Macquarie Generation

Corporate Office

34 Griffiths Road
LAMBTON NSW 2299

PO Box 38
HUNTER REGION MC
NSW 2310 AUSTRALIA

Telephone 61 2 4968 7499
Facsimile 61 2 4968 7433
Website www.macgen.com.au
ABN 18 402 904 344
AFSL No: 284379

Australian Energy Market Commission
PO Box A2449
Sydney South
NSW 1235

Attention: Mr Paul Bell

Reference ERC0133

Dear Mr Bell

Macquarie Generation welcomes the opportunity to comment on the AEMO's proposed Rule change for a *New Prudential Standard and Framework in the NEM,* dated 20 October 2011.

Macquarie Generation supports the comments made by the National Generators Forum in its submission; however we would like to take this opportunity to make some additional comments.

The analysis done by Seed Advisory & Taylor Fry[1] (SEED) has highlighted the severe under-provisioning of the current prudential scheme. The introduction of the Reduced Maximum Credit Limit (RMCL) in 2004 has led to the a situation where the amount of collateral held by AEMO is well short of a "reasonable worst case" estimate, defined by the NEL as a level that would not likely be exceeded more than once in 48 months. The SEED analysis shows potential defaults of up to 70 days over a 10 year period compared to the current standard of 2.5 days in 10 years (once in 48 months). For this reason, the AEMO proposal to remove the RMCL is welcomed by Macquarie Generation.

Macquarie Generation supports revised methodology to calculate the Maximum Credit Limit (MCL) and the Prudential Margin (PM). Calculating a participant's prudential obligation as a function of their load factor and the season is vast improvement on the current calculation.

We support the introduction of a statistical model for the Probability of Loss Given Default (PLGD) if it is reflective of the present standard in the Rules. However, we are extremely concerned that the setting of 2% PLGD falls well short of this. The SEED report recommended the PLGD be <u>no more than 2%</u>. In Appendix B, SEED estimates the standard error to be "about 0.6%." We believe the error in the analysis is large enough to warrant setting the standard to at least one standard deviation below 2% in order to provide greater confidence that the collateral provided by retailers would be sufficient to cover the amount owed to AEMO at least 98 times out of every 100.

Macquarie Generation acknowledges that a strict application of a "once in 48 months" threshold to the PLGD methodology would result in an unrealistically high level of collateral for many participants. In our view, the best way to resolve this is to move to a shorter settlement cycle. The SEED report finds numerous benefits when combining the new PLGD methodology with a shorter settlement cycle. These include a reduction in the reliance on additional securities, a reduction in the overall level of prudential requirements and a reduction in the seasonality displayed by the PLGD.

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[1] The Prudential Standard in the National Electricity Market Final Report – August 2010

Paul Bell
Australian Energy Market Corporation

We realise that AEMO has not included a review of the settlement cycle timeframe in its rule change submission but we believe the SEED report clearly identifies this option as delivering substantial benefits to the prudential standard and therefore should be incorporated into the proposed rule change. However if AEMO insist on moving to a PLGD regime, without shortening the settlement cycle, given the magnitude of the error, Macquarie Generation suggest the prudential standard to be set at no more than 1.4% PLGD.

Yours faithfully

TIM ALLEN
GENERAL MANAGER MARKETING

6 January 2012