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Istvan Szabo
Australian Energy Market Commission

Lodged online

Dear Mr Szabo

ERC0220: Response to the draft determination on Secondary Trading of Settlement Residue Distribution Units rule change proposal

The Australian Energy Market Operator (AEMO) welcomes the opportunity to provide a submission to the Australian Energy Market Commission's (AEMC) draft determination on the above rule change request from Westpac.

The effect of the rule change would be to enable the Settlement Residue Committee (SRC) to consider implementing secondary trading of Settlements Residue Distribution Agreement (SRDA) units through the existing Settlements Residue Auction (SRA) run by AEMO.

By allowing the SRC to contemplate and potentially implement secondary trading through the SRA, the rule change should promote the National Electricity Objective (NEO) by enhancing allocative efficiency. This is because the reduction in transaction costs from using the SRA to facilitate secondary trading will enable SRDA units to be more efficiently re-allocated to market participants that value them the most.

1. AEMC's more preferable rule

The AEMC's draft rule is a more preferable rule that allows the SRC to implement secondary trading of SRDA units through the existing SRA. However, the AEMC's draft determination differs from Westpac's proposal in a key way: the risk of default from secondary sellers and buyers is allocated to secondary market participants and not TNSPs, as was proposed.

The rule change request, which was developed in consultation with the SRC, proposed that consumers (through TNSPs) bear the default risk of secondary trading of SRAs for the following reasons:

- Consistency with risk allocation in the primary SRDA unit market – SRAs are uncollateralised and default risk (which is currently considered minor) is allocated to consumers through TNSPs;
- Primary and secondary units could be allocated in a single auction, reducing costs and enhancing participation and liquidity; and
- Greater certainty that AEMO's existing Australian Financial Service Licence (AFSL) exemption from ASIC for running the SRA would apply, as the relationships between buyers and sellers and AEMO would not change.

It was judged that the benefits to consumers from secondary trading of SRDA units, in the form of an ability for market participants to manage inter-regional hedge positions more efficiently, would outweigh any risk allocated to consumers – therefore promoting the NEO.

As noted in our submission to the consultation paper, the risk that a TNSP (i.e. consumers) would need to make a payment to keep a SRA participant whole in the event of default is an extreme example that relies on a confluence of events occurring.

2. Options to implement secondary SRDA unit trading

Under the governance arrangements for the SRA Rules, set out in the NER, the SRC, which is made up of representatives from generators, market customers, TNSPs, traders, governments and end-use customers, approves SRA Rule changes.

In order for the SRC to consider implementing secondary trading of SRDA units, a minor change to the NER was required to allow AEMO to direct auction proceeds to secondary sellers as well as TNSPs. AEMO's submission to the consultation paper did not address potential mechanisms for implementing secondary SRDA unit trading, as this level of detail is covered by the SRA Rules, not the NER. However, because the AEMC's draft decision affects the ability to re-auction units, the practicalities of the draft determination are set out below for the AEMC to consider.

2.1. Westpac's approach to the rule change request

The mechanism for secondary trading of SRDA units contemplated by the SRC when developing the rule change was as follows:

- SRDA unit holders provide units to AEMO to be re-auctioned.
- SRDA units are re-auctioned in a single SRA with the primary units.
- If secondary units are sold, AEMO cancels the SRDA with the seller and enters into a SRDA with the buyer.
- If a secondary unit holder defaults on payment, and a gain or loss is realised upon re-auction, secondary sellers would be kept whole (with the risk falling to the TNSP).

This approach allows primary and secondary units to be auctioned in a single auction and minimises implementation costs for industry. It also results in no legal relationship between the buyer and seller, which is a key argument that AEMO's existing AFSL would cover secondary trading if this market design was adopted.

2.2. Implementation options under the AEMC's draft rule

Under the AEMC's draft determination, Westpac's approach would not be allowed as the risk of default for secondary units rests with the TNSP. AEMO has identified two options that could be implemented to meet the AEMC's draft rule, which are discussed below.

Option 1: Socialise the risk of default among all secondary sellers

The mechanism under this approach would be as follows:

- SRDA unit holders provide units to AEMO to be re-auctioned.
- SRDA units are re-auctioned in a single SRA with primary units.
- AEMO would make a notional allocation of primary and secondary units to buyers, pro rata based on the total number of units in a SRA.

In the event of default, a gain or loss on re-auction of units would be shared between the TNSP and socialised across all secondary sellers in proportion to the primary/secondary SRD units held by the defaulting party. This places the default risk of primary units on the TSNP and secondary units on secondary participants, as per the draft determination.

In order to do this, AEMO would need to notionally allocate primary and secondary units to buyers as part of the auction process. Secondary sellers would not know their counterparties or their credit worthiness, making it impossible for them to mitigate default risk. This is a substantial change from the current arrangements in the primary market and is allocating a risk to a party that is not best placed to manage it.

Option 1 would more likely require AEMO to seek AFSL exemption relief from ASIC because an indirect relationship has been created between sellers and buyers through the risk allocation approach.

Option 2: Collateralise secondary trading

The mechanism under this approach would be as follows:

- Separate auctions would be run for primary and secondary SRDA units.
- A buyer would be required to lodge collateral with AEMO against the settlement exposure associated with secondary units.

Holding two auctions allows sellers and buyers to price secondary units separately from primary units after taking into account the cost of providing collateral. In the event of default of a participant holding secondary units, the collateral would be used to keep the impacted counterparties whole.

Feedback from participants suggests that prudential costs, along with splitting liquidity across two auctions, will reduce the attractiveness of participating in secondary trading. The overall cost of establishing two auctions and developing a collateralisation framework for SRAs will also likely result in this option being practically infeasible to implement.

AEMO notes that since the inception of the SRAs the primary market has not been collateralised. There is no requirement in the NER or Auction Rules for AEMO to require participants to post collateral for SRDA unit purchases. While this has been the approach since the start of the market, the management of credit risk is a reasonable topic for consideration as part of an AEMC review into the SRA framework or within a specific rule change process on the topic.

2.3. Challenges implementing secondary trading under the draft rule

AEMO considers there will be challenges in implementing secondary SRDA unit trading under options 1 and 2 above, putting at risk the efficiency enhancements of the proposal.

Key concerns under these options discussed above are: un-manageable risks on participants, splitting liquidity across two auctions and collateralising only the secondary market, higher system implementation costs and a greater likelihood that AEMO would need to seek an additional AFSL exemption from ASIC.

These challenges have been discussed at the SRC and members were invited to provide private views on whether, if the draft determination were made as it stands, they would be likely to support implementation of either option 1 or 2. On the basis of the feedback we have received, we expect the SRC would be unlikely to implement secondary trading and the provisions would sit dormant in the NER.

3. Alternative approach to the final determination

Notwithstanding this, we acknowledge the AEMC's concerns around risk allocation on consumers and propose an alternative approach that includes risk mitigation measures. These are intended to reduce the risk of default in the secondary market to a point where the

Commission is comfortable that the efficiency benefits of secondary trading outweigh the risks to consumers, and in doing so promote the NEO.

Before looking at the proposed risk mitigation measures, we set out the two secondary market default scenarios:

- Risk 1: Participant buys ‘secondary’ units and defaults on payment to AEMO.
- Risk 2: Participant buys ‘secondary’ units, on-sells them for a loss, then defaults on payment to AEMO.

Risk 1: Participant buys ‘secondary’ units and defaults on payment to AEMO

Under Risk 1 a TNSP could be required to make a payment to AEMO in the event a participant defaults *and* that participant has purchased a large number of units from secondary sellers *and* these are at a relatively high price.

The likelihood of such an event could be reduced by placing a limit on the number of secondary units that are cleared in a SRA. AEMO has considered two options to do this:

1. Limit the total number of secondary units to no more than the total number of primary units in any auction. For example: if there are 100 primary units then only 100 secondary units can be auctioned; or
2. Limit the number of secondary units a participant can auction to no more than a proportion of a trader’s unit holding. For example, if a limit was set at 50% and a participant held 100 units of a specific product, then the most secondary units they could auction of that product would be 50.

We note that limiting the number of secondary units in an auction may reduce the market’s efficiency, but consider this drawback is outweighed by the counterfactual, which is the lack of trading in the current illiquid secondary market for SRDA units.

Limiting secondary units in a SRA could be a principle that is included in the NER.

Risk 2: Participant buys ‘secondary’ units, on-sells them for a loss, then defaults on payment to AEMO

Risk 2 could be mitigated by requiring cash settlement of any trading loss soon after the secondary transaction. If the participant was unable to cash settle the loss then this would be treated as a default event for all of the participant’s SRDA unit transactions on foot. The benefit of this approach is as follows:

- If the participant can cash settle the trading loss, then consumers are protected if a future default event occurs.
- If the participant cannot cash settle the loss, their financial issues will be known to AEMO and the market earlier than otherwise would have been the case. This allows AEMO to suspend the participant from further trading and close out positions and crystallise any gain or loss as soon as possible.

Cash settling a trading loss could be a principle included in the NER.

3.1. Benefits of the proposed approach for the final determination

AEMO considers the benefits of the proposed approach are as follows:

- Original design for SRDA secondary unit trading that was developed in consultation with the SRC can be implemented;

- No requirement for AEMO to track primary and secondary units and make material changes to systems, minimising implementation costs for participants;
- Measures implemented to mitigate risks of secondary trading;
- Greater likelihood AEMO's existing AFSL exemption will apply; and
- Efficiency benefits of secondary SRDA unit trading have the potential to be realised, benefiting consumers and promoting the NEO.

On the basis of the private views received by AEMO on the proposed approach, AEMO considers that there is a reasonable prospect of the SRC implementing a form of secondary trading consistent with it.

If you have any questions regarding this submission, please contact Daniel Hamel, Principal, Policy and Market Development on (07) 3347 4578.

Yours sincerely

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