21 November 2024

Australian Energy Market Commission

Submitted online

Cash Credit Support

The Australian Financial Markets Association (AFMA) is responding to the Australian Energy Market Commission's (AEMC) consultation paper for the allowing AEMO to accept cash as credit support rule change.

AFMA is the leading financial markets industry association promoting efficiency, integrity and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets. Our membership base is comprised of over 130 of Australia's leading financial market participants, including many energy firms who are key participants in the NEM.

Key Points

- **AFMA supports making this rule change**
- **AFMA considers there is a case for a more holistic review of AEMO's settlement and credit support arrangements**

The appropriateness of AEMO's settlement and credit support arrangements has been an ongoing area of discussion in the energy market. The current rule change and GloBird's recent proposal to shorten the NEM settlement cycle suggest that it is probably an appropriate time to consider if they remain fit for purpose. While we consider that the AEMO settlement and prudential framework would benefit from a full review we appreciate that it is appropriate for Delta's issue to be addressed now.

1. Delta's change

The NEM is in a period of rapid transition as large amounts of conventional controllable generation retires and is replaced by variable renewable generation. This has had a significant impact on the financial market as the decline in the amount of controllable generation has led to a decrease in the availability of firm financial contracts and reallocation services. This decrease has made it more difficult for retailers to hedge their spot price risk and to use reallocations to manage their prudential exposure.

While AFMA is optimistic that the market will be able to address these issues in the longer term we consider that in the short term it is important for market stability to ensure that existing conventional generation, such as Delta's Vales Point, is able to continue operating and supporting the market by offering financial hedge products and reallocations. We therefore support making this rule change.

2. Broader market benefits

Allowing AEMO to accept cash as credit support is likely to have broader market benefits beyond the peculiar challenges that Delta faces. Providing credit support is one of the largest costs for small retailers and we understand that accessing bank guarantees is generally more expensive for small retailers than larger businesses. Giving retailers the option to provide cash as credit support is likely to reduce their costs and boost competition in the market.

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We also understand that the operational processes around managing bank guarantees, which are literally signed pieces of paper that AEMO stores in a safe, are complex, time consuming and costly for both AEMO and market participants. Moving to accepting cash, which can be transferred electronically, is likely to deliver significant operational benefits compared to the current arrangements.

3. Clawback risk

AEMO has considered accepting cash as credit support in the past but, as discussed in the paper, they have chosen to stay with bank guarantees as they consider there is a greater risk of cash being clawed back by an administrator as an unfair preference. Despite the potential for increased risk, AFMA considers it is worth exploring alternatives to bank guarantees as there are potentially gains to be made through reduced costs to participants and improvements to administrative processes. We also note that margin payments in the NEM are made with cash and that AEMO accepts cash for credit support in Western Australia's Wholesale Energy Market, suggesting that the increased risk of cash may be manageable.

AFMA suggests that AEMO and the AEMC should explore if alternative structures for providing credit support could minimise the unfair preference risk. We suggest particularly considering if credit support could be structured as a pre-payment, noting that this may introduce additional operational challenges for AEMO. AFMA also considers that in the longer term there would be value in studying if the current credit support arrangements are fit for purpose or if the market would benefit from a different allocation of risk.

4. Technical issues

4.1. Payment of interest

AFMA considers that if AEMO is permitted to take cash as credit support, the rules will need to deal with treatment of interest earned on the cash. Currently, before providing a bank guarantee to many classes of participant, banks often require the participant to deposit an amount of funds equivalent to the bank guarantee as security for the guarantee. While the participants lose access to these funds while the guarantee is in place, the cost to them is often reduced by the bank agreeing to pay interest earned on the funds to the participant. As the amounts involved can be quite large, receiving interest on the funds materially reduces the cost of bank guarantees for market participants.

AFMA therefore suggests that AEMO should be required to pay interest on any cash it holds as credit support. This could work in a similar way to how ASX Clear (Futures) treats initial margin payments and other cash balances that it holds on behalf of participants. ASX Clear (Futures) pays interest at the RBA Exchange Settlement Account Rate on all cash balances, interest is calculated daily and paid to participants monthly. Alternatively, if the AEMC does not think AEMO should pay interest on funds the rules should be clear that no interest is payable.

4.2. Rule drafting

Currently market participants may comply with AEMO's credit support requirements in two ways:

a) meeting the acceptable credit criteria; or
b) having a credit support provider, who meets the acceptable credit criteria, provide credit support (in the form of a bank guarantee) on their behalf.

We understand Delta's proposal is to introduce a third option allowing market participants to provide cash to AEMO themselves in place of having a credit support provider provide a bank guarantee. We do not think the proposed drafting achieves this. As currently written, we think the proposed rules require a credit support provider to provide cash on the participants behalf, which we do not think is Delta's objective. We suggest that the drafting should be reviewed to ensure the rules achieve the desired objective.

5. AEMO settlement and credit

AEMO's settlement and credit support arrangements are largely unchanged since market start. While they have proven effective with the market suffering close to zero losses from participant defaults, the combination of a long settlement period, the lack of netting with gas markets and the high cost of bank guarantees, has made credit support across AEMO markets very expensive for participants. As highlighted above, the transition to net-zero has further complicated the arrangements as the number of participants able to provide reallocations has declined. This rule change has also shown that changes to sustainability policies may limit some participants access to bank credit. AFMA therefore thinks there would be benefit in a longer-term review of the AEMO settlement and prudential framework to ensure that it is fit for purpose.

We think a review could considered the length of the settlement period and netting of credit support across gas markets and between gas and electricity. Additionally, we think it might be an appropriate time to reconsider alternative approaches to managing the risk of participant failure.

Currently the market attempts to remove credit risk by requiring participants to essentially pre-pay AEMO for energy purchased through the market. This has the benefit of ensuring participants are well capitalised and quarantining the cost to the failed participant, but it is very expensive, particularly for small retailers and ultimately there is no clear mechanism to allocate losses in the event that credit support is inadequate to cover a default. AFMA thinks it is time for the market to consider if a different approach, where the market explicitly recognises the potential for credit risk, would be more appropriate. This could include AEMO conducting more sophisticated credit assessments of participants and applying individual risk-based credit support to different participants, combined with an explicit mechanism for pooling the cost of a default across the market.

AFMA Recommendations

i. The rules should deal with the treatment of interest on any cash held by AEMO
ii. The AEMC should review the drafting of the proposed rule to ensure it achieves its objectives
iii. AEMO and the AEMC should consider if alternative structures for providing credit support, such as pre-payments, could minimise the unfair preference risk
iv. There should be a holistic review of AEMO's settlement and credit support arrangements

AFMA would welcome the opportunity to discuss this submission further. Please contact me at lgamble@afma.com.au or 02 9776 7994.

Yours sincerely,

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