



1 February 2016

Leah Ross
Senior Director
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

AEMC Reference: ERC0188

Dear Ms Ross

RE: Application of Offsets in the Prudential Margin Calculation Consultation Paper

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (the Commission) Consultation Paper on the application of offsets in the prudential margin calculation rule change request proposed by the Australian Energy Market Operator (AEMO).

About ERM Power Limited

ERM Power is an Australian energy company that operates electricity generation and electricity sales businesses. Trading as ERM Business Energy and founded in 1980, we have grown to become the fourth largest electricity retailer in Australia, with operations in every state and the Australian Capital Territory. We are also licensed to sell electricity in several markets in the United States. We have equity interests in 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, both of which we operate.

General comments

ERM Power strongly supports AEMO's proposed change to the National Electricity Rules (NER) to enable trading and reallocation amounts to be offset when calculating a market participant's prudential margin. The proposed change, to remove clause 3.3.8(e) of the NER, would enable AEMO to equally account for participants' risk-management approaches, whether they be reallocations or hedging, in calculating collateral requirements that protect the market in the event of participant default. Improved capital efficiency will enable market participants to further invest in solutions to benefit consumers.

We agree with AEMO that the proposed change would improve competitive neutrality between independent and vertically-integrated market participants. This, in turn, would support the entry and expansion of a range of different business models, encouraging a more robust competitive environment. With the prudential standard maintained, we do not believe the proposed change would materially increase the level of risk to the market.

In the submission that follows, we have responded only to those consultation questions where we have particular views.



Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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Manager, Regulatory Affairs
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Question 2: The impact of the proposed rule on market efficiency

- (a) Is the proposed Rule likely to result in cost savings for Market Participants? Are the potential cost savings estimated by the Proponent (\$200,000-\$500,000 per annum across all Participants) consistent with stakeholders' expectations? How do these savings compare with the costs of implementing such changes?
- (b) What impact would the proposed Rule have on the ability of AEMO to maintain the prudential standard in the NEM?

The proposed rule change is expected to lead to cost savings for ERM Power, with negligible implementation costs. Our assessment indicates that the potential cost savings estimated by AEMO may understate the total savings across all market participants.

We have no reason to believe that the prudential standard would not be maintained, with the current probability of exceedance levels remaining below 2% across the NEM, as stated by AEMO.

Question 3: Appropriate allocation of risks - part 1

- (a) Do stakeholders agree that adequate processes exist to determine the firmness of reallocations?
- (b) Do stakeholders agree that adequate processes exist to deregister those reallocations not considered sufficiently firm in a timely manner? If so, why? If not, why not?

ERM Power believes that there are adequate processes available to determine the firmness of reallocations.

In particular, we support AEMO's existing right to deregister reallocations in the case of a default event in respect of either party to the reallocation, and that neither party to a reallocation has a unilateral right to deregister. This is an important process to ensure AEMO can mitigate market exposure. We also note that there has been no history of large generator default, and therefore processes are appropriate in the context of a low-likelihood (though high impact) risk.

Question 5: Trade-off between flexibility and regulatory certainty

- (a) If the proposed rule were made, AEMO will retain some discretion in relation to the extent it takes account of prospective reallocations in the calculation of the prudential margin (under clause 3.3.8(d)(6)). In this context, have concerns raised in the context of the 2012 rule change proposal about the level of discretion provided to AEMO in relation to the calculation of the prudential margin been addressed?
- (b) Would regulatory transparency be improved by specifying in the Rules that AEMO must allow for offsets of trading amounts and reallocation amounts in the prudential margin calculation?
- (c) Are there other ways in which the offsetting between trading amounts and reallocation amounts can be made more transparent, in a manner consistent with the prudential standard?

We note that AEMO already has considerable discretion in the calculation of the outstandings limit and the prudential margin. We consider there to be benefit in improving the transparency of AEMO's decision-making processes with regards to these calculations generally (whether it be in the NER or the procedures).

For example, AEMO currently assesses whether it believes that a historical period is reasonably reflective of a market participant's credit risk, and may restrict this period at its discretion for the purpose of

calculating an outstandings limit and prudential margin. This uncertainty can impact a market participant's capacity to forecast its forward position, reducing the efficiency of operations.

In regards to reallocations specifically, we believe there would be no detriment in including a clause in the NER explicitly outlining AEMO's right to offset reallocation and trading amounts in the prudential margin calculation.

Question 6: Competition and barriers to entry

Would the proposed change to the treatment of offsetting trading amounts and reallocation amounts in the prudential margin improve competition in the NEM (by reducing barriers to entry/expansion for smaller Market Participants)? Would the costs imposed by the revised rules accurately reflect the risks and costs associated with stand-alone retail or generation Market Participants in the NEM?

The current restriction on offsetting reallocation and trading amounts in the calculation of prudential margins provides a competitive advantage to vertically-integrated market participants, because they are able to use internal hedging to minimise their prudential margin. By removing this restriction, independent retailers and generators will be able to compete on equivalent terms, supporting competition. We expect this will also reduce the barriers to entry, as entrants' collateral requirements will be more efficient.

Question 7: Costs and benefits of the rule change

- (a) Are there any additional costs or benefits to Market Participants associated with making AEMO's proposed rule change, beyond those identified by AEMO in section 3?
- (b) Is the modelling approach used by AEMO to estimate the reduction in MCL requirements appropriate? If not, please identify improvements that could be applied the modelling approach.
- (c) What would be the impact on consumers of an overall reduction credit support costs (as a result of the proposed rule change)?

ERM Power has not identified any additional costs and benefits associated with the proposed rule change.

The capital efficiency improvements that result from the proposed rule change are likely to benefit consumers as competition strengthens, and market participants are better placed to invest in future energy solutions.