RULE CHANGE

Australian Energy Market Commission

# CONSULTATION PAPER

## National Electricity Amendment (Call Notice Timing) Rule 2014

**Rule Proponent**

Australian Energy Market Operator

1 May 2014

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Reference: ERC0163

**Citation**

AEMC 2014, Call Notice Timing, consultation paper, 1 May 2014, Sydney

**About the AEMC**

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

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# 1 Introduction

## 1.1 The rule change request

On 25 July 2013, the Australian Energy Market Operator (AEMO) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission). The rule change request seeks to amend the National Electricity Rules (NER) to delay by one hour the time at which a call notice issued by AEMO is taken to have been issued on the next business day.

## 1.2 The rule change process

AEMO considers the proposed rule change request to be non-controversial and has requested that the proposal be subject to the expedited rule making process set out under section 96 of the National Electricity Law (NEL). The Commission proposes to treat this rule change request as a non-controversial rule.

The timetable for submissions in relation to this rule change request is therefore as follows:

- the final date for stakeholders to submit written objections to the expedited rule making process is 15 May 2014; and
- the final date for stakeholders to provide written submissions on the content of the request is 29 May 2014.

If the rule change request proceeds on the expedited basis, the final rule determination (and final rule, if applicable) should be published on 12 June 2014.

## 1.3 The consultation paper

This consultation paper has been prepared to facilitate consultation on the rule change proposal, and to seek stakeholder submissions on the rule change request.

The paper:

- sets out a summary of, and a background to, the rule change request;
- identifies a number of questions and issues for consultation; and
- outlines the process for making submissions.

# 2 Background

This Chapter provides background on the prudential requirements in the National Electricity Market (NEM). It focuses on key aspects of those prudential requirements relevant to this rule change request.

## 2.1 The NEM wholesale market

In the NEM all purchases and sales of electricity occur through a central platform that is operated by AEMO. On this platform "market participants" trade in half hourly intervals in the wholesale market (also known as the "spot" market).[1] Through that platform, AEMO acts as the principal in each transaction a market participant enters to purchase or sell electricity in the wholesale market.

The financial obligation to pay AEMO (or be paid by AEMO) for the electricity purchased or sold, is settled on a seven day billing period. However, the final settlement (taking into account all adjustments) between AEMO and a market participant occurs up to five weeks after a liability is accrued in the wholesale market. This means that large sums can be outstanding between AEMO and a market participant at any given time.

## 2.2 Prudential requirements in the NEM

Prudential requirements are obligations placed on businesses that operate in certain financial and other markets that are designed to limit the risks to participants in those markets.[2] The NEM has prudential requirements designed to protect AEMO, other market participants and consumers. These requirements are set out in rule 3.3 of the NER.

There are two broad components of the NEM prudential framework:

- the requirement that certain market participants post "credit support" such as a bank guarantee to AEMO; and
- the process to suspend a market participant that breaches certain limits to its trading in the NEM and cannot sufficiently rectify the breach.

These components are described further below.

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1 A market participant is generally a retailer, generator or a transmission or distribution network service provider. Eligibility for registration as a market participant must be in accordance with rule 2.4 of the NER. Market participants must register in one or more of the categories "Market Customer", "Market Small Generation Aggregator", "Market Generator" and "Market Network Service Provider".

2 Such as, the risk that the failure of a business in the market will affect other participants.

### 2.2.1 Credit support and the maximum credit limit

If a market participant does not meet certain "acceptable credit criteria" it must post an amount of "credit support" to AEMO.[3] The credit support posted must be a bank guarantee or letter of credit provided on behalf of the market participant by an entity that meets the *acceptable credit criteria* (for example, a bank). The amount of credit support posted must not be less than the market participant's current "maximum credit limit", which is an amount determined by AEMO for each market participant.[4]

The *maximum credit limit* is a "reasonable worst-case" estimate of the potential exposure based upon the aggregate payments (after reallocations) to be made by a market participant to AEMO over the "credit period".[5] Two key concepts for the determination of the *maximum credit limit* are:

- the **reasonable worst case**: which is defined as "a position that, while not being impossible, is to a probability level that the estimate would not be exceeded more than once in 48 months";[6] and
- the **credit period**: which is comprised of:
  - a period of 7 days of electricity trading during which liabilities are accrued (the "billing period");
  - a period of 28 days which includes the number of days in the billing period plus the number of days until payment is due with respect to transactions for that billing period (the "payment period"); and
  - a further period of 7 days which represents the time from the day that a market participant could be in breach of a limit to its trading to the time when the market participant could be suspended from trading (the "reaction period").

The *maximum credit limit* therefore represents the estimated value for each market participant of 35 days of electricity trading liabilities at the "reasonable worst case" level.[7]

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3 These criteria are set out in clause 3.3.3 of the NER. Broadly it is only financial institutions with existing prudential obligations regulated by the Australian Prudential Regulation Authority and certain government bodies that can meet those *acceptable credit criteria*.

4 See clauses 3.3.5 and 3.3.8 of the NER.

5 The *maximum credit limit* is an amount determined by AEMO for each market participant under procedures that it is required to develop and that must take into account a number of matters set out in clause 3.3.8 of the NER.

6 See Australian Energy Market Operator, *NEM Settlement Prudential Supervision Process, version 13.1*, AEMO, 2009 at page 5.

7 This calculation is also subject to an option for market participants to have the calculation based on a notional payment period of 14 days.

In the event that the market participant cannot meet its liabilities, AEMO will call upon the bank guarantee or letter of credit. If the *maximum credit limit* is set at the appropriate level, the credit support should cover the market participant's liabilities up to the date of its suspension, which occurs at the end of the *reaction period*.

The process to suspend a market participant, including the issuance of a "call notice", is described below.

### 2.2.2 Breach of trading limits and issuance of a call notice

The beginning of the process of suspending a market participant occurs where the market participant breaches its "trading limit". The *trading limit* is set by AEMO for each market participant and is equal to the actual amount of *credit support* posted for the market participant, less the market participant's "prudential margin". The *prudential margin* is calculated on a similar basis to the *maximum credit limit*, but represents only the reasonable worst case estimate of accrued liabilities during the 7 day *reaction period*.[8]

The purpose of the *trading limit* therefore is to trigger the process to suspend a market participant at a time where AEMO holds enough credit support to cover any liabilities that the market participant may incur during the period until its suspension (the *reaction period*).

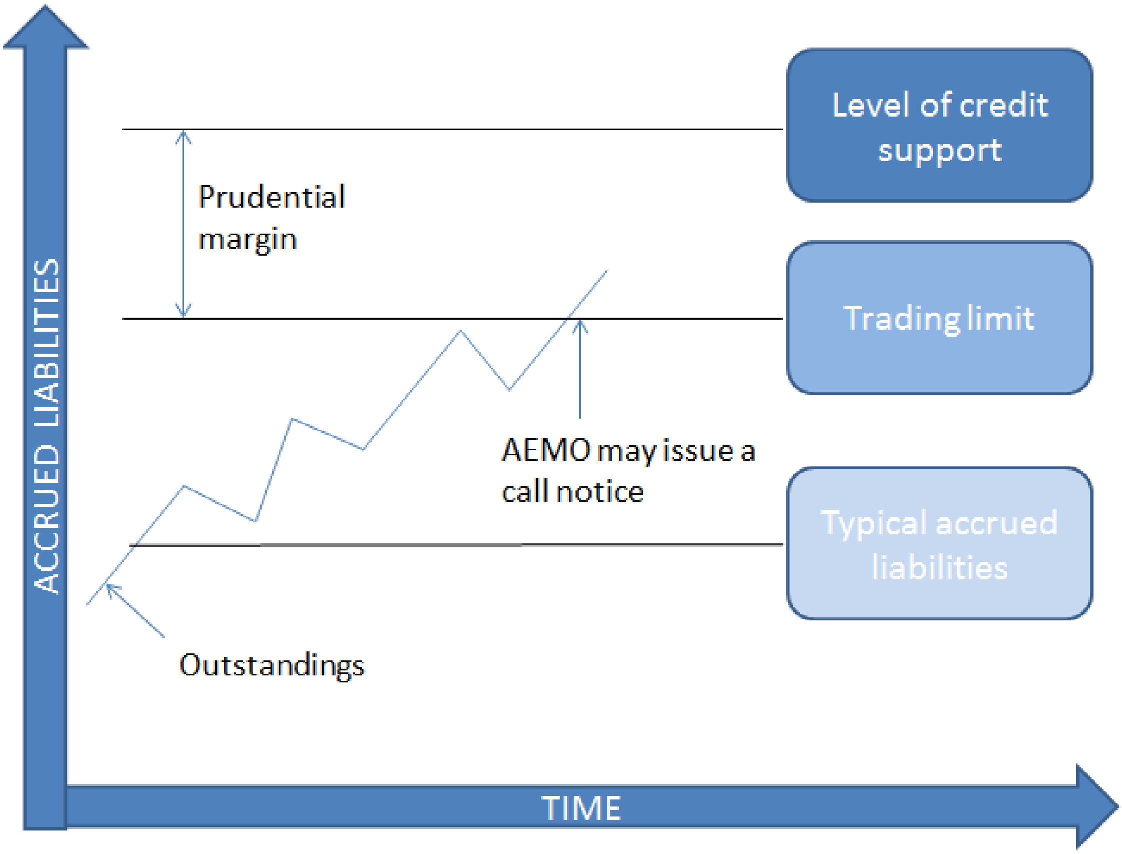
If a market participant's accrued net liabilities in the NEM are at any time greater than its *trading limit* AEMO may issue a *call notice* to the market participant. The net liabilities accrued by a market participant in the NEM are referred to as its "outstandings".[9]

Figure 2.1 below shows the *credit support* and *trading limit* concepts in the NEM prudential requirements. The figure also shows a market participant accruing *outstandings* over time and that when those *outstandings* are greater than the *trading limit* AEMO may issue a *call notice*.

8 The *prudential margin* is set by AEMO in accordance with clause 3.3.8 of the NER.

9 The level of *outstandings* of a market participant is determined in accordance with clause 3.3.9 of the NER.

**Figure 2.1 Prudential requirements in the NEM**




### 2.2.3 Responding to a call notice and the process to suspend a market participant

If a *call notice* is issued to a market participant, the market participant must respond by 11:00 am on the next business day (Sydney time) by reducing its *outstandings* to the level of "typical accrued liabilities". That is, the amount which AEMO determines would have been the *outstandings* of the market participant at that time if the wholesale market prices and the trading amounts of the market participant had been at average levels.[10] This amount is usually around 30 to 40 per cent of the *maximum credit limit*. A market participant may therefore need to significantly reduce its *outstandings* if a *call notice* is issued.[11]

As noted above, if a *call notice* is issued by AEMO the market participant must respond by 11:00 am the following business day. However, if a *call notice* is issued by AEMO after 12:00 pm, the *call notice* is deemed to have been issued on the next business day

10 The average levels are determined based on the average levels used by AEMO in the most recent determination of the market participant's *maximum credit limit*.

11 A market participant's *outstandings* can be reduced to the level of typical accrued liabilities by either providing AEMO with additional credit support (if this is agreed with AEMO), paying cleared funds to AEMO as a security deposit, or lodging a reallocations request. See clause 3.3.13(a) of the NER.

(so the market participant has an extra business day to respond).[12] It is this deadline that is the subject of this rule change request.[13]

If a market participant does not adequately respond to the *call notice*, AEMO may issue a default notice, which requires the market participant to rectify the default by a particular time, usually 1:00 pm on the following business day.[14] If the default is not rectified to the satisfaction of AEMO within the time prescribed in the default notice, AEMO may issue a suspension notice to the market participant.[15] This notice will set out the time from which the market participant is suspended from trading in the NEM. The suspension is announced publicly and takes effect from the midnight following that public announcement.

## 2.3 AEMO processes to issue a call notice

The NER provides that AEMO *may* issue a *call notice* to a market participant if its *outstandings* exceed its *trading limit*.[16] The NER does not provide that AEMO *must* issue a *call notice* at any particular time and does not set out any processes for AEMO to monitor the NEM prudential requirements.

Given the importance of prudential supervision of the NEM, AEMO has developed internal processes to monitor compliance with, and respond to breaches of, the prudential requirements of the NEM. AEMO publishes details of some of these processes.[17] AEMO's internal processes are carried out on each business day and those processes relevant to the timing of the issuance of *call notices* are:

- **8:00 am** - AEMO checks for any *trading limit* breaches by market participants;
- **9:00 am** - AEMO contacts any market participants that are in breach of their *trading limit*;
- **9:00 am to 10:30 am** - AEMO monitors the process of market participants in breach bringing their *outstandings* below their *trading limits*; and
- **10:30 am** - AEMO formally assesses the prudential position of all market participants and, for those market participants that are in breach of their *trading limit*, AEMO begins the process of drafting and issuing a *call notice*.

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12 See clause 3.3.13(b) of the NER.

13 This will be discussed in more detail in section 3.1 below.

14 See clause 3.15.21 of the NER.

15 See clause 3.15.21(c) of the NER.

16 However, if a call notice is issued, the NER will determine when the call notice is deemed to have been issued and when the market participant will need to respond to the call notice.

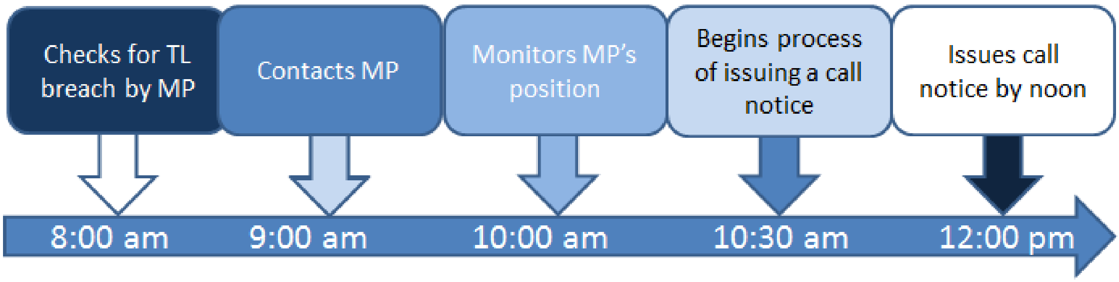
17 Certain parts of AEMO's internal processes are set out in the *NEM Settlement Prudential Supervision Process*, AEMO and also in Australian Energy Market Operator, *NEM Security Deposit Arrangements, version 11*, AEMO, 2011. Additional information in relation to AEMO's internal processes that have not been provided in these documents has been sourced from the rule change request.

AEMO begins the process of preparing and internally approving the issuance of a *call notice* at 10:30 am. This is done so that AEMO can issue a *call notice* by 12:00 pm which would mean that the market participant would be required to respond by 11:00 am on the next business day.[18]

To date, AEMO has never issued a *call notice*. However, we understand from AEMO that it is not uncommon for market participants to be in breach of their *trading limits* at the beginning of a business day. This particularly occurs when there has been a series of days in which electricity prices on the wholesale market have been high. We also understand that when this has occurred there has been a small number of occasions where a market participant has had difficulty managing its *outstandings* below its *trading limit* by 10:30 am due to administrative issues (such as, having difficulty contacting and arranging a transfer from its bank).

AEMO's daily prudential monitoring process is represented in figure 2.2 below.

**Figure 2.2 AEMO's daily prudential monitoring processes**




TL = trading limit
MP = market participant

## 2.4 Other relevant work of the AEMC

### 2.4.1 Futures Offset Arrangements rule change request

In 2009 the AEMC considered a rule change request (the Futures Offset Arrangements rule change request) that proposed linking the prudential requirements in the NEM with those in the Sydney Futures Exchange. Such arrangements are called "futures offset arrangements". The proposed rule change was not made, principally because of the difficulty and uncertainty in legal and other arrangements for linking the prudential requirements of the NEM with those of the Sydney Futures Exchange.

### 2.4.2 Review into the role of hedging contracts in the existing NEM prudential framework

The AEMC's *Final Report: Review into the role of hedging contracts in the existing NEM prudential framework*, published on 30 June 2010, recommended "that rules be amended

18 See rule change request, AEMO, at page 7.

to permit AEMO to issue a *call notice* by 1.00 pm, and for that *call notice* for the purposes of issuing the default notice, to be taken as being issued on the same business day."[19] This recommendation was made on the basis that other recommendations in the review would be accepted, including that there should be certain linkages between the prudential requirements in the NEM and the Sydney Futures Exchange. The recommendation was proposed to apply to all market participants and not only those that trade on the Sydney Futures Exchange.

### 2.4.3 NEM financial market resilience review

The AEMC is currently conducting a review of NEM financial market resilience.[20] This review is concerned with the extent to which the failure of one market participant could affect other market participants. The review is not specifically considering issues concerning *call notice* timing.

19 See Australian Energy Market Commission, *Final Report, Review into the role of hedging contracts in the existing NEM prudential framework*, AEMC, 2010 at page 122.

20 The project page for this current project can be found here: http://www.aemc.gov.au/Market-Reviews/Open/nem-financial-market-resilience.html.

# 3 Details of the Rule Change Request

## 3.1 The proposed rule change

Currently, if AEMO issues a call notice after 12:00 pm (Sydney time), it is deemed to have been given on the following business day. The market participant would then have an extra business day to respond to the call notice. The rule change request proposes to amend the NER to extend that time to 1:00 pm (Sydney time).

The rule change request includes a proposed rule as follows:

**Box 3.1: Proposed new rule 3.3.13(b)**

3.3.13(b) - if AEMO gives a *call notice* to a *Market Participant* after ~~noon~~ 1:00 pm (Sydney time), then AEMO is deemed to have given that *call notice* on the next *business day* for the purposes of this clause.

## 3.2 AEMO's issues with the current NER provisions regarding call notice timing

In the rule change request, AEMO outlines two concerns with the current rule in the NER regarding call notice timing.

The first concern raised by AEMO is that during eastern daylight savings time (when 9:00 am Brisbane time is 10:00 am Sydney time), Queensland based market participants can have difficulty rectifying breaches of their trading limits because:

- AEMO may have difficulty contacting the relevant person at the market participant at 9:00 am (Sydney time) which is before usual business hours in Queensland; and

- banks in Queensland may not be available before usual business hours to arrange for the transfer of cash or additional credit support to AEMO on behalf of a market participant.

The second concern raised by AEMO is that market participants currently cannot access settlements from the Sydney Futures Exchange to help rectify a trading limit breach before at 10:30 am (Sydney time). That is, the time that AEMO begins its internal process to issue a call notice by 12:00 pm.[21]

21 Most market participants trade financial products in electricity on the Sydney Futures Exchange in order to hedge their exposure on the wholesale electricity market. If the proposed rule is made the amounts received in settlements from the Sydney Futures Exchange could be aligned with the timing of payments to reduce *outstandings* to comply with the prudential requirements in the NEM.

### 3.3 AEMO's consideration of the National Electricity Objective

AEMO considers that the proposed rule would promote the National Electricity Objective (NEO).[22] In particular, AEMO considers that the proposed rule would promote the efficient operation of electricity services by:

- providing market participants with the ability to more efficiently manage their financial obligations in the NEM. AEMO considers this would occur because market participants would be able to utilise settlements from the Sydney Futures Exchange towards managing the participant's prudential obligations;
- improving the efficiency of the processes for the management of prudential obligations for both AEMO and market participants. AEMO considers that this would occur because less time would be spent by AEMO and market participants actively managing trading limit breaches; and
- providing Queensland based market participants with more time to manage their prudential obligations during eastern daylight savings time.

AEMO also considers that the proposed rule could promote the NEO by reducing the level of risk in the NEM. AEMO states that this is because market participants will have more time to remedy a trading limit breach before a call notice is issued, requiring the market participant to respond by reducing its outstandings or increasing its credit support by a significant amount.

### 3.4 AEMO's consideration of the expected costs and benefits of the proposed rule

AEMO expects that the proposed rule would allow market participants and AEMO to avoid certain administrative costs. These include the costs of actively managing those trading limit breaches that have occurred as a result of administrative difficulties between the market participant and its bank. AEMO also notes that it would avoid its current costs associated with beginning the process of drafting and approving call notices, which AEMO estimates is approximately $12,000 per year.

### 3.5 Consideration as a non-controversial rule

The Commission proposes to treat this rule change request as a non-controversial rule.

Under section 87 of the NEL, a "non-controversial Rule" is defined as:

> “a Rule that is unlikely to have a significant effect on the national electricity market”

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22 See Australian Energy Market Operator, *Rule Change Request: Extension of Call Notice Timing*, AEMO, 2013 at page 7.

Rule changes that are considered to be non-controversial may be processed under an expedited process, as provided under section 96 of the NEL. Any person or body may object to the making of a rule under this expedited process within two weeks of the publication of the notice of initiation of the rule change process under section 95 of the NEL. If the objection is not misconceived or lacking in substance the AEMC must follow the usual rule change process.

The AEMC will therefore proceed on an expedited basis unless a valid objection is received. Additional information on due dates for submissions and objections is contained in Chapter 6.

# 4 Assessment Framework

The Commission's assessment of this Rule change request must consider whether the proposed rule promotes the NEO as set out under section 7 of the NEL. The NEO states that:

> "The objective of this law 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."

Based on a preliminary assessment of this rule change request, the most relevant aspect of the NEO for consideration appears to be the efficient operation of electricity services with respect to the price of supply of electricity. This assessment has two aspects, including considering:

- the impact of the proposed rule on the level of risk in the NEM; and
- the impact of the proposed rule on the costs of supplying electricity in the NEM.

In relation to the first of these considerations we will consider the impact of the proposed rule on:

- the risk that a market participant would be required to respond to a call notice because of administrative issues (rather than its experiencing financial difficulties); and
- the risk that a market participant could accrue liabilities in the NEM for an additional business day before it is suspended from trading in the NEM.

With respect to the costs of supplying electricity, we will focus our assessment on any increases and reductions in costs over the long-term as a result of the proposed rule, compared with the status quo. This will include considering:

- the costs to AEMO and market participants of implementation of the proposed rule; and
- any reductions in costs over the longer term due to a greater ability for market participants to manage their prudential position without the need to interact with AEMO to actively manage trading limit breaches.

# 5 Issues for Consultation

Taking into consideration the assessment framework and the potential implementation of the proposed rule, we have identified a number of issues for stakeholder consultation. These issues are provided for guidance only. Stakeholders are encouraged to comment on these issues as well as any other aspect of the rule change request or this paper, including the assessment framework set out in Chapter 4.

## 5.1 Risk in the NEM

The proposed rule may impact upon the level of risk in the NEM. The impact could occur in a number of ways, including:

- a reduced risk that a market participant would be required to respond to a call notice because of administrative issues; and
- a reduced risk that a market participant could accrue liabilities in the NEM for an additional business day before it is suspended from trading in the NEM.

The issuance of a call notice formally begins the process to suspend a market participant that cannot pay its liabilities in the NEM. The aim of this process is to protect the NEM from a market participant incurring liabilities beyond the level of credit support it has posted. Given this, a call notice should generally only be issued because a market participant is experiencing financial difficulties and not because the market participant is having difficulty contacting its bank or some other administrative difficulty.

If AEMO changes its internal processes to align with the new timing in the proposed rule, market participants will have an additional hour to manage trading limit breaches before AEMO begins the process of drafting and approving the issuance of a call notice. This could in turn reduce the risk that a call notice is issued due to an administrative rather than a significant financial issue for a market participant.

If the proposed rule is made, it may be more likely that a call notice would be issued that needs to be responded to on the next business day. It would therefore be less likely that a market participant would have an additional business day to respond to the call notice. Due to weekends and public holidays, one business day could amount to multiple days trading in the NEM.

The proposed rule may therefore reduce the risk that the market participant could accrue liabilities beyond the amount of credit support that it has posted with AEMO. This would translate to a reduced risk that other market participants would bear losses because the defaulting market participant cannot meet its payment obligations in the NEM.

**Question 1 Risk in the NEM**

**(a) Would the proposed rule reduce the risk that a market participant would be required to respond to a call notice because of administrative issues?**

**(b) Would the proposed rule reduce the risk that a market participant could accrue liabilities in the NEM for an additional business day before it is suspended from trading in the NEM?**

**(c) Could the proposed rule in any way increase risk in the NEM for AEMO, market participants or consumers?**

## 5.2 Costs and benefits of the proposed rule

If the proposed rule is made, allowing AEMO to change its internal processes to align with the proposed rule, both AEMO and market participants would incur costs associated with the implementation of the proposed rule. There may equally be cost reductions in the long-term. These impacts on costs will flow through to consumers because ultimately all costs associated with the supply of electricity are paid by consumers. It is therefore important to determine whether the costs associated with the proposed rule outweigh the benefits in the long-term.

Increased costs resulting from the proposed rule could include:

- AEMO's costs of amending its processes for monitoring compliance with NEM prudential requirements;[23] and
- costs to market participants associated with changing internal prudential obligation management processes in response to any changes that AEMO makes to its processes for monitoring prudential requirements.

Reduced costs resulting from the proposed rule could include:

- reduced costs for AEMO associated with drafting call notices (which AEMO has estimated at approximately $12,000 per year); and
- reduced costs for AEMO and market participants associated with actively managing trading limit breaches in the lead up to the time at which AEMO begins the process of drafting and issuing a call notice.

23 See for example *NEM Settlement Prudential Supervision Process, version 13.1*, AEMO, 2009 and *NEM Security Deposit Arrangements, version 11*, AEMO, 2011.

**Question 2 Costs and benefits of the proposed rule**

**(a) Over the long-term, would the benefits of implementing the proposed rule outweigh the costs?**

**(b) Are there any other costs or benefits of implementing the proposed rule that have not been identified in this paper?**

# 6 Lodging a Submission

The Commission has published a notice under sections 95 and 96 of the NEL for this rule change request:

- noting that stakeholders may make a written request not to make a rule under the expedited process; and
- inviting stakeholders to provide written submissions on the rule change request.

Objections to the making of a rule under the expedited process are to be lodged by 15 May 2014. Submissions on the rule change request are to be lodged by 29 May 2014. Any objections or submissions are to be lodged online or by mail in accordance with the requirements set out below.

Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on rule change requests.[24] The Commission publishes all submissions on its website, subject to considering any claim of confidentiality.

All enquiries on this project should be addressed to Dominic Adams on (02) 8296 7800.

## 6.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code "ERC0163". The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

## 6.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0163

24 This guideline is available on the Commission's website.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

## Abbreviations

| | |
|---|---|
| AEMC | Australian Energy Market Commission |
| AEMO | Australian Energy Market Operator |
| Commission | See AEMC |
| NEL | National Electricity Law |
| NEO | National Electricity Objective |
| NER | National Electricity Rules |