INFORMATION

New Prudential Standard and Framework in the NEM

Consultation 20 October 2011

This proposed Rule amends the prudential framework in the National Electricity Market (NEM), by introducing a new statistical standard that will be used to calculate collateral requirements for participants.

The NEM Prudential Framework

As there is a delay between the time of energy consumption and the time of energy settlement in the NEM, the National Electricity Rules (Rules) contain a suite of prudential requirements, designed to oblige retailer participants to post an amount of collateral (bank guarantees and cash deposits) to offset the risk posed by their potential default on monies owed. Though they are normally creditors in the NEM, generator participants are also on occasion required to post collateral under the requirements.

The amount of collateral to be posted by each participant is calculated by the Australian Energy Market Operator (AEMO) on a rolling basis. The calculation features the establishment of two values, the Maximum Credit Limit (MCL), and the Prudential Margin (PM). These are calculated separately for each participant every few months. AEMO continually assesses the amount owed by a participant against the amount of collateral posted, and when the difference becomes lower than the PM, 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 collateral 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.

AEMO propose to amend the Rules so that the MCL and PM are calculated with reference to a statistic called the Probability of Loss Given Default [P(LGD)]. The standard proposed is a 2% P(LGD), meaning that in the event of default, the collateral posted by the defaulter to meet the MCL and PM would be sufficient to cover the amount owed to AEMO 98 times out of every 100. Note that this proposed standard does not include any measure of the amount of shortfall that could occur.

The AEMC's Consultation Paper

The Consultation Paper accompanies publication of AEMO's Rule change request, and:

- outlines the existing architecture in place to protect participants, and ultimately consumers, from the effects of participant default;
- summarises AEMO's proposed amendments to the prudential framework and its proposed introduction of a statistical prudential standard; and
- invites comments from respondents.

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Retailers in the NEM post collateral to AEMO to cover the risk that they may default on monies owed. This Rule change proposal sets a statistical standard to be used to quantify the amount of collateral required.

Background

AEMO's Rule change request follows 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 on 22 May 2010. The request contemplates 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 collateral
- Integration of the NEM with contract markets
- Creation of a single guarantee for related entities
- A shorter settlement cycle

The motivation for this Rule change is to give effect to the first dot point above. AEMO intend to explore the others following conclusion of this Rule change.

Next steps

The AEMC invites submissions to this Consultation paper by the closing date of 6 January 2012.

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