NEMMCO

National Electricity Market
Management Company Limited
ABN 94 072 010 327

Sydney

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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
SOUTH SYDNEY NSW 1235

Dear John

Preservation of Prudential Margin through Call Notices - Clause 3.3.11

NEMMCO requests the Australian Energy Market Commission (**AEMC**) to consider making a Rule under sections 91 and 96 of the National Electricity Law (**NEL**). The proposed Rule change seeks to ensure that the call amount specified in a call notice issued by NEMMCO, can restore a Market Participant's prudential margin in all cases.

NEMMCO considers that the proposed Rule change is non-controversial in nature as it is unlikely to have a significant effect on the National Electricity Market (**NEM**), as is required for an expedited consultation process under section 96 of the NEL.

A description of the proposed Rule, statement of the issues concerning the existing Rules, and how the proposed Rule addresses those issues consistent with the National Electricity Objective (**NEO**) is in Attachment A.

I look forward to your consideration of this proposal. If you wish to discuss the proposal, please contact Craig Parr on 02 8884 5030 or Murray Chapman on 02 9239 9106.

Yours sincerely

Brian Spalding

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Chief Operating Officer

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Attachment A

1. Statement of Issues

1.1 Background

The prudential requirements for participation in the National Electricity Market (**NEM**) are set out in clause 3.3 of the Rules. Broadly, the following elements of the Rules' prudential requirements are relevant to this proposal:

- Under clause 3.3.8, NEMMCO is required to determine a maximum credit limit (**MCL**) and prudential margin for each Market Participant.[1]
- Market Participants are required to lodge credit support with NEMMCO to the level of at least their MCL.[2]
- Each Market Participant has a trading limit, which is specified in clause 3.3.10 to be the Market Participant's level of credit support, less their prudential margin.
- The outstandings of a Market Participant is a dollar amount determined in accordance with clause 3.3.9. This broadly represents the net settlement amount payable by the Market Participant, up to the present time, irrespective of whether the payment date has been reached, and net of any security deposits that have been made.
- If a Market Participant's outstandings exceed its trading limit, NEMMCO may issue a call notice; this specifies a call amount NEMMCO calculates in accordance with clause 3.3.11. The Market Participant is required to respond to a call notice by 11 am the following business day.
- The call amount is specified in clause 3.3.11 as being equal to the difference between a Market Participant's outstandings and its typical accrual.
- The typical accrual is defined in clause 3.3.12. It is an amount determined by NEMMCO that is broadly equal to the level of outstandings that the Market Participant would have reached if spot prices and consumption levels had been at average levels.[3]
- In accordance with clause S3.3.1(b)(6)(iii) Participants can request NEMMCO to use a shorter credit period when determining their MCL. This results in a reduced MCL and a correspondingly lower trading limit. The prudential margin between the credit support and the trading limit is maintained. The effect is to require more frequent payments, by way of security deposits from participants when their outstandings approach the reduced trading limit, while the participant has a lower MCL obligation.

[1] NEMMCO has published its "Method for Determining Maximum Credit Limit and Prudential Margin" at: http://www.nemmco.com.au/met_sett_sra/prudentials.html#MethodofDeterminingMaximumCreditLimits

[2] National Electricity Rules, clause 3.3.5.

[3] Details of how a Market Participant's typical accrual is determined are set out in the "Method for Determining Maximum Credit Limit and Prudential Margin" – refer footnote 1.

1.2 The issue with the current provisions

The proposed Rule change is intended to address an anomaly relating to clause 3.3.11(a)(2), which specifies the formula to be used to calculate the call amount. The anomaly creates a risk that a call amount calculated in respect of a Market Participant will be insufficient to ensure that the Market Participant's outstandings are brought within its trading limit. In some specific circumstances, there is potential for the call amount, which is the difference between a Market Participant's outstandings and their typical accrual, could be a zero amount even if a Market Participant's outstandings to NEMMCO exceed the Market Participant's trading limit. This would result in a Market Participant's prudential margin being eroded. Thus, NEMMCO considers it necessary to modify the formula so it can, in all circumstances, restore a Market Participant's prudential margin.

NEMMCO notes that the probability of this situation occurring has been low in the past, but has increased because of the following factors:

- An increase in the number of Market Participants using the reduced MCL as provided in clause S3.3.1(b)(6)(iii). This allows these Market Participants to lodge a lower level of credit support with NEMMCO, and to have a reduced trading limit, however, because they are still settled on the normal settlement cycle, their typical accrual is not reduced. Market Participants that have opted for a reduced MCL would, therefore, have an increased likelihood of their typical accrual exceeding their trading limit.

- The volatility of spot prices has recently reached very low levels in some regions – the volatility factor is currently 1.3 in NSW and Victoria.[4] This factor is used in calculating a Market Participant's MCL, but is not used in calculating the typical accrual. If the volatility factor reduces, the separation between a Market Participant's MCL and typical accrual also reduces.

If the Market Participant is using a reduced MCL, its typical accrual could potentially exceed its trading limit, so that the call amount determined in accordance with clause 3.3.11(a)(2) would be zero. NEMMCO has estimated that, for a Market Participant using a reduced MCL, its typical accrual could potentially exceed its trading limit if the volatility factor is less than around 1.55.

Under the Rules, NEMMCO has no means of addressing this situation. Ultimately, the risk arising from this issue is borne by the credit providers in the NEM, which are generally Generators, because they carry the risk of short payment in the event of a payment default.

2. Description of the Proposal

This section provides a description of the proposed Rules developed by NEMMCO, NEMMCO's right to submit the proposed Rule changes to the AEMC, the power that NEMMCO considers that the AEMC has to consider this proposed Rule change, and NEMMCO's request that the Rule be considered non-controversial under section 96 of the NEL.

[4] The volatility factor is described in NEMMCO's published "Method for Determining Maximum Credit Limit & Prudential Margin".

2.1 Description of the Proposed Rule

The proposed Rule change corrects the identified anomaly by modifying the formula in clause 3.3.11 of the Rules to ensure that a call notice restores a Market Participant's prudential margin, including in situations where its typical accrual is greater than its trading limit.

NEMMCO suggests that the current formula should be replaced with the following formula:

Call Amount = the higher of:

(OS – TypA); and

(OS – TL)

Where:

OS and TypA have the same meanings as in the current version of clause 3.3.11; and

TL is the *trading limit* for the Market Participant, as at the date of issue of the call notice. *Trading limit* is a defined term in the Rules.

2.2 NEMMCO's Right to Submit this Proposal

NEMMCO requests that the AEMC make this proposed Rule in accordance with section 91 of the NEL.

NEMMCO has the following relevant functions under the NEL:

- to operate and administer the NEM;
- to promote the development and improve the effectiveness of the operation and administration of the NEM.

Under section 91(1) of the NEL, the AEMC may make a Rule at the request of any person, the MCE or the Reliability Panel. As such, NEMMCO may request the AEMC make a Rule.

2.3 Power of the AEMC to Make the Proposed Rule

The subject matters about which the AEMC may make Rules are set out in section 34 of the NEL and, more specifically, in Schedule 1 to the NEL.

NEMMCO considers that the proposed Rule falls within the subject matter that the AEMC may make Rules about, as it relates to the operation of the NEM and the activities of persons, particularly Market Participants, participating in the NEM or involved in its operation. Specifically, the proposed Rule is within matters set out in Schedule 1 to the NEL, as it relates to the prudential requirements to be met by a Registered Participant.

2.4 Request for a Non-Controversial Rule

NEMMCO requests that the AEMC reviews this Rule change proposal under section 96 of the NEL. Section 96 applies if the AEMC considers that a request for a Rule is a request for a non-controversial Rule. A non-controversial Rule means a Rule that is unlikely to have a significant effect on the NEM.

NEMMCO considers that section 96 applies to this proposal as the Rule would:

- correct an anomaly in the application of a process, rather than making a substantive change to the process; and
- have an insignificant effect on the market as a whole.

3. How the proposed Rule is likely to contribute to the achievement of the National Electricity Objective

Before the AEMC can make a Rule change it must apply the rule making test set out in the NEL, which requires it to assess whether the proposed Rule will or is likely to contribute to the National Electricity Objective (**NEO**). Section 7 of the NEL states the NEO 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:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system.

NEMMCO submits that the proposed rule satisfies the requirements of the rule making test. The remainder of this section discusses the expected costs and benefits of the proposed rule and how it contributes to the NEL

3.1 Analysis of the Proposed Rule against the National Electricity Objective

NEMMCO submits that the proposed Rule will advance the NEO because it improves the operation of the NEM by addressing the identified anomaly in the application of the prudential arrangements. The anomaly reduces the ability of the prudential regime to protect credit providers from the effects of a default event, and also gives rise to uncertainty for all parties about what outcomes the prudential regime would deliver in certain circumstances. This correction would make the prudential regime more robust for both credit providers and payers. Ultimately, correcting the anomaly reduces the risk to be factored into investment decisions in the NEM.

3.2 Expected Benefits and Costs

NEMMCO does not expect that the proposed Rule change would adversely affect any party. The implementation cost would be negligible for NEMMCO and other parties would not need to take any action to implement the change. The expected benefits of a more robust prudential regime would accrue to all Market Participants.

4. Proposed Rule

It is proposed that clause 3.3.11(a)(2) of the Rules be amended as follows:

"(2) give the *Market Participant* a notice (a "*call notice*") that specifies an *invoiced amount*, the current *maximum credit limit* for the *Market Participant*, the current *trading limit* for the *Market Participant*, and the *call amount*, where:

Call Amount = <u>the higher of:</u>

<u>(</u>OS – TypA)<u>; and</u>

<u>(OS – TL)</u>

except where the formula produces a negative result, in which case the *call amount* is zero,

where:

OS is the *outstandings* for the *Market Participant* as at the date of the issue of the *call notice*; ~~and~~

TypA is the *typical accrual* for the *Market Participant* as at the date of the issue of the *call notice*<u>;</u>~~.~~ <u>and</u>

<u>TL is the *trading limit* for the *Market Participant* as at the date of the issue of the *call notice*.</u>

Note: If the value of *outstandings* of a *Market Participant* has a negative value and the *trading limit* also has a negative value, the *outstandings* will be greater than the *trading limit* if the absolute value of the *trading limit* is greater than the absolute value of the *outstandings*, in which case *NEMMCO* may exercise its powers under either or both of clauses 3.3.11(a)(1) or 3.3.11(a)(2)."

GLOSSARY

Term or Abbreviation	Explanation
AEMC	Australian Energy Market Commission
MCL	Maximum credit limit
NEM	National Electricity Market
NEO	The national electricity objective contained in section 7 of the NEL
NEL	National Electricity Law
Rules	National Electricity Rules