

16 January 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2249
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

NEW PRUDENTIAL STANDARD AND FRAMEWORK IN THE NEM

Loy Yang Marketing and Management Company (LYMMCo) welcomes the opportunity to comment on the Australian Energy Market Commission (AEMC) consultation paper National Electricity Amendment (New Prudential Standard and Framework in the NEM) Rule 2011.

LYMMCo trades the largest privately-owned generator in the National Electricity Market (NEM). In total, LYMMCo trades in excess of 2,200 MW which is approximately one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia.

Prudential Standard and Framework Changes

In framing its response to this proposed rule change LYMMCO notes the extensive work, particularly the *Energy Market Prudential Readiness Review*, completed by the Australian Energy Market Operator (AEMO).

Further, LYMMCO is particularly supportive of the conclusions reached by the consultants to the AEMO, the Competition Economics Group (CEG), in that the CEG specifically acknowledges the importance of appropriately allocating prudential risk amongst relevant parties in the NEM. As referenced in the AEMC consultation paper the CEG state that "economic efficiency will be promoted with all parties fac[ing] price signals that accurately convey to them the costs of all of their actions. In the case of retailers, this means that they should be required to bear the risks that their business strategy exposes them to".

LYMMCO supports the proposed AEMO rule change, and any further changes to the NEM Prudential Standards and Framework, to the extent that such changes align with this approach and also provide transparent, predictable and understandable arrangements for protection from default in the NEM.

Prudential standard – Probability of Loss Given Default

LYMMCO supports the deletion of references to the “reasonable worst case” in clause 3.3.8 and its replacement with the new definition for the prudential standard, defined as a 2% Probability of Loss Given Default P(LGD).

However, LYMMCO notes that although introducing the P(LGD) will more appropriately align responsibility for prudential risk management the issue of shortfall payments to NEM generators remains unaddressed. LYMMCO considers that there is no benefit in exposing to the possibility of shortfall payments as their capacity to manage such conditions is limited.

Accordingly, further refinement of this approach is warranted given that “the P(LGD) does not reflect the size of the potential losses that could occur in the 2% of cases” and further that, “the magnitude of these actual losses would instead be left to generators, their insurers and financiers to estimate and manage as seems best to them”. LYMMCO suggests that such a refinement may include a reduction in the value of the P(LGD) to reduce the risk borne by generators – noting that this would increase the level of prudential requirements on relevant entities – providing that the change does not have the effect of reducing retailer incentives to effectively manage their own risks.

LYMMCO considers that any further amendment should be aimed at reducing the possibility of shortfall payments to NEM generators thereby mitigating the risk of systemic failure being triggered in the NEM as a result of prudential default.

Assessment Framework

LYMMCO considers that there is merit in amending the Consultation Paper Assessment Framework (Chapter 5). At present, the Framework does consider the degree to which the proposed Rule change impacts electricity generators. Therefore, LYMMCO proposes that the following dot point be included in the assessment framework:

- The Rule change reduces the risk exposure of generators, or at least facilitates exposure to a level of risk that is not excessive.

The inclusion of this criterion effectively recognises that generators are directly exposed to the possibility of prudential default which could, depending on circumstances, be substantial.

If you have any queries in relation to this submission please do not hesitate to contact me on 03 9612 2236.

Yours sincerely



Simon Camroux
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LYMMCo