

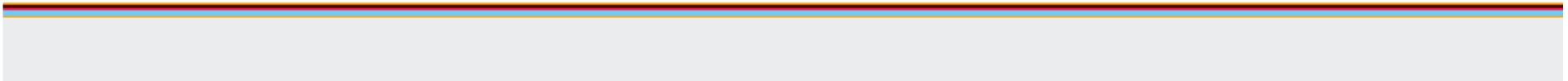
Draft presentation on weekly settlement

SPSTG

11 December 2012

Overview of presentation

- WAG's proposal for weekly settlement
- Increasing settlement frequency to weekly
 - Reduces prudential requirements
 - Reduces impact of a default
 - Cash management analysis
- Reducing settlement delay period
- Reflections on weekly settlement
- How weekly settlement could be implemented



WAG: weekly settlement

Settlement should :

- move to a weekly cycle;
- occur immediately following the billing week
(Settlement would be on the basis of estimated quantities)

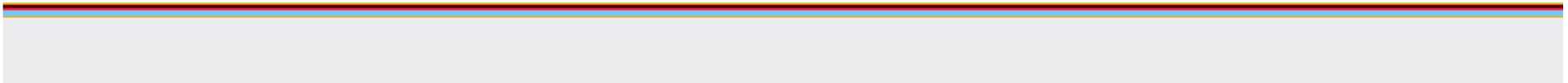
Note: No suggestion that reconciliation arrangements should change from a monthly process

Purpose of proposal

The WAG noted that weekly settlement will:

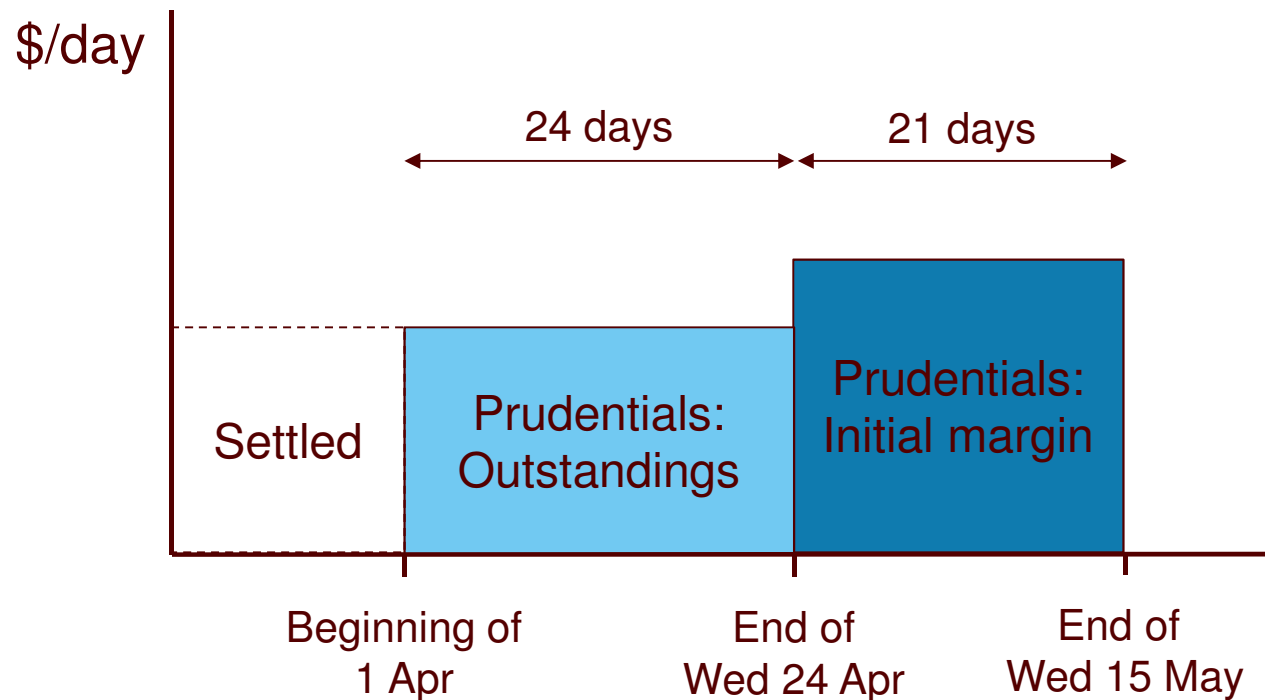
- reduce required levels of prudential security; and
- limit the size of the impact of any potential insolvency.

Increasing settlement frequency to weekly



Analysis: Prudential requirements (1)

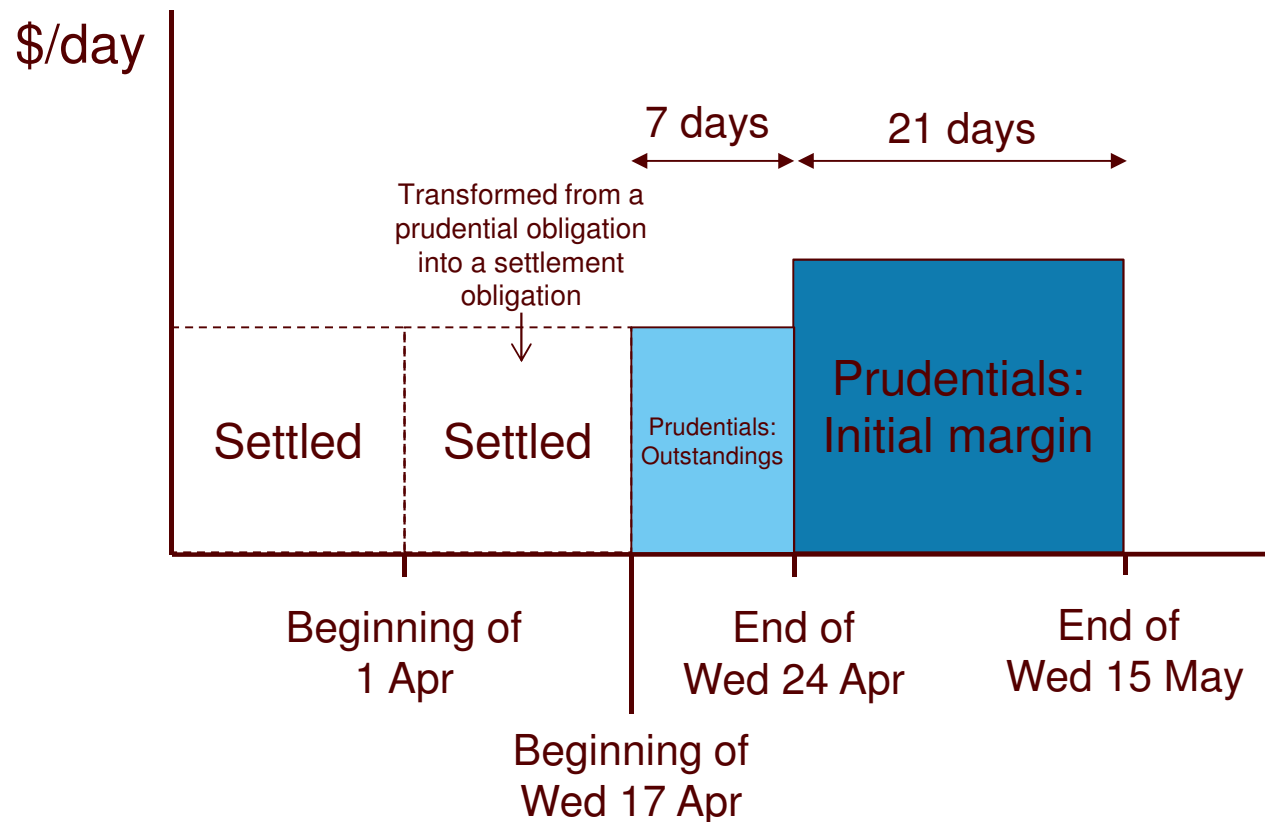
Situation on Thurs 25 Apr (randomly selected)



Monthly settlement
(say, 3 days after billing period)

Analysis: Prudential requirements (2)

Situation on Thurs 25 Apr (randomly selected)



Weekly settlement
(on Fri for week ended Tue)

Conclusion:

Weekly settlement will reduce required prudential security, but settlement requirements will increase by a corresponding amount

Analysis: Impact of a default

Weekly settlement will:

- **Reduce each settlement amount**
- **In the short term** (to extent prudential security can't be liquidated)
 - smaller settlement amounts will reduce size of short payments to generators following a default. Less chance of contagion driven by short term issues
- **In the longer term** (or to extent prudentials can be immediately liquidated)
 - there is no change in risk faced by generators because the short payment will be the same under either approach...
 - unless there is a difference in the clearing manager's access to settled funds and prudential security

Analysis: Cash flow

Purchaser perspective

- If purchaser uses a guarantee for prudentials, moving to weekly settlement will worsen their cash position (increase need for cash)
- If purchaser uses cash for prudentials, weekly settlement won't make any difference

Generator perspective

- Generators get cash earlier
- But if they have a close relationship with a bank, this might not be much benefit? (firm accounts receivable \approx cash)

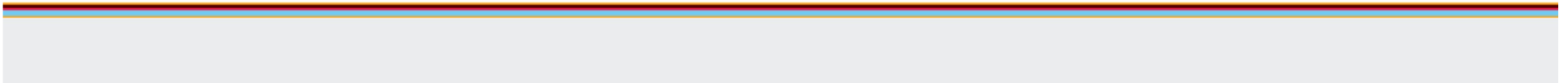
Conclusion

- May improve the industry's cash position, but significance of that benefit needs further teasing out

Problems / design questions

- Would FTRs move to weekly settlement? Should FTRs become a weekly product?
- Would HSAs settle weekly?
- Alignment with commercial standard of monthly settlement on 20th
- ‘Progress payment’ approach v integrated weekly settlement
 - PP approach: Emphasis on monthly settlement framework. Weekly settlements are estimated contribution to that.
 - IWS approach: Emphasis on weekly settlement framework. Monthly process remains only to cope with arrival of reconciliation outputs
 - Treatment of week/month misalignment. For example, payer X pays for a week that straddles 2 months. Under PP approach, that weekly settlement amount would need to be allocated (split) between the two months. Under the IWS approach it would not need to be split
 - Would risk pooling be weekly (IWS) or monthly (PP)?
 - Would all ancillary service cost recovery methods move to a weekly basis (IWS) or would a monthly basis remain (PP)?

Reducing settlement delay period



Current arrangements

- Settlement delay is 20 days (\approx 14 business days)
- Final prices usually available 2 days after flow day
- Reconciliation by 7th business day of month
- Invoices by 9th business day
- Disputes: if resolved before 2 business days before settlement day, invoices can be reissued
- Reconciliation still incorporates some estimation / errors. So washups after 1, 3, 7 and 14 months
- Prudential assessment estimates outstandings quantities in absence of reconciled quantities

Options for settlement delay

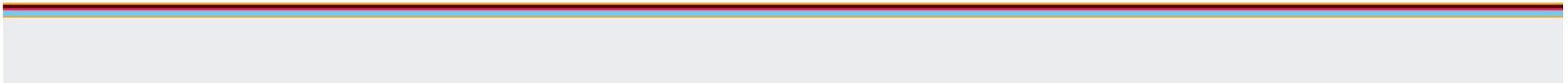
Assuming settlement is weekly...

1. Settle 1 business day after billing period
 - How accurate? For purchasers? For generators? $\pm 10\%$?
 - May be able to improve existing estimates
 - How would we treat days for which final prices not yet due?
Use interim prices?
2. Settle 2 or 3 business days after billing period
 - Final prices will almost always be available
 - Probably not much improvement in quantity estimates

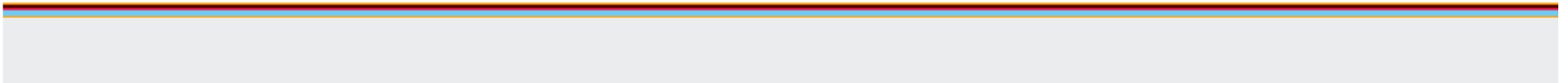
Note: Waiting for (monthly) reconciliation outputs won't work in conjunction with weekly settlement

Effect of reducing settlement delay

- Purchaser perspective: Lower prudential requirements, but settlement requirements increase by same amount
- Generator perspective: Get cash earlier but there is the issue of: firm accounts receivable \approx cash
- Overall: May be some cash advantages. Needs more teasing out



Reflections on weekly settlement



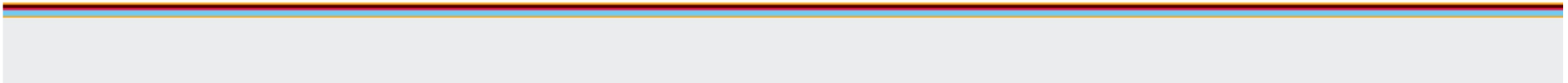
Moving towards greater settlement complexity

- Partial net settlement
- Complex calculations for allocation of any shortfall
- Different 'accounts' have different treatment
- Settle weekly (not much breathing time). Overlapping complexity with partial net settlement
- Invoices issued very quickly and not much time for disputes
- (PP) Need a monthly alignment process (different from a wash up)
- (IWS) Pools get smaller (affects default management, FTR revenue inadequacy). FTRs can be sold after settlement?
- Need a washup once reconciliation outputs available

Costs and benefits

- Costs of moving to weekly settlement
 - System changes (NZX, SO, participants)
 - Transitional participant costs (e.g. alignment with bilateral settlements)
 - Higher ongoing administrative costs
- Benefits may need further teasing out
 - Key benefit? Reduces short term impact of default (over the period until guarantees can be liquidated)
 - From purchaser's perspective it reduces prudential requirements... but increases settlement requirements by same amount
 - Some benefits from lower industry cash needs?

How weekly settlement could be implemented



Weekly invoices

- Invoices for week ended Friday sent on Monday
- Payment due Wednesday
- Invoices are on a partial net settlement basis. Largest planned prudential risk identified each week and invoice offsets calculated
- Progress payment approach: If a weekly invoice straddles 2 calendar months, invoice contains a split. Integrates better with monthly FTR products
- If there is a default on a weekly payer invoice, allocate shortfall over the weekly pool, but there is a later monthly alignment process

Monthly processes

- Monthly alignment process (shortly after month end)
 - To align with monthly settlement framework
 - The weekly invoice for the last (partial) week in the month would be special
 - It would calculate settlement amounts for the whole month and give credits for previous progress payments
 - Would operate on a partial net settlement basis
- Monthly wash up process (after 7th business day)
 - First weekly invoice after reconciliation outputs available
 - Washups for previous month

Idea: A staged approach?

1. Set prudential requirement = outstandings + initial margin, but retain monthly settlement on 20th
2. Improve outstandings calculations over time and make very transparent
 - Iron out any problems
 - Help participants understand outstandings for each week
 - Payer-related and payee-related payments should be separately specified
3. Provide partial net settlement (PNS) information
 - Identify what would be the largest planned prudential risk each week
 - Inform each participant of what their PNS weekly payer and payee invoices would be
4. Require prudential cash
 - Each week on the planned invoice day, issue a call for cash prudentials equal to what will later become settled amounts
 - Cash prudential call to be due on the planned settlement day
5. Transition the prudential requirement into a settlement requirement

Any questions/comments?

