2 February 2023

OUR PURPOSE IS TO LEAD COMMUNITIES INTO THE **ZERO CARBON** WORLD.

Australian Energy Market Operator
Level 22, 530 Collins Street
Melbourne, VIC 3000

Email: prudentials@aemo.com.au
RE: Credit Limit Procedures - Reassessing MCL in Extreme Market Conditions

About ZEN Energy

ZEN Energy welcomes the opportunity to respond to AEMO's consultation paper on the proposed changes to the Credit Limit Procedures. ZEN is Australia's first electricity retailer committed to the 1.5°C Science-Based Target Initiative (SBTi), as outlined in our inaugural ESG Report. Our mission is to lead communities into the zero-carbon world. As such, ZEN seeks to be a supportive partner to AEMO in finding practical solutions to better position our national electricity markets and corresponding processes and systems as our grids accelerate towards 100% renewable.

ZEN Energy Submission

ZEN acknowledges the key driver for the proposed amendments to the Credit Limit Procedures. We note that the sustained period of very high pricing in the NEM in 2022 (particularly from May onwards) resulted in a mismatch between market participant credit support and accrued liabilities. We therefore understand AEMO's desire to ensure that the prudential standard remains below 2% as prescribed in the NER 3.3.4A. Fundamentally, ZEN is aligned with AEMO in upholding the National Electricity Objective (NEO).

ZEN's response in this submission is driven by the operational considerations of the proposed amendments to the Credit Limit Procedures and, more importantly, the broader medium- to long-term challenges of the current prudential arrangement in view of the ongoing renewable transition. ZEN also strongly believes in the importance of maintaining a competitive retail market for the benefit of consumers. With these core principles in mind, our key responses are as follows.

1) Guaranteeing sufficient notice of MCL reviews
   ZEN sees potential operational risks of this proposal for non-vertically integrated retailers. To mitigate these risks, we propose mechanisms to guarantee retailers have sufficient notice of MCL reviews. ZEN proposes 15 business days be deemed as a reasonable notice period.

2) Reviewing the settlement period
   ZEN is concerned that prudential requirements will increase over the coming decade of renewable transformation. We propose AEMO investigate reducing the settlement period to lessen system wide credit risk. ZEN proposes that the settlement period be reduced to two weeks.

1. Guaranteeing sufficient notice of MCL reviews

ZEN thanks AEMO for acknowledging in section 3.9.2 of the consultation paper that time for providing additional credit support is a major concern. We are encouraged that AEMO has committed to working with market participants to allow a reasonable notice period to provide any additional credit support required to cover a revised MCL. It is critical to ZEN, and other new entrant, transformation focused participants like ZEN, that these acknowledgments lead to concrete measures.

Our current engagement with our bankers informs us that the shortest period that we can procure a new bank guarantee is 10 business days. Our experience was echoed by others in the stakeholder meeting held by AEMO. One stakeholder raised that:

> "*bank[s] treat additional [bank guarantee applications] as a security application, even if it is backed with 100% cash. They need [to] get their credit team to approve issuing, which could take a long time*"

and another that:

> *"Guarantees cost more and are far far far more difficult to put in place than cash for users".*

Given these comments, we believe 10 business days is representative of the time required to procure a bank guarantee. If AEMO agrees with this suggestion, an alignment of this operational consideration with the section 3.3.6 of the National Electricity Rules (NER) (as quoted below) will need to be factored in the execution plan. Without advanced notice there is a risk that solvent retailers will fail to meet their obligations under the NER.

> *"The Market Participant must procure that the replacement credit support is issued to AEMO within 24 hours after the Market Participant first becomes aware that the credit support has ceased to be current or valid"*

Regarding consultation issue 3[1], ZEN supports the choice of a backward-looking trigger (the 21-day average of accrued liabilities). This decision makes it significantly easier to forecast a review than the other options considered. However, during a market failure, liabilities are difficult to forecast and can accrue quickly. As such, ZEN is not confident that it will always be possible to forecast a trigger with 10 or more business days' notice. This is especially a concern if multiple reviews are called in quick succession as section 3.5 of the consultation paper suggests could be the case.

Proposal 1

To mitigate the risk that a solvent retailer may fail to procure a bank guarantee in the time required by section 3.3.6 of the NER, ZEN proposes AEMO guarantee 15 business days' notice of a review. Potential ways of achieving this include:

- After a trigger, AEMO provides retailers with an indicative new MCL and a 15-business day period to procure it. The hard figure for the new MCL could be revised during the notice period.
- AEMO provides a forecast of trigger events and guarantees not to call a review until 15-business days after a forecast warning.

ZEN is keen to have further conversations with AEMO on the operational considerations of the above proposal.

[1] From AEMO's consultation paper: "Are there comments on the trigger chosen for the MCL reassessment (i.e. average current accrued liabilities over 21 days above the credit support amount)?"

2. Reviewing the settlement period

Regarding consultation issue 6[2], ZEN would like to highlight the following:

1. We anticipate that the MCL will increase significantly under the proposed amendments. This will impose a greater cost of capital, particularly on non-vertically integrated retailers. Increased costs will result in consumers paying more. Such an outcome would be inconsistent with the National Electricity Objective.
2. We are concerned that, in some instances, the proposed amendments impose further solvency risks on smaller retailers and thereby lead to a less competitive market for consumers. While ZEN survived the winter of 2022 through our strong cash and credit management principles, we saw several of our peers become insolvent or encourage their customers to leave for another retailer. In this context, an unintended/adverse consequence of the proposal is that it puts smaller retailers at risk and further entrenches incumbency.
3. In the long run, with fossil-based generation retiring and the challenges of securing ex-ante reallocations from new renewable projects[3], we are concerned that the prudential requirements will grow to an unmanageable level.

With the above in mind, ZEN recommends the below two proposals.

Proposal 2 ZEN encourages AEMO to conduct an assessment of the amendments to the Credit Limit Procedures impact on the cash requirements of particularly the non-vertically integrated retailers and assure the market that these amendments will not impose significant solvency risks on the retail market participants. This is critical to continue to uphold the National Energy Objective[4] which emphasises price, reliability, security, and safety equally.

Proposal 3 ZEN proposes for AEMO to conduct a broader assessment on how the prudential system could be reviewed considering the ongoing renewable transition. ZEN recommends AEMO to consider reducing the settlement period to two weeks.

Across other financial markets, new technology has allowed settlement periods to be substantially reduced, yet we have not seen a similar reduction in the 24-year history of the electricity market's prudential system. The benefits of a shorter settlement period are broad. From the system operator's perspective, total liabilities reduce, increasing confidence in the market. From the generator's perspective, their receivables are reduced and their risk of non-payment decreases. From the retailers' perspective, their prudential requirements can be lessened, allowing them to provide better value for customers. ZEN believes that such an outcome is consistent with the National Electricity Objective.

[2] From AEMO's consultation paper: "Are there any unintended/adverse consequences of the proposed changes as described in the Procedures?"

[3] ZEN understands that most renewable assets are financed at the project level and debt has refused to be subordinated and take on the credit risk of the off-taker. This is the key challenge for ex-ante reallocations to work effectively for renewable asset projects.

[4] National Electricity Objective is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
- price, quality, safety and reliability and security of supply of electricity
- the reliability, safety and security of the national electricity system."

Finally, ZEN would like to note a separate, but related, issue that we would welcome the opportunity to follow up with AEMO in the future. In relation to section (2) of our submission, we note that our comments are premised on a particular feature of the Australian electricity market, which is that credit risk management procedures to cover customer supply obligations (AEMO prudentials) and generation purchase obligations (ASX margins and OTC credit) are independent of each other. This leads to the outcome that non-vertically integrated retailers are effectively required to cover the credit risk associated with their supply obligations twice, providing cash to cover several weeks of the pool costs of customer supply as well as 14-30% of the face value of swaps and caps purchased from the ASX electricity board (a similar amount if the retailer is hedging on a rolling 12-month basis). These credit exposures naturally offset one another, which means that there would be lower credit exposure in the market and less cash security posted by retailers to cover any residual credit liability to the market if the AEMO and ASX electricity margin accounts were linked. In the context of the collapse of the gentailer model and emergence of new business models that focus either on retail service or generation (IPPs), this single initiative would substantially reduce the cash intensity and therefore the cost to customers of the electricity market.

ZEN welcomes further engagement on this issue and look forward to sharing our feedback at the next phase of the consultation journey. For any clarifications on the above submission and to further engage with us on the above proposals, please liaise with Mark Dawkins, Commercial & Insights Analyst, at mark.dawkins@zenenergy.com.au.

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