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

Draft recommendations and reasoning

Rory Campbell / Kamlesh Khelawan
Senior Director / Director

AEMC offices
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Review process

- Terms of reference published - Jan 2009
  - definition of scope
- Working Group established to provide advice - Feb 2009
- Consultation on Framework and Issues Paper – Mar 2009
  - assessment framework, matters for investigation
- Request for Proposal developed for risk assessment – Jun 2009
  - main deliverables, working examples of FOA models
- PricewaterhouseCoopers report on risk assessment – Feb 2010
- Legal advice from Allens Arthur Robinson – Dec 2009
- Publication of Draft Report – Mar 2010

Assessment framework

- National Electricity Objective (NEO) and following assessment criteria:
  - maintain or improve prudential quality of the NEM;
  - maintain or reduce cost of capital to trade in the NEM wholesale market; and
  - ensure operational effectiveness.
- Tested against current arrangements.
- Draft recommendations are likely to reduce costs to Market Participants whilst maintaining confidence in settlement of spot market electricity transactions.

MCL methodology

Reasonable worst case scenario, MCL methodology

Maximum credit limit (MCL)

- Two objectives:
  - – interpret the “reasonable worst case” performance target (“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”).
  - – examine opportunities to improve on current MCL methodology (i.e. approach to meeting the target).

- Alternative approaches to determination of the Maximum Credit Limit (MCL)
  - historical prices;
  - futures prices;
  - stress test approach;
    - – e.g. based on CPT with the remainder at the APC
  - Hybrid.

Draft recommendations on MCL

- Consensus that further work is required on both the “reasonable worst case” and MCL methodology.

- Commission recommends that AEMO continue with this work:

  – examine appropriateness of 98^{th} percentile 7-day load weighted price observation as “reasonable worst case” for PM and load weighted average price as the minimum TL; and if suitable

  – develop a MCL methodology that would best meet this target.

- The Commission suggests that a distinction be made between the calculation on the PM and MCL, in the context of the prudential supervision process.

Integrating futures and other types of contracts

Reallocations, Futures Offset Arrangements – including internal offsets

Draft recommendations – offsets generally

- Security deposit accounts and clawback risk (3.2.1)
  - not material for reallocation arrangements
  - FOA arrangements can also be implemented in similar manner
- Contractual basis for offset arrangements (3.2.2)
  - be based on hedge contracts (OTC or futures)*
  - recommended that this be a civil penalty provision
- Volume of energy under offsets (3.2.3)
  - no limit on offsets
  - MCL relief be capped at average load

* Implemented by Rule

Draft recommendations – offsets generally

- Load profile risk (3.2.4)
  - adequate procedures are in place
  - AEMO to develop and publish principles and/or procedures
- Licensing considerations (3.2.5)
  - matter for consideration by AEMO and ASIC
  - Reallocations and FOAs designed to reduce costs of participation in the NEM wholesale market without materially impacting on the prudential quality of the NEM
- Fundamental change to markets (3.2.6)
  - AEMO may choose not to register offset arrangements by providing advance notice, if in its reasonable opinion to do so, would have a material impact on the prudential quality of the NEM*

* Implemented by Rule

Draft recommendations – reallocations

- Clawback risk (uncommercial transaction) (3.3.1)
  - based on advice, reallocations are not likely to be uncommercial, defences available to AEMO.
- Termination risk to NEM (3.3.2)
  - risk is not material and is effectively managed
  - sequence of event for risk to be realised make it a low probability
- Termination risk to retailers (3.3.3)
  - AEMO examine providing early warning when a party to a reallocation arrangement has been issued a call notice.

* Implemented by Rule

Draft recommendations – FOAs

- Termination risk (3.4.2)
  - additional prudential margin
  - AEMO hold irrevocable power of attorney over payments a retailer entitled to from CSA with the SFECP in respect of futures contracts underlying an FOA
- Variation margin payment (3.4.3)
  - futures margin payment with reference to the future lodgement price + a floor to ensure that margin is sufficient to meet outstandings for energy under FOA*
  - margins payments to be returned when futures price falls subject to sufficient security being held to meet outstanding for energy under FOA*

* Implemented by Rule

Draft recommendations – FOAs

- FOAs and RMCL (3.4.4)
  - MCL for load under FOA based on futures lodgement price*
- SFECPs to provide timely information to AEMO on status of futures contracts subject to FOA (3.4.5)
- A Market Participant must pay variation margin as determined by AEMO*
- AEMO may terminate FOA for breach of terms*

* Implemented by Rule

Draft recommendations – internal offsets

- Internal netting
  - maintain a prudential margin for internally offset load*
  - AEMO review procedures to ensure load profile risk of internal offsets is effectively managed

* Implemented by Rule

Rules versus procedure

- Rules:
  - generally more appropriate for substantive rights and obligations that have material impact on the NEM and NEM Participants
  - deal with matters that are likely to change relatively infrequently over time
  - address matters that have industry wide application

- Procedures:
  - more appropriate for technical and operational matters
  - deal with matters that rely on an assessment of individual market participant conditions or circumstances

- Commission seeks views on the appropriate balance between Rules and procedures

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