27 June 2012

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235
Reference ERC0133

Dear Mr Bell

The NGF welcomes this opportunity to respond to the Draft Determination on AEMO's proposed Rule change for a "New Prudential Standard and Framework in the NEM".

It is our understanding the Rule change proposal seeks to replace the "*reasonable worst case*" calculation of a Maximum Credit Limit (MCL) with a level associated with 2% Probability of Loss Given a Default[1] (P(LGD)). Using the concept of P(LGD), the existing standard had proved to be 4%[2] over 2000-2010. The AEMO proposal aims to change the calculation of the MCL and the Prudential Margin to reduce this to 2% P(LGD) with approximately the same level of collateral provided by retailers. The proposal is appealing as it improves creditworthiness of the pool whilst using the same level of resources (collateral).

The NGF held concerns over the justification of the proposed 2% benchmark as it appeared this had been selected for no other reason than retailers should post no more or less collateral than they do today. As a result of these concerns, we considered not just the concept of the Probability of Loss Given Default but its application, which is the percentage itself, to be under consultation.

In response to concerns over the selected Standard, the Commission stated in the Draft Determination there is enough empirical evidence that 2% is a reasonable benchmark[3]. The NGF concurs with this assessment, believing there is enough evidence from Seed Advisory & Taylor Fry's work that 2% P(LGD) is a reasonable measure to implement the new Prudential Standard.

[1] Please note that Probability Loss Given Default is not the Probability of a Default in itself, but that should a default occur there will be insufficient collateral to cover pool debts of the defaulting party.
[2] Using the calculation of the Reduced MCL
[3] AEMC New Prudential Standard and Framework in the NEM, p 19

The NGF had suggested, given the expected error in setting the 2% P(LGD), it may be prudent to shorten the Credit Period[4] and improve the standard (to a lower percentage). This would be done by maintaining at least a proportion of the existing collateral requirements with the shorter settlement cycle. The results from SEED[5] showed the Prudential Standard can be improved by reducing the Credit Period, to a P(LGD) of approximately 0.8%, if the same level of collateral is required to the Rule change proposal.

The NGF's pragmatic view was that the proportion of existing collateral that need be retained with a shorter settlement cycle is that to cover the expected error, as calculated by Seed Advisory in its analysis for AEMO and the NGF.

By making this recommendation, the NGF would be spreading the benefits of shortening the settlement cycle across competing objectives of reducing market or credit risk:

- Reduce the level of collateral to ease the Prudential Requirement on our counterparties; or
- Reduce the Probability of Loss Given Default to improve the creditworthiness of the NEM.

The NGF firmly believes the creditworthiness of the pool can be improved without increasing the prudential Requirement on retailers. This can be done by reducing the Credit Period. We are therefore pleased with the statements on the shorter settlement cycle in the draft Determination where the NGF's analysis, completed by Seed Advisory was viewed as a "valuable precursor to any future Rule changes[6]".

If we compare the benefits of combining the Rule change proposal with a shorter credit period, it is clear the economic efficiencies will be greater than that of the adopting the Rule change proposal in isolation. This is not to say the Rule change does not better satisfy the NEO than the existing Rules, therefore the NGF supports the Draft Determination to make the Rule change.

A comment on AEMO's Credit Limits Procedure Consultation

The NGF wishes to thank for AEMC for allowing it and extension to the consultation period to allow consideration of AEMO's consultation on its new Credit Limits Procedure for the implementation of the Rule change proposal.

The overall aim of the proposal is to hold enough credit support, at the right time, to ensure a level of 2% loss given default of pool debtor. This is expressed by AEMO as:

'prudential probability of exceedance (POE) means the probability of the Market Participant's maximum credit limit being exceeded by its outstandings at the end of the reaction period following the Market Participant exceeding its outstandings limit on any day, and failing to rectify this breach.'

This standard is assessed over the entire life of the NEM and can be considered as an event that is only allowed to happen on average seven times a year. An exceedance event occurs when there is a breach of the trading limit today and in the reaction period there is a run through the Prudential Margin. In this case, if there is a suspension at the end of the reaction period a shortfall to the market would occur.

[4] In this instance the Credit Period is the billing week, four weeks settlement and the Reaction Period totalling 42 days.
[5] Supplementary Report: the Prudential Standard in the National Electricity Market – January 2012
[6] AEMC New Prudential Standard and Framework in the NEM, p 20

The NGF used AEMO's new and old credit calculators to assess the aggregate level of credit support that needs to be provided by pool debtors under the different approaches.

	Old (RMCL)	New (2%POE)
Aggregate Credit Requirements	$1,007,962,676	1,894,385,904

Please note in this simplistic analysis I have used the published values for price (Pr) for 2012Q3 in both cases. The volatility factor (VF) for the new method remains the same as the one published in the calculator. The VF for the old RMCL is taken from the AEMO website for 2012Q3[7].

The aggregate credit requirements for the 2%POE were considered to be equivalent to the RMCL at 28 days, whereas the table below shows it is almost double.

This is because the NEM has had a really soft period of pool prices, such that the existing approach for calculating credit requirements presents a lower number than the new 2%POE. For example the VF under the existing method is at a record low and far lower than that used under the 2%POE. Please note that if prices had recently been more volatile, then the opposite would have occurred.

The NGF considers this to be proof of the failings of the existing method – always holding too much or too little credit support. We hope that the requirement for additional credit support under the Rule change does not bias the view of some participants away from supporting the Rule change.

Should you have any questions regarding the content of this response please contact David Scott of CS Energy on 07 3854 7440.

Yours faithfully

Tim Reardon
Executive Director

[7] http://www.aemo.com.au/en/Electricity/Settlements/Prudentials