*. In this letter we provide some introductory comments and also some specific comments. We have restricted our specific comments to those areas that relate directly to questions examined in our earlier work, with Taylor Fry, for the Australian Energy Market Operator (AEMO) on the Prudential Framework.

Introductory comments

Looking at the broader issues raised by the proposed Rule Change, we think the real world's likely to be messier than implied by the discussion in Issue 5 suggesting AEMO can take its time and exercise some level of discretion.

We're also not convinced the timeline implicit in, for example, a consultation process is consistent with events occurring elsewhere. In the Dick Smith failure, for example, although the company's financial deterioration was the subject of extensive public speculation in the period preceding its failure, the appointment of an external administrator by the Board was overtaken on the same morning by the appointment of receivers by the secured creditors. If a similar scenario was to occur in the energy sector:

- When is AEMO likely to be advised of the (potential) appointment of external administrators, and under what conditions? For example, if in strict confidence, would this affect AEMO's ability to consult other parties?
- How much time is AEMO likely to have to consult other parties?
- When does AEMO act? Presumably, not before an actual event of default, but, how soon afterwards?
- What, if anything, happens if the appointed receivers withdraw the market participant from the market before AEMO has taken a decision, whether for or against the participant's ongoing participation?
- If AEMO decides, based on the benefits to the NEM, that the market participant should be allowed to continue, but the receivers are unprepared to consider this (or to enter into whatever agreements AEMO requires to impose the conditions it seeks), what, if anything, happens?

These are legal and practical questions that need to be worked through with experienced advisors looking at the sorts of scenarios that could arise in the event of a market participant's failure; they cannot be answered in isolation from a realistic scenario of the circumstances in which AEMO is likely to find itself.



One outcome of these explorations may be that the original, narrower question relating to AEMO's powers in the event of the failure of one of a market participant's corporate vehicles can be successfully addressed – that is, that the Rules could be amended to allow other corporate vehicles not affected by the original failure to continue as market participants, subject to the requirement, as for all other market participants, that they continue to meet their prudential requirements, but that wider discretionary powers for AEMO, however exercised, present too many practical difficulties to introduce.

Specific comments

Looking at *Issue 2: Risk of external administration*:

3. *A market participant in financial distress may pose a threat to the financial integrity of the market. Examples include allowing continued operation and possible accumulation of debt towards the spot market or immediate removal from the market and possible exacerbation of financial contagion. What other risks to the NEM may be associated with a market participant under external administration continuing to participate in the market?*

The Consultation Paper asks whether the current prudential framework would be sufficient to maintain the desired level of performance if market participants are to be allowed to continue to accumulate debt operating in the market after the appointment of external administrators.

The design of the current prudential framework is based on the assumption that this will not occur. The Consultation Paper correctly assumes a review of the current basis for meeting the prudential standard would be required. If market participants' prudential requirements are not differentiated on the basis of their credit ratings, the likely effect of a review would be to increase all market participants' prudential requirements to maintain the existing prudential standard given the higher risk than previously projected of a loss given default. Whether or not the costs of higher prudential requirements would be sufficient to offset the benefits from allowing a market participant to continue in the market is a matter for analysis and judgement.

Other risks to the NEM depend on:

- the continuing status of swap and option reallocations, if any, that the market participant under external administration may hold at the time of appointment of the external administrator; and
- the effect, if any, that AEMO's decision may have on the status of these agreements, and on other market participants in the event of their termination.

If swap and/or option reallocations were to be in place, in our view AEMO's discretion should not be influenced by the existence of these agreements. However, in assessing the Rule Change proposal the status of these agreements after the appointment of an external administrator needs to be considered. In the event that the agreements lapse at the time of appointment, market participants' exposure to a loss in the event of default may be larger than allowed for in the prudential requirements.

We note that Promontory Australasia, in its Final Report *Offsets in the Prudential Margin: Economic Analysis*, June 2016, shares our concern that in the event of a default offsets may not be firm. We think that AEMO's proposed enhancements discussed by Promontory need to be tested in a scenario where an event of default has occurred to understand whether, as proposed by AEMO, the enhancements will materially reduce the risks to the prudential framework of reallocations.

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If you have any questions about any element of this, please call us on 03 9658 2351 (Peter Eben) or 03 9658 2352 (Patricia Boyce).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Patricia Boyce', enclosed in a light grey rectangular box.

Patricia Boyce

Director