Australian Energy Market Commission

RULE CHANGE

NEW PRUDENTIAL STANDARD AND FRAMEWORK IN THE NEM, SECOND CONSULTATION PAPER

National Electricity Amendment (New Prudential Standard and Framework in the NEM) Rule 2012

Rule Proponent

Australian Energy Market Operator

27 August 2012

For and on behalf of the Australian Energy Market Commission

Inquiries

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AEMC 2012, ERC0133, New Prudential Standard and Framework in the NEM, Second Consultation, 27 August 2012 , Sydney

About the AEMC

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

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1 Introduction

On 27 July 2011, the Australian Energy Market Operator (rule proponent, AEMO) made a request to the Australian Energy Market Commission (AEMC) to make a rule to implement a new prudential standard and framework in the National Electricity Market (NEM)[1] (rule change request). The request included a draft rule, and an attachment that set out the proposed arrangements to amend AEMO's procedures for the calculation of the necessary level of credit support by debtor participants to AEMO.

The AEMC subsequently published a consultation paper[2] on 20 October 2011 which explored the background and detail of the rule change request. A draft determination was published on 12 April 2012, stating the AEMC's intent to make the proposed rule, with some amendments.

AEMO made a submission to the draft determination raising an issue relating to the calculation of the Prudential Margin, noting that it does "not permit the inclusion of reallocation credits to be offset against load, however generation credits can be fully offset against load[3]" (AEMO's submission). AEMO contend that this feature of the calculation should be amended, arguing "the current offset arrangement does not appropriately reflect the respective prudential benefits of reallocation and generation credits".

AEMO propose amendments to replace clause 3.3.8(e) as it is drafted in the draft rule. The provisions in this clause (currently contained in Schedule S3.3.2 of the existing rules) prevents netting of positive reallocation amounts against load in the calculation of the Prudential Margin. The amended clause would instead grant all types of netting in the first instance, but then allow AEMO to reduce the contribution of assumed positive amounts (including from generation and positive reallocations) to the Prudential Margin if or when it considers there to be a risk that the positive amounts would not materialise during the reaction period.

The AEMC considers that the issue as raised falls within the scope of this rule change. The AEMC has decided to publish this Second Consultation Paper and extend the rule change process using the provisions set out in Section 107 of the National Electricity Law (NEL) in order to seek submissions from interested stakeholders on AEMO's submission. Section 107 of the NEL permits the AEMC to extend the period of time for making of a final Rule determination where there are "issues of sufficient complexity or difficulty or there is a material change in circumstances" such that it is necessary that the relevant period of time to make a final determination and final rule is extended.

The AEMC considers that the issue identified in AEMO's submission is of such significance as to require additional consultation. The AEMC published a notice under

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1 AEMO, National Electricity Rule Request - New Prudential Standard and Framework

2 AEMC, National Electricity Amendment (New Prudential Standard and Framework in the NEM) Rule 2011.

3 AEMO, NEM Prudential Standard and Framework Draft rule Determination - ERC0133, 9 July 2012

Section 107 on 26 July 2012 extending the period of time allowed for the making of a final determination to 18 October 2012.

2 Issue for additional consultation

2.1 Netting of credit and debit amounts in the Prudential Margin

The AEMC considered netting of credit and debit amounts in the Prudential Margin in its final recommendations as part of the review into the role of hedging contracts in the NEM prudential framework[4]. The AEMC recommended "that:

- a rule change be made to specify that AEMO must determine the Prudential Margin of a gentailer based on the gentailer's estimated load; and
- AEMO review its procedures on load profiling to ensure that any Maximum Credit Limit reduction for gentailers reflects the risk of any mismatch between the load profiles of a gentailer's estimated load and generation.

The AEMC proposes to amend S3.3.2 (1) of the Rules relating to the principles for the determination of the prudential margin, by substituting "if the aggregate of all" with "if any"."

That final statement would effectively make positive generation amounts unable to be used to net against load in calculating the Prudential Margin for those participants with both load and generation.

These recommendations were made in the context of the standing prudential framework, and were intended to "improve the consistency with reallocation arrangements and the effectiveness of risk management...", and to allow the profile of gentailer load to be better reflected in the calculation.

We believe there may be merit in AEMO's submission[5] that under the new prudential framework built around a statistical probability of loss given default, a 'first principles' approach to improving the consistency in the Prudential Margin calculation may be warranted.

2.2 The proposed provisions

AEMO's proposal is to replace the clauses set out in the AEMC's draft rule determination (where clause S3.3.2(1) is moved to clause 3.3.8(e)) with provisions that "would allow AEMO to limit credit offsets where there is a reasonable probability that the offset may not be effective during the reaction period". The clause as drafted by AEMO also requires AEMO to have regard to the prudential standard when deciding whether there is a risk that the offset may not be effective, and prevents the calculation from yielding a negative value for the Prudential Margin.

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4 AEMC, Final Report - Review into the role of hedging contracts in the existing NEM prudential framework, July 2010

5 AEMO, NEM Prudential Standard and Framework Draft rule Determination - ERC0133, 9 July 2012

3 Proposed additional rules amendments

The below is taken from AEMO's submission to the draft determination, with minor formatting amendments.

Clause 3.3.8(e)

In determining the *prudential margin*, AEMO must take the following factors into consideration:

1. Where AEMO considers there to be a risk that a *Market Participant's prospective reallocations* may cease or be deregistered during the *reaction period*, the corresponding *reallocation amounts* must be reduced accordingly;

2. Where AEMO considers there to be a risk that a *Market Participant's* positive *trading amounts* may cease during the *reaction period*, the corresponding positive *trading amounts* must be reduced accordingly;

3. In assessing the risk, AEMO will have regard to the prudential standard; and

4. The *prudential margin* cannot be negative.

4 AEMC's considerations

4.1 Potential impact of proposed provisions

The proposed rule as contained in AEMO's submission would give AEMO the discretion to disallow elements from the calculation of the Prudential Margin for participants. AEMO contend that the means by which they would generally approach the exercise of this discretion would be by way of consultation on the Credit Limit Procedures. A possible set of assumptions that might generally apply are that:

- all reallocation amounts will be effective during the reaction period; and
- the generation from the largest generator in a portfolio will not be effective during the reaction period.

AEMO provide several test cases for consideration in their submission to support these potential assumptions. The impact of the first assumption would be to lower the Prudential Margin that would apply to stand-alone retailers which have significant prospective reallocations, relative to the rules in place presently. By contrast, the second assumption would increase the Prudential Margin for retailers with generation relative to the rules in place currently. This would be expected because the existing rules automatically fully net generation against load, by only testing the aggregate of the two in constraining the offsetting in the calculation.

Aside from procedures developed under consultation, the clause would also give AEMO the ability to reduce a retailer's assumed offsets in response to prevailing circumstances where AEMO considers that there is a risk that an offset may cease to be effective during the reaction period.

4.2 The National Electricity Objective

The proposal may have merit with regard to the National Electricity Objective (NEO). The prudential standard, though defined using a statistical measure under the rule change, will not stand in isolation. It will combine with the other input assumptions[6] used in the Credit Limits Procedures to deliver the out-turn 'protection from default' for generators participating in the NEM.

With this in mind, it is important that necessary input assumptions to the methodology are realistic and reasonable. Further, it is possible that the implicit assumptions currently in place - that netting generation is always effective during a retailer default, while reallocations are not - may not be the most reasonable assumptions that could applied.

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6 As noted in the first consultation paper, the reaction period of seven days is an example of an assumption that combines with the value of the prudential standard to deliver the prudential quality or effective 'protection from default' for the NEM.

In this way it is likely that the NEO could be promoted by pursuing transparent and reasonable input assumptions. This could help to improve confidence in the robustness and effectiveness of the prudential framework, improve the climate for investment and thereby promote better outcomes for consumers with regard to price and reliability over the long term.

4.3 AEMC invites submissions

The AEMC invites submissions regarding the merit of the proposal put forward by AEMO in their submission to the draft determination. Respondents may wish to consider any implications the proposal may have on other aspects of the broader rule change in their responses. Some specific questions for consideration are laid out below.

Question 1 Amending the Prudential Margin calculation

Should clause 3.3.8(e) as it appears in the draft determination be amended; such that all forms of positive and negative elements are able to be included in calculating the Prudential Margin that applies to a participant?

Question 2 AEMO's ability to discount elements

Should AEMO be granted the ability to reduce the assumed contribution of reallocation and trading amounts in the calculation of the Prudential Margin to allow for situations in which those elements may not be effective during the reaction period?

Question 3 Constraining AEMO's ability to discount elements

If 'yes' is the answer to Question 2, what guidelines, if any, should be included in the rules to guide AEMO's decision making when using its discretion to discount elements from the PM calculation?

Question 4 Reference to the prudential standard

AEMO's drafting requires AEMO to 'have regard' to the prudential standard when assessing the risk that the offset amounts may not be effective. Is this an appropriate obligation to include in the clause?

Question 5 Non-negative prudential margin

AEMO's drafting prevents the Prudential Margin from being negative. Is this an appropriate constraint?

5 Lodging a Submission

The AEMC has published a notice under section 95 of the NEL for this Rule change proposal inviting written submission. Submissions are to be lodged online or by mail by 21 September 2012 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the AEMC's Guidelines for making written submissions on Rule change proposals.[7] The AEMC publishes all submissions on its website subject to a claim of confidentiality.

All enquiries on this project should be addressed to Paul Bell on (02) 8296 7800.

5.1 Lodging a submission electronically

Electronic submissions must be lodged online via the AEMC's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code "ERC0133". The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the AEMC 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.

5.2 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 AEMC
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: ERC0133.

Except in circumstances where the submission has been received electronically, upon receipt of the hard copy submission the AEMC 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.

7 This guideline is available on the AEMC's website.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective