09 May 2017

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Chief Executive
Australian Energy Market Commission
PO Box A2449
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Secondary Trading of Settlement Residue Distribution Units – ERC0220

Consultation Paper

Energy Networks Australia welcomes the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) Secondary Trading of Settlement Residue Distribution Units Consultation Paper.

Energy Networks Australia is the national industry body representing businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia.

The Consultation Paper recognises that Transmission Network Service Providers (TNSPs) receive Settlement Residue Auction proceeds on behalf of customers and use these proceeds to reduce prescribed transmission charges. As TNSPs are not direct participants in the market, Energy Networks Australia takes a neutral position on the potential development and possible establishment of secondary trading arrangements for settlement residue distribution units.

Nevertheless, Energy Networks Australia has identified several key issues in the Consultation Paper requiring further consideration. These issues relate primarily to the scope of consultation compared to the rule change proposed, as well as the consideration of risk and volatility. A response to selected Consultation Paper questions is also attached.

Scope

The intent of Westpac's original rule change request is to facilitate the consideration of the amended arrangements by the Settlement Residue Committee (SRC). The SRC is established under Rule 3.18.5 of the National Electricity Rules (NER) with a broad representative membership. Part of the SRC's role is to approve proposed amendments to the auction rules developed by AEMO.

Energy Networks Australia understands that Westpac extensively consulted with the SRC on the scope of the rule change prior to lodging with the AEMC. Westpac notes [emphasis added]:

> *"The primary purpose of the proposed NER change seeks to remove the unintended prohibition of secondary trading in the NER. Whilst the NER change proposal is* ***intended to empower the SRC to implement the secondary trading proposal****, it does not mandate its implementation. As per the governance of the auction laid out in 3.18.3,* ***the decision to implement any auction rule changes remains with the SRC****[1]".*

The Consultation Paper **extends the scope** of the rule change proposal to a significant discussion on issues around existing settlement residues arrangements and mechanisms. This is beyond what Westpac intended in its narrow rule change proposal.

Volatility and default risk

The Consultation Paper appears to conflate two issues:

- the volatility in returns from the settlements residue auctions
- the corresponding value of settlements residue units to purchasers with the risk of default by the purchasers.

Settlements Residue Auction proceeds largely reflect the value that participants place on access to regulated interconnectors. Higher values will typically result from a lack of liquidity in the contract market in a region and/or limited interconnector capacity between regions. Volatility in Settlements Residue Auction outcomes are usually reflected in volatility in transmission pricing outcomes.

Default in the primary Settlements Residue market is very rare. Energy Networks Australia is aware of only one instance in which a participant has defaulted, when the purchaser was in administration. We understand that the consequences to a participant of default is material and includes actions under the prudential arrangements administered by AEMO.

Energy Networks Australia recommends the AEMC seek advice from AEMO and/or the SRC in relation to secondary market defaults in the current operating environments and the potential for such defaults under the proposed arrangements. Further consideration should only be given to mitigating these risks if there is evidence that the proposed changes would lead to a material increase in the risk of default.

The Consultation Paper also proposes a risk mitigation measure of introducing full or partial collateralisation for non-market auction participants, which implies that the existing prudential arrangements might not be sufficient nor allocate risks to the party best placed to manage such risks. It is recommended that, prior to introducing risk mitigation

1 Refer to page 3 of its initial rule change request.

measures, the AEMC should also consider the type and quality of participants in the secondary market.

Should you have any additional queries, please feel free to contact Norman Jip, Energy Network Australia's Senior Program Manager – Transmission on (02) 6272 1521 or njip@energynetworks.com.au.

Yours sincerely

John Bradley
Chief Executive Officer

Attachment 1

Responses to Selected Consultation Paper Questions

Issue 2 - Liquidity and auction design

Q9. Does the current design of the settlements residue auctions inhibit the development of market based solutions, that is the lack of a requirement for collateral in the AEMO auction process versus the requirement for collateral or credit limits in bilateral and market based transactions?

The current practice for settlements residue auctions only requires auction participants to pay AEMO for the units they purchase by the 14^{th} business day of the relevant quarter, while noting that the auction units can be purchased up to almost three years in advance. While expressing our concerns with the scope of the Consultation Paper, should the AEMC broaden the scope beyond the Rule change proposed by Westpac, it may wish to consider whether the above practice is still 'fit for purpose' as part of this rule change proposal.

Any prudential arrangements contemplated for secondary trading of settlement residue distribution units may need to examine practices in other sectors' secondary trading markets.

Issue 3 - Managing default risk

Q11. Do auction participants have better information, ability and incentives to manage the risk of default in comparison to TNSPs?

Auction participants have better information, ability and incentives to manage the risk of default. TNSPs are relatively passive participants in these auction arrangements, and response to potential (albeit low probability) auction participant defaults are usually beyond TNSPs' direct realms of control.

Q12. How would default risk be best managed in the auction process in relation to secondary units?

Should the AEMC support a secondary trading mechanism for settlement residue distribution units for further consideration by AEMO and the SRC, an examination of 'collateralisation' options for auction participants is warranted. The following prudential options (refer pp.27-28 of the Consultation Paper) could be considered:

- Introduction of full or partial collateralisation. For market participants, this could be an increase to their current prudential requirements, and for non-market participant (non-customer facing) auction participants, a standalone collateral requirement could be introduced.
- A default risk fund could be set up that would allow the recovery of any shortfall from previous payments to be funded by auction participants.

Issue 4 – Value Maximisation and costs of implementation

Q16. Are there any other costs that would need to be considered?

The Consultation Paper does not provide any advice or consideration of how this potential rule change may financially impact upon TNSPs. Given that the rule change is more of an enabling one, this issue needs to be further examined at some stage, should it progress, against the normal National Electricity Objective benchmark.

There may also be some additional costs of this potential arrangement whereby TNSPs and ultimately consumers could be responsible for a counterparty default risk in what can reasonably be perceived as a speculative market. As the AEMC highlights at page 28, that

> *"If secondary trading was to be facilitated by AEMO, counterparty risk originating from secondary trading may be socialised among consumers as a result of the impacts on TNSPs".*

At face, should AEMO facilitate this arrangement, this counterparty risk appears to allocate the residual risk on a party, poorly placed to manage such commercial risks.