INFORMATION

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Improved calculation of credit support requirements

New prudential standard and framework in the National Electricity Market (NEM)

Final rule determination 18 October 2012

The AEMC has made a final determination to make a rule introducing a new framework for calculating the amount of credit support that is required to be posted by NEM participants to the Australian Energy Market Operator (AEMO). The new framework is based on a statistical standard called the probability of loss given default (P(LGD)). The rule sets a standard of 2% P(LGD), which implies an expectation that in 98 out of 100 instances of participant default, there would be no shortfall in monies owed to AEMO by the participant at the time of its suspension. The rule also requires AEMO to develop procedures that will accurately align payment shortfall risks with credit support required to cover those risks.

The NEM prudential framework

In the NEM, there is a delay between the time of energy consumption and the time of energy settlement. This delay creates a risk of short-payment to AEMO from participants that default on their obligations.

To address the risk of short payment in the event of a participant default, the National Electricity Rules (rules) contain a set of prudential requirements, designed to oblige participants to post an amount of credit support (bank guarantees and cash deposits) to AEMO. Though credit support is mainly required from retailers, generator participants are also on occasion required to post credit support under the requirements.

The amount of credit support to be posted by each participant is calculated by AEMO on a rolling basis. The calculation features the establishment of two values, the maximum credit limit, and the prudential margin. These are calculated separately for each participant every few months. The maximum credit limit is a dollar value that the participant must match with bank guarantees. In addition, AEMO continually assesses the net amount owed by a participant against the amount of credit support posted, and should the difference become lower than the prudential margin, act to rectify this by issuing a call notice. Failure by the participant to satisfactorily address the call notice can then lead to a default event, followed by suspension from the NEM and the activation of Retailer of Last Resort provisions. Should there be a shortfall in credit support available to AEMO following suspension relative to the amount owed, this shortfall is shared on a pro-rata basis across the generator participants in the NEM.

Before this rule change, the rules required the setting of the level of the credit support to be accomplished with reference to the “reasonable worst case” of monies that could accrue during the settlement window, and default window. This rule changes the arrangements so that the credit support is calculated with reference to a 2% P(LGD) standard. Retaining credit support commensurate with this standard will imply an expectation that the credit support will be sufficient to cover the amount owed to AEMO in 98 times out of every 100 instances of participant default.

Participants in the NEM post credit support to AEMO to cover the risk that they may default on monies they owe. This rule change sets a statistical standard to be used to determine the amount of credit support required.

The AEMC's final determination

The AEMC's final determination is the same as that laid out in its earlier draft determination, and introduces the new prudential standard and framework as originally proposed by AEMO, with minor consequential amendments.

In response to the draft determination, AEMO proposed an additional set of amendments to the calculation of the prudential margin related to the netting of positive amounts against negative amounts. The AEMC consulted with stakeholders separately in a second consultation on this proposal. Submissions received to that consultation were generally not in favour of the additional amendments, citing a lack of substantive analysis or justification relative to the larger body of work compiled for the rest of the project. The AEMC has subsequently decided not to implement AEMO's proposed additional amendments, and these are not included in the rule as made. Instead, the original provisions for the calculation of the prudential margin, as reflected in the draft determination, are implemented in the final rule as made.

Implementation of the new framework

Although the rule takes legal effect from 1 November 2012, AEMO is not required to calculate the credit support required of participants under the new framework until 1 December 2013, at the latest. This delay will allow sufficient time for AEMO to complete its Credit Limit Procedures consultation and make necessary changes to software and internal processes.

Background

AEMO's rule change request followed its completion of a large body of work called the 'Energy Market Prudential Readiness Review'.

The review commenced following a request from the MCE received in May 2010. The request contemplated a number of possible reforms to the prudential regime in the NEM, including:

- Implementation of a new prudential standard and credit limits methodology,
- Permitting alternative forms of credit support,
- Integration of the NEM with contract markets,
- Creation of a single guarantee for related entities,
- A shorter settlement cycle.

AEMO submitted its rule change proposal in order to give effect to the first point above, noting the potential for further reforms to then be subsequently pursued.

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