8 May 2017

Mr John Pearce
Chairman
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Pearce

RE: Secondary Trading of Settlement Residue Distribution Units Consultation Paper (Reference ERC0220)

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (the Commission) Consultation Paper (the Paper) on the Secondary Trading of Settlement Residue Distribution Units rule change request proposed by Westpac Banking Corporation (the Proponent).

About ERM Power Limited

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load[1] with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. ERM Power also sells electricity in several markets in the United States. The Company operates 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland. www.ermpower.com.au

General comments

ERM Power supports the rule change proposal. Amending the Rules to allow payments from the Australian Energy Market Operator (AEMO) to parties other than Network Service Providers (NSP's) who offer Settlement Residue Distribution Agreement (SRDA) units for sale through the Settlement Residue Auction (SRA) would be a positive outcome to promote additional trading of SRDA units. Currently, SRDA units due to their lack of firmness are of limited use for inter-regional trading. Whilst the Paper raises concerns that this may result in the possibility of increased financial risks to NSP's, ERM Power believes this risk to be small and could be managed by the introduction of an Initial Margin payment similar to that used in the trading of ASX Electricity Futures contracts payable at the time of Auction. ERM Power believes there are also some small amendments to the current process which if implemented, would improve the usefulness of the current SRDA units for inter-regional hedging. We set out these as well as comments to the issues raised in the Paper below.

[1] Based on ERM Power analysis of latest published financial information.

SRDA Unit Design

As identified in the Paper, every 3 months AEMO auctions on behalf of NSP's SRDA units for a number of regulated interconnectors located between regions in the National Electricity Market (NEM). The number of units auctioned for each interconnector is based on the nominal capacity of the interconnectors as advised by the relevant NSP. However, the distribution of settlement residues to SRDA unit holders is based on actual flows across the relevant interconnector at the time a price separation between the 2 adjacent regions occurs; at times this may result in very low (less than 10% flow) or NIL settlement residues being accrued for distribution. This introduces an unmanageable basis risk for parties seeking to facilitate trade between regions using SRDA units and limits the effectiveness of SRDA units for supporting inter-regional trade.

A simple improvement to the current process would be to require AEMO, in consultation with the Settlement Residue Committee (SRC), to regularly review the number of SRDA units available for auction and to base the number of units to be auctioned on an expected average limit outcome rather than the nominal outcome as set by the NSP's. Currently, the expected average outcome for most interconnectors would be 50% or less of the NSP's advised nominal ratings; the only exception to this is the Qld to NSW interconnector which is closer to 90%. The expected average limit outcome could be based on the historical interconnector limits over a specified time period plus any additional capacity upgrades. The methodology for calculating the expected average limit outcome could be determined via a Market Consultation process conducted by AEMO. Ensuring that the SRDA units offered at auction more closely aligned with the expected outcomes would reduce some of the risks associated with the use of SRDA units for inter-regional trading.

Another issue that repeatedly impacts the firmness of SRDA units and hence their effectiveness in supporting inter-regional trading is network outages. Currently when a network outage occurs, the holder of the SRDA unit incurs the reduction in settlement residue outcomes associated with the outage. The NSP however incurs no significant cost[2] for their decision to plan an outage for a particular period nor does the NSP incur costs for any additional time taken to restore the network following an unplanned outage. In effect, the seller of the SRDA unit incurs no financial risk associated with the sale of their instrument based on their operational decisions. This is completely at odds with normal seller/buyer contractual obligations; in this instance the seller fails to provide a product as agreed yet keeps the consideration paid for the product.

The SRDA unit holder has no control over the NSP's decision process where outages are often submitted or moved to other times at short notice or the time taken to restore the network following an unplanned outage, yet ultimately incurs the financial risk caused by the operational decisions of the NSP. This is a risk that cannot be pre-calculated or estimated by the purchaser of the SRDA unit as it rests solely within the confines of the NSP's operational and planning processes. It is the single largest barrier to the use of SRDA units for inter-regional hedging.

An improvement which could be made to SRDA unit design would be to require NSP's to incur the costs associated with their operational decisions by amending the settlement residue calculation process to calculate the interconnector flows for the settlement residue as if there was no outage.

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[2] NSP's are subject to the Market Impact Component of the Service Target Performance Incentive Scheme (STPIS) administered by the Australian Energy Regulator (AER), however, this scheme allows for a large number of market impact events due to planned outages to occur prior to commencement of a modest impact on NSP revenues. It is possible for planned outages to significantly impact Market outcomes without incurring a negative impact on the relevant NSP's revenue.

This would also have a positive impact on NSP's outage planning process as it would incentivise NSP's to plan outages at times of lower market impact. Whilst this has the potential to reduce the flow through benefit from the auction proceeds to consumers, offsetting benefits to consumers would accrue due to the increased firmness of SRDA units to support inter-regional trade and also result in increased price outcomes at the SRDA auction.

Alternatively, if it is decided consumers should not incur this risk, amendments could be made to the SRDA auction proceeds pass through process such that these costs for an NSP operational decision remain solely with the relevant NSP.

Amending the Rules to more correctly align incentives to maximise the value of SRDA units at times when they are most required, by ensuring the financial risks associated with NSP's operational and planning decisions are incurred by those responsible, would further reduce the risks associated with use of SRDA units for inter-regional trading. This is consistent with the *Causer Pays* philosophy adopted in many physical markets.

The current rule change requests limits the offering of secondary SRDA units to only allow for the surrender of SRDA units purchased at a previous auction. In effect, this is simply a transfer of an existing primary SRDA unit between 2 parties facilitated by the auction process; it does not add additional liquidity in the form of additional SRDA units to facilitate inter-regional trading. ERM Power believes this is unnecessarily restrictive.

We believe that the NEM financial market has achieved a level of maturity and sophistication such that additional secondary SRDA units could be offered by approved parties, as per the current Settlement Residue Auction Rules, for sale in conjunction with the primary SRDA units. This is similar to how the NEM financial markets currently facilitate the liquid trading of other hedge products where the ability to buy or sell a financial product is not restricted based on a participants physical participation in the NEM.

Settlement of these secondary SRDA units would be based on the same calculation methodology as the primary SRDA units and administered by AEMO. AEMO would hold all auction proceeds for secondary SRDA units until the end of the relevant quarterly settlement period following which the remaining balance would be distributed to the sellers of the secondary SRDA units. In the event that the settlement amounts for the SRDA units may exceed the auction proceeds, AEMO would be empowered to implement the payment of variation margins, as calculated by AEMO in consultation with the SRC. Amended Rules could also allow for the payment to AEMO of an initial margin by the secondary SRDA unit seller. If warranted, this could be based on an agreed methodology, determined by AEMO in consultation with the SRC. This initial and variation margin process would ensure that the SRDA auction and settlement process would remain fully self-funded from an AEMO perspective.

The revised Rules should contain provisions that require AEMO to advise the market at least 10 business days prior to the auction date the total number of SRDA units for each directional interconnector offered for sale. All secondary SRDA units which have been notified to AEMO as offered for sale should be offered at the current auction in addition to the primary SRDA units. The Rules should not allow AEMO to seek to smooth the auction outcomes by distributing secondary SRDA units offered for sale over successive auctions.

The rule change request contains the provision that the seller of a secondary SRDA unit would be entitled to submit an offer (reserve) price at which the SRDA unit would be available to be purchased. This is an understandable requirement. If the Commission agrees to this provision then the Rules should require that AEMO publish this offer curve (offer prices and quantities of SRDA units offered) similar to how the bid curve is published following the auction.

Alternatively, rather than allowing submission of an offer price, sellers of an SRDA unit who wish to implement a reserve price function could bid for the purchase of an SRDA unit at their reserve price. In the event the auction cleared at a lower price, the effect would be to net both the sell and buy. This would then require AEMO to only publish the bid curve post auction and would retain a degree of anonymity with regard to offer prices.

Allowing the sale of additional secondary SRDA units by approved parties as part of the current AEMO administered auction process based on a similar settlement risk management process currently used in hedging in the financial markets would be an efficient mechanism to add liquidity and ultimately improve in inter-regional trading. Allowing AEMO to facilitate this through use of the existing SRDA auction and settlement processes would be an efficient use of existing resources and facilitate additional liquidity to support inter-regional trading at low marginal cost.

Managing Counterparty Default Risk

ERM Power believes that counterparty default risk is best managed by an amendment to the Rules that allows AEMO to implement and administer an initial and variation margin regime for both sellers and buyers of SRDA units similar to the initial and variations margin arrangements utilised for trading of electricity futures. This process is used extensively through the world to successfully manage counterparty default risks.

We believe the SRC is well placed to provide both guidance and assistance to AEMO in developing the process, methodologies and procedures to be adopted in this regard. Prior to coming into effect AEMO would be required to conduct a Market Consultation to ensure general agreement with the proposed procedures and methodologies to be implemented. Over time, any amendments to these procedures or methodologies could be determined via consultation between AEMO and the SRC prior to a further Market Consultation prior to implementation.

Conclusion

ERM Power supports the proposed rule change. Furthermore, we have submitted some additional amendments for consideration by the Commission that we believe, if implemented, would be effective in firming up SRDA units to promote inter-regional trading for the net benefit of consumers. Currently, the SRDA units as offered via the Settlement Residue Auction process are of little value for supporting inter-regional trading. With the NEM entering a period of greater uncertainty, effective and efficient inter-regional trading will be required to ensure stable risk management to ensure the lowest prices are available to consumers. ERM Power believes the issue of counterparty default risk would be best managed by implementing an initial and variation margin regime for both sellers and buyers of SRDA units.

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

Yours sincerely,

[signed]

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