

29 August 2017

Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney, NSW, 2000

To whom it may concern,

The AEMC's draft rule will not resolve any of the stated issues in our original rule change submission. Implementation issues will prevent the AEMC's draft rule being used in practice and will therefore not deliver any of the AEMC's stated benefits. As such, there is no value to implementing the AEMC's draft rule and it would be preferable to make no rule change.

In making the draft rule, the AEMC has placed a particular importance on controlling the chance of any increase in default risk faced by TNSPs (and ultimately consumers). However, the draft rule does not eliminate the chance that default risk faced by TNSPs would increase. We also believe the AEMC has misapplied the principles of efficient risk allocation, resulting in a highly inefficient draft rule.

As an alternative to the AEMC's draft rule, we propose additional margin requirements and limits on secondary trading that would be compatible with a single class of units as proposed in our original rule change proposal. Our proposed risk controls would be more effective than the AEMC's draft rule at limiting any increase in default risk faced by TNSPs.

We make the additional point that there are other rule-change mechanisms open to the AEMC if they wish to control for default risks in the SRA market as it exists now. For example, the AEMC could initiate a review of default risk in the SRA market and make a rule-change recommendation to the COAG energy council.

Summary of the AEMC's proposed draft rule

The AEMC proposes to create 2 classes of units; primary and secondary. When a primary unit is sold by an auction participant, it becomes a secondary unit. Default risk from the buyers of secondary units is socialised amongst the sellers of secondary units and vice-versa.

Due to the conversion of primary units into secondary units as trade occurs, the default risk faced by TNSPs would be transferred over time to secondary sellers. However, the AEMC seems chiefly concerned with the entry of low-credit speculators into the SRA market. In the event of a large influx of poor credit speculators into the market, the AEMC's proposal does little to mitigate a possible degradation in the average credit quality of SRA buyers, which would also affect TNSPs. Therefore, the AEMC's draft rule does not mitigate the primary risk perceived by the AEMC.

The AEMC's proposal also requires buyers of SRA units to consider default risk, something that has never been a part of the auction process. It is worth noting that no other market requires participants to take default risk against anonymous counter-parties. Asking the SRA market to function on that basis would degrade market efficiency and ultimately result in worse outcomes for consumers.

Issues with default risk on secondary units

Trading desks (including desks at electricity companies) typically operate within risk frameworks set by independent risk teams. The purpose of a risk team is not to analyse the profitability of a risk, but to quantify and cap the absolute level of risk taken by trading teams. It is worth quoting the response of our credit risk team to the idea of pro-rata pass-through of aggregated default risk.

"we can't provide approval/risk acceptance under the proposed structure given that credit risk cannot be quantified nor attributed to the relevant counterparties."

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The result of the draft rule change for us would be a complete inability to trade secondary SRA units as designed by AEMC. We cannot comment on views of other participants' risk departments, however it should be of concern to the AEMC that only participants with relatively weak risk oversight would be allowed to trade under the AEMC's proposed structure.

Practical implementation issues

The AEMC leaves implementation up to the SRC and AEMO. To date, members of the SRC have identified only two possible implementations, neither of which are considered to be preferable to the status quo.

Any secondary units issued by AEMO must have some method to allocate those units to buyers at an auction. Either the units can be allocated pro-rata to all auction buyers, or a pricing mechanism such as a second auction can be run to allocate secondary units. We would not deem either implementation to be capable of furthering the NEO.

Issues with pro-rata allocation

In the case of pro-rata allocation of units, buyers at auction will now be issued some percentage of SRA units which carry some default risk. There is no way for the SRC to impose credit support mechanisms on secondary units without also affecting primary units. Participants who currently buy through the auction process would have no option to continue as per the status quo.

The result of introducing a primary/secondary distinction with an implementation that allocated secondary units to participants at auction could result in the total withdrawal from the auction by participants.

Issues with creation of a secondary Auction

In the case of allocation of secondary units at a second auction, the primary objective of concentrating liquidity would not be achieved. Any mechanisms to mitigate default risk for the secondary units in the secondary auction such as margining or prudential requirements would make secondary units less desirable than primary units.

Implementation of a second auction would be more costly than our original proposed changes. Also, we are not confident that a second auction would attract the range of buyers and sellers necessary for a functioning market.

The secondary auction would embed a fracturing of liquidity as currently exists with the brokered OTC SRA market. It is our opinion that trade in such a secondary market would be less preferable to the current brokered secondary SRA market.

An alternative proposal – Additional risk mitigation mechanisms

We propose two additional mechanisms to limit any change to the aggregate default risk faced by TNSPs (and consumers) at the SRA auction.

Prudential controls on secondary sellers

Our first proposal is to require sellers to immediately make cash settlement for any SRAs sold at a loss. So for example, if a participant bought units at a high price and sold at low price, they must immediately transfer to AEMO the difference in value for the sale to take effect. This additional requirement would have the effect of eliminating default risk on the sell side of the market.

In the case where a participant bought at a low price and sold at a high price, then they are owed money by AEMO, so AEMO (and therefore TNSPs and consumers) do not face any default risk against that participant. The cash would be held by AEMO until the settlement date for that unit, so the default risk for that participant would actually be reduced compared to the status quo.

Additional controls on buyers at auctions

The number of total SRA units is not changing and our first proposal eliminates sell-side default risk. Therefore, any increase in aggregate default risk to TNSPs can only come from degradation in average credit quality of buyers at the auction.

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The AEMC appears to be concerned that introducing secondary trading at auction will encourage the entry of poorly capitalised trader-class participants who would attempt to make short-term profits by predicting inter-auction price moves in SRA unit prices. To control for that perceived risk, we propose that a limit be placed on the aggregate value of sell trades each participant can make, relative to the size of their primary market holdings. For example, if a 30% sell limit was placed on each participant, the participant could only sell SRAs up to 30% of the current value of their long SRA holdings.

Participants would be forced to always hold a substantially net long SRA position. Selling of SRAs could only be used to adjust previously purchased volumes, not to speculate in large volumes auction to auction. Participants buying SRA units would still have to purchase units with the intent of holding the majority of those units through to spot.

Possible variations that the AEMC might like to consider would include limiting the total number of units that may be sold by each participant or limiting the total volume of SRAs sold at any particular auction.

Efficient risk allocation

The draft rule change relies on a commonly repeated mantra on efficient risk allocation that has been incorrectly applied in this case;

“Risk allocation is considered efficient if it is being allocated to the party that has the information, ability and incentives to best manage the risks.” (p14)

The application of this principle appears to be the primary motivation behind the AEMC’s creation of primary and secondary units and the decision to allocate default risk to secondary participants. As such, it bears close scrutiny.

The relevant parties for consideration in this case are the individual buyers and sellers of SRD units, as they will ultimately be bearing some of the default risk that was previously borne by TNSPs.

Information: The auction is designed to be an anonymous process. Auction participants can have no information about counter-parties in the auction. There can be no information advantage in an anonymous auction process therefore auction participants are no better placed than consumers.

Ability: An ability to manage risk implies some action can be taken to minimize that risk. The only action an auction participant can take is to adjust their prices and or volumes in the auction. i.e. the participants can demand a price discount in exchange for bearing additional default risk, or they can refuse to participate in the auction which lowers prices and demands. We do not believe it is the AEMC’s intention to encourage withdrawal of participants from the auction.

The AEMC also appears to equate auction participants with the SRC. It is worth noting that approximately half of the representatives that sit on the SRC are not able to trade in the auction, or do not trade in significant volumes. Also, the majority of auction participants at any one time do not have a seat on the SRC, so it is not possible to say that auction participants have any meaningful ability to control default risk via the SRC either individually, or in aggregate.

Incentives: Without information or ability to act on an incentive, there can be no efficient action taken.

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Conclusion

The most likely result of the AEMC's draft rule will be a decision by the SRC not to implement secondary trading. As such, the AEMC's draft rule will not achieve any benefits and would have the downside of embedding a highly problematic definition of dual unit classes in the rules.

The draft rule could lead to a reduction of participation in the existing SRA market, a higher cost implementation and would not achieve any of the desired benefits.

The AEMC should reassess the change in aggregate default risk borne by TNSPs, with our two additional proposed risk control measures. We also submit the AEMC should focus on evaluating drivers that would change the aggregate level of risk versus the status quo.

The draft rule in its current form does not advance the National Energy Objective and should not be implemented. However, with a few additional changes and the retention of a single class of units, there is still potential to make a change that will further the National Energy Objective.

Yours Sincerely,

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