28 September 2017

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Credit Limit Procedures – Modelling Parameters and MNSP Prudential Requirements Changes

Alinta Energy (**Alinta**) appreciates the opportunity to provide a submission to the Australian Energy Market Operator's (**AEMO**) issues paper; *Credit Limit Procedures – Modelling Parameters and MNSP Prudential Requirement Changes*.

As part of the Credit Limit Procedures review, Alinta notes that AEMO has specifically proposed to amend the "life of the National Electricity Market (**NEM**) model" parameters by changing the:

- weighting factor for average regional price from 10% to 20%;
- weighting factor for volatility factors from 10% to 20%; and
- capping factor (for price and volatility factors) from +/-10% to +/-20%.

The overall effect of these changes would be to give more weighting to these parameters than is currently the case in the calculation of an individual participant's Maximum Credit Limit (**MCL**).

General Background

Alinta understands AEMO's current statistical MCL methodology is in part based on "smoothing" changes in market participant's required MCLs from one season to the next, taking into account changes in average prices and regional price volatility, to generate a long term MCL trend.

The effect of capping the aforementioned parameters at 10% is that individual participant's MCLs lag somewhat, causing them to be less volatile when transitioning between seasons and thus in an operational sense more manageable for both participants and AEMO.

Nonetheless, this smoothing affect does possess an operational drawback, which is that of actual electricity prices being significantly higher than anticipated at select times, due to the tightening supply market conditions in the NEM.

The resulting effect has been to cause the total amount of outstandings in the market to exceed the MCL at very select times of market volatility. In short, participants MCLs lag somewhat behind market conditions, running the risk that 2% prudential standard may be unmet.

Proposed Changes Invite Materially Higher Prudential Costs for Market Participants

Whilst aware of the challenge facing AEMO's Life of the NEM model, Alinta does not support raising the magnitude of the parameters to 20%. Initial discussion and analysis by industry participants indicates that doing such would significantly raise market participant's MCL requirements substantially and thus incur non-trivial costs to prudential management overheads.

It is worth noting that market participants face real costs associated with managing their prudential obligations including:

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- a percentage fee charged by financial institutions on the face value of bank guarantees;
- ongoing financial fees and administrative costs in servicing security deposits; and
- the weighted average economic opportunity cost of holding cash in escrow as a form of prudential, which could have been otherwise used to pursue other productive business opportunities.

If implemented, the proposed 20% parameter change will have a direct impact on the costs associated with managing individual participant's prudentials to meet a materially higher MCL requirement. Any increased prudential management costs faced by market participants ultimately will be priced into participant bidding and hedging strategies in the wholesale market which will in turn impact consumer retail prices.

Furthermore, it is worth noting that depending on the individual commercial terms reached with different financial institutions cost increases associated with managing a higher MCL requirement will vary across participants. For instance, prudential cost increases for new entrants and smaller participants are likely to be proportionately greater as they likely face higher costs of debt and charges for bank guarantees, potentially amplifying barriers of entry for new participants.

In Alinta's view AEMO should be seeking to lower barriers to entry for new entrants wherever possible, freeing up working capital to support product innovation and growth and thus allowing the competitive market to deliver the lowest energy prices to consumers.

Given the above, Alinta does not support the 20% parameter increase and instead suggests an alternative pathway forward should be canvassed.

Alternative Pathway Forward

Alinta is cognisant of the core principle of the existing prudential regime - that participants post guarantees with AEMO to cover their MCL. This provides a level of security in the market, which ensures that in the event of a default, there is enough credit to support the orderly exit of a participant who may be unable to cover their outstanding debts.

Whilst supportive of this key principle, in Alinta's view the proposed procedure change appears to be proposed to cover a specific highly selective short summer time period. For the remaining time of the year, the 20% parameter change would result in participants MCLs being significantly raised above and beyond what is required to meet market outstandings. Alinta considers that AEMO's proposal would impose greater costs on the market than may be necessary.

Instead, Alinta's preferred option would be for an alternative solution which aims to appropriately manage peaky price periods and tightened supply conditions in summer months; and which also ensures participants MCL's are as low as reasonably possible.

This suggests a dynamic approach in order to manage MCL's in the market. For example one approach may be to place a greater reliance on short term MCL top-up mechanisms in response to peak summer periods. Operationally, participants could function as per standard practise through a third party such as Austraclear or financial banking institution at the direction of AEMO.

Whilst a new approach is somewhat beyond the scope of this specific consultation, it is worth raising it as an issue which AEMO should be actively canvassing in the near future.

Further work required

AEMO has modelled parameter change scenarios of magnitudes 50%, 30% and 20%, with the latter being deemed as the most appropriate given its achievement of the prudential standard obligation. Nonetheless, even a 20% parameter change would have a significant effect on prudential management costs. As such, Alinta would appreciate further modelling work be undertaken which models alternative parameter changes such as a 15% parameter weighting change.

Conclusion

To conclude, Alinta does not support the 20% weighting parameter increase and instead suggests that AEMO consider developing a dynamic approach to prudential management. A dynamic approach has the potential to result in savings in business as usual operation costs which could ultimately flow through to cheaper electricity for consumers through competitive efficiencies.

Alinta recognises that a more dynamic approach may not be able to be assessed and implemented within the proposed time frame, and therefore strongly recommends that AEMO model and consider other options such as a 15% parameter weighting change.

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Yours Sincerely

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