



Australian Energy Market Commission

Draft Rule Determination

**Draft National Electricity Amendment (Reallocations) Rule
2006**

Rule Proponent
NEMMCO

23 November 2006

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For and on behalf of
Australian Energy Market Commission

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy market. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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Contents

SUMMARY	1
1 NEMMCO's Rule Proposal	3
1.1 Summary of the Rule Proposal	3
1.2 Context for Reallocations	5
2 Draft Rule determination	6
2.1 The Commission's power to make the Rule	6
2.2 Assessment of the draft Rule: the Rule making test and the national electricity market objective	7
2.3 Consultation on the NEMMCO proposal	8
2.4 Joint submission from 20 NEM participants	8
3. Commission's analysis of the Proposed Rule	10
3.1 Status of Reallocator in the NEM	11
3.1.1 NEMMCO's proposal	11
3.1.2 Submissions	11
3.1.3 The Commission's consideration and reasoning	12
3.1.4 The Commission's finding in relation to this issue	13
3.2 New reallocation procedures	13
3.2.1 NEMMCO's proposal	13
3.2.2 Submissions	13
3.2.3 The Commission's consideration and reasoning	14
3.2.4 The Commission's finding in relation to this issue	15
3.3 Changes to existing prudential requirements	16
3.3.1 NEMMCO's proposal	16
3.3.2 Submissions	16
3.3.3 The Commission's consideration and reasoning	16
3.3.4 The Commission's finding in relation to this issue	17
4. Differences between the Proposed Rule and the Draft Rule	18
Appendix A: Analysis of the proposed changes to the existing prudential requirements	19
A1.1 Prudential Requirements of Generator	20
A1.2 Prudential Requirements of Retailer	21
Appendix B: Draft Rule	22

SUMMARY

On 4 April 2006, the National Electricity Market Management Company (NEMMCO) lodged a Rule change proposal to introduce robustness and increased flexibility in market settlement reallocations. The Rule change proposal is intended to allow for the development of the recognition of generic financial market contracts, including futures, which are currently traded to hedge the market risk of market participants, within the National Electricity Market (NEM) settlements procedures. Additionally, NEMMCO is seeking to tighten the prudential market framework to adequately address the credit exposure of a reallocating market participant.

The Proposed Rule has three main elements:

- first, the introduction of a new category of registered participant, a Reallocator, whose participation in the NEM would be limited to reallocations;
- second, the removal of the procedural details of reallocations from the Rules and placing them in separate reallocation procedures that would be established and maintained by NEMMCO, in accordance with the Rules consultation procedures; and
- third, the improvement of prudential requirements of market participants to better manage NEMMCO's credit exposure to those participants who reallocate.

The Australian Energy Market Commission (Commission) published the Rule proposal in accordance with section 95 of the National Electricity Law (NEL) and submissions closed on 11 August 2006. The Commission received five submissions at this stage of consultation.

A joint submission representing 20 interested parties raised a number of detailed issues that went beyond the scope of the NEMMCO Rule change proposal. The submission did not address the particular approach presented by NEMMCO, and also raises questions about prudential regulation that are beyond the scope for the Commission to consider without more detailed information. In any event, these are matters that should be further discussed between the 20 interested parties and NEMMCO and may be incorporated through the draft Rule reallocation procedures developed by NEMMCO, or through a further Rule change proposal.

The key elements of the draft Rule are:

- **Providing for a new category of registered participant - a Reallocator.** The draft Rule provides for financial institutions and other entities to become a registered participant for the purpose of participating in a reallocations transaction;
- **Improving flexibility in reallocation procedures.** The draft Rule requires NEMMCO to develop and maintain reallocation procedures, in accordance with the Rules consultation procedures provided in Chapter 8 of the Rules. This will allow reallocation procedures to adapt in response to changing market circumstances; and
- **Changes to prudential requirements.** To better address the prudential risks associated with market participants who reallocate or generators who have

market load, the draft Rule changes the approach to the provision of prudential requirements by providing for a prudential margin according to the anticipated credit risk associated with each market participant.

The Commission is satisfied that NEMMCO's proposed Rule change would contribute to the NEM objective and in this draft Rule determination has approved NEMMCO's proposed Rule changes, with some modifications.

Submissions on the draft Reallocations Rule and determination should be received by 25 January 2006.

Submissions can be sent electronically to submissions@aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box H166
Australia Square NSW 1215
Fax (02) 8296 7899

In accordance with section 101 of the NEL, any interested person or body may request that the AEMC hold a hearing in relation to the draft Rule and determination. Any request must be received no later than 30 November 2006.

1 NEMMCO's Rule Proposal

On 4 April 2006, the Commission received a Rule change proposal from the National Electricity Market Management Company (NEMMCO) requesting that the Australian Energy Market Commission (Commission) make a Rule to introduce robustness and increase flexibility in market settlement reallocations.¹ The Rule change proposal is intended to provide settlement reallocations that reflect generic financial market contracts, including futures contracts, which are currently traded by participants in the National Electricity Market (NEM) to hedge their market risk. In addition, NEMMCO is also seeking to tighten up the prudential market framework to better address the credit exposure of a reallocating market participant.

In the remainder of this section, the NEMMCO proposed Reallocations Rule is summarised. In addition, the context for the proposed Rule is explained, including a discussion of the problem that the proposed Rule is seeking to address.

1.1 Summary of the Rule Proposal

NEMMCO's Rule change proposal is essentially in three parts:

1. the introduction of a new category of registered participant, a Reallocator, whose participation in the NEM would be limited to reallocations;
2. the removal of the procedural details of reallocations from the Rules and placing them in separate reallocation procedures that would be established and maintained by NEMMCO, in accordance with the Rules consultation procedures; and
3. the improvement of prudential requirements of market participants to better manage NEMMCO's credit exposure to those participants who reallocate.

NEMMCO has identified that the current Rules do not permit a clearing participant of the futures exchange, or any other relevant party, to become a party to a reallocation arrangement. The first part of NEMMCO's proposal is the introduction of a new category of registered participant, called a Reallocator, which would permit any two market participants to be parties to a reallocation, including financial institutions.

The inclusion of financial institutions as reallocation parties enables those market participants with futures positions through a financial institution (such as a clearing participant of the futures exchange) a mechanism to leverage the value of their futures, which are used as risk management instruments, to be recognised in the NEM. This would particularly benefit electricity retailers who extensively use futures contracts or who are not able to negotiate a reallocation agreement with a generator.

NEMMCO also believes that moving the procedural details of reallocations from the Rules and placing them into a separate reallocation procedures document will

¹ A process under which two market participants request NEMMCO to make matching debits and credits to the position of those market participants with NEMMCO. Further detail provided in section 1.2 of this determination.

provide increased flexibility so that reallocations may accommodate a broader range of common types of hedges (such as caps, floors and collars)² that would improve prudential efficiencies. This is the second part of the proposal. By requiring these procedures to be amended in accordance with the Rules consultation procedures contained in Chapter 8 of the Rules, the reallocations procedures will be able to be more easily amended. This will allow additional reallocations options to be offered, for example the ability to net the value of financial contracts directly against the physical energy transactions of market participants, or allowing the full settlement value of common hedging instruments to be applied to the settlement statements of reallocation transactions.

NEMMCO argues that by using these types of reallocation alternatives, market participants could reallocate the full, or at least a major portion of, the settlement value of their basic hedging instruments so that there is a more stable and predictable NEM settlement and with little residual transactions required directly between the contracting parties. As a consequence, the direct financial contract settlement risk between the allocating partners can also be reduced.

NEMMCO is also proposing that these new reallocation procedures be established and maintained by NEMMCO, in accordance with the Rules consultation procedures, to provide an open and transparent consultative approach to the development of the procedures, which may in turn result in a better uptake and use of reallocations.

The third aspect of the proposal addresses NEMMCO's concerns that the implementation of a more effective settlement reallocation regime also brings increased prudential risks associated with allowing participants to enter into large volume settlement reallocation agreements. NEMMCO has identified that the present prudential framework does not adequately address the implications of a generator reallocating to a substantial level, and then experiencing difficulty in fulfilling their side of the reallocation transaction, such as through a plant failure or an industrial dispute during a period of high spot prices. Such a continuing situation could result in the generator's ongoing settlement reallocation liabilities exceeding the value of their generation income, so that the generator would owe money to NEMMCO but, at present, does not provide any form of credit support to manage such a liability.

NEMMCO argues that the current Rules have an implied concept of "prudential margin", which is the difference between the trading limit and the credit support provided by a participant. This prudential margin is equivalent to seven days' reasonable worst-case trading. NEMMCO's proposal formalises this concept and also applies this same margin to the reasonable worst-case scenario for generators, thus ensuring that all participants in market settlement reallocations may now be required to provide some form of credit support.

² 'Cap' is a financial market option that allows for an upper limit on the price the holder will pay for electricity; 'floor' is an option that ensures that no matter how low spot prices in the NEM fall, the minimum price for the quantity of electricity is specified in the option; and 'collars' are financial market instruments that combine both a cap option and a floor option.

NEMMCO believes that its proposal would contribute to the achievement of the NEM objective by improving the efficiency of the prudential arrangements within the market. This, in turn, would result in reductions in:

- participant risk and market failure risk;
- required prudential support by retailers;
- levels of security deposits needed to stay below trading limits;
- short payments to generators;
- cash management costs; and
- direct credit exposure between market participants.

NEMMCO argues that all of these benefits would lead to more efficient investment in the NEM, which serves the long-term interests of customers.

NEMMCO believes that the creation of a more effective net settlement regime has the potential to benefit all market participants by reducing financial risks for all parties, reducing collateral costs, reducing circular cash flows in the market, and enhancing market stability through improved linkages between the spot and financial markets.

1.2 Context for Reallocations

In the NEM, a settlement reallocation is a Rules-supported voluntary risk management tool between NEMMCO and a pair of market participants. Settlement reallocation is a mechanism by which market participants can bundle cash flows arising from their bilateral hedge transactions with the cash flows arising from their spot market activity, for the purpose of settlement. In this way, it allows for 'netting' between the spot and hedge markets, and is particularly effective at times of extremely high electricity prices.

NEMMCO believes that reallocation has the capacity to significantly improve the efficiency of the NEM prudential framework, in relation to costs and risks. However, there are currently barriers to the uptake of reallocations such that there has been no significant reduction in total market exposure.

The current Rules only recognise reallocation of an energy quantity or a defined dollar amount, in advance of real time settlement. The existing Rules do not allow settlement reallocations that closely reflect the settlement requirements of generic financial market contracts.

As a result, current reallocations have had little use and the NEM settlements market continues to represent mainly the spot market transactions. These spot market transactions can be very large and volatile, with inherent financial settlement risk.

Furthermore, some parties in the NEM have sought to have futures contracts become part of a reallocation transaction. However, the current Rules do not permit a clearing participant of a futures exchange, or any other relevant party, to become a party to a reallocation arrangement. NEMMCO and stakeholders believe that the current structure of the Rules do not readily accommodate the reallocation alternatives that could improve prudential efficiencies in the settlements market.

2 Draft Rule determination

The Commission has determined in accordance with section 99 of the National Electricity Law (NEL) to make, with amendments, the draft Rule. A draft of the Rule to be made (the draft Rule) is attached to this determination, which is different to the proposed Rule put forward by the proponent.

This determination sets out the Commission's reasons for making the draft Rule. The Commission has taken into account:

1. the Commission's powers under the NEL to make the Rule;
2. the proponent's Rule change proposal and proposed Rule;
3. submissions received; and
4. the Commission's analysis as to the ways in which the Rule will or is likely to contribute to the promotion of the NEM objective so that it satisfies the statutory Rule making test.

2.1 The Commission's power to make the Rule

The Commission is satisfied that the draft Rule falls within the subject matters for which the Commission may make Rules, as set out in section 34 of the NEL and in Schedule 1 to the NEL.

The draft Rule relates specifically to item 34(1) of the NEL, which states that:

"...the AEMC, in accordance with this Law and the Regulations, may make Rules, to be known, collectively, as the "National Electricity Rules", for or with respect to regulating –

- (a) the operation of the national electricity market; and
- (c) the activities of persons (including Registered participants) participating in the national electricity market or involved in the operation of the national electricity market."

The draft Rule also falls under the following subject matter items under Schedule 1 of the NEL, namely:

- item 1. the registration of persons as Registered participants or otherwise for the purpose of this Law and the Rules, including the deregistration of such persons or suspension of such registrations;
- item 3. prudential requirements to be met by a person –
 - (a) before being registered as a Registered participant; and
 - (b) as a Registered participant;
- item 4. the suspension of Registered participants from participation in the wholesale exchange operated and administered by NEMMCO; and
- item 34(a). the payment of money (including the payment of interest) for the settlement of transactions for electricity or services purchased or supplied through the wholesale exchange operated and administered by NEMMCO.

2.2 Assessment of the draft Rule: the Rule making test and the national electricity market objective

The Rule making test requires the Commission to be satisfied that a Rule that it proposes to make will contribute to the NEM objective.

The test requires the Commission to consider the implications of the proposed new Rule, for efficient investment in, and efficient use of these electricity services, in respect of price, quality, reliability and security of supply, and reliability, safety and security of the NEM, which impact on the long term interests of end users of electricity.

The Proposed Rule seeks to provide increased flexibility to market participants on their approach to managing settlements within the NEM. The Proposed Rule, by improving flexibility surrounding reallocations, allows market participants to manage prudential requirements within the Rules. As NEMMCO indicates:

“A non-trivial cost of participating in the NEM is that associated with complying with prudential requirements imposed by the Rules. The requirement on parties with expected trading debits to source and provide financial guarantees imposes a cost on those parties proportionate to the size of the guarantee.”³

NEMMCO highlights that:

“To the extent that any cost of this nature is higher than it needs to be:

- investment signals will be skewed; and
- operational costs (including the cost of credit support and risk premiums imposed on trades between Market Participants) will ultimately be passed to end users in the form of higher prices.”⁴

The draft Rule substantially accepts the Proposed Rule by improving the flexibility of the procedures for reallocations to respond to changing market circumstances by moving detailed matters to procedures and out of the Rules; defining a new category of registered participant, called a Reallocator, to allow for financial institutions to participate in the NEM settlement procedures and thereby providing greater reallocation flexibility; and providing for a prudential margin in the Rules. The Commission believes that the draft Rule promotes the NEM objective by allowing for market participants to better manage their market trading risks and credit exposure.

The Commission has applied the Rule making test to the draft Rule, as modified by the outcomes of analysis and discussion in section 3 of this determination. The Commission is satisfied that the draft Rule is likely to promote the NEM objective. Section 3 presents the Commission’s reasoning as to the issues raised by NEMMCO’s proposal and how it satisfies the NEM objective and the statutory Rule making test.

³ NEMMCO Proposal, 27 March 2006, p13

⁴ NEMMCO Proposal, 27 March 2006, p13

2.3 Consultation on the NEMMCO proposal

NEMMCO submitted its Rule change proposal to the Commission on 4 April 2006.

On 29 June 2006, under section 94 of the NEL, the Commission determined to commence initial consultation on this proposal by publishing a notice under section 95 of the NEL. The Rule change proposal was open for public consultation for six weeks. Submissions closed on 11 August 2006.

On 21 September 2006, given the technical and complex nature of the proposal, the submissions received, and the possible impacts on the financial settlements market, the Commission published a notice under section 107 of the NEL extending the publication of the draft Rule determination and draft Rule until 30 November 2006.

The Commission received five submissions on the proposed Rule change at the first round of consultation, which are available on the Commission's website. The Commission received submissions from:

- Energy Response Pty Ltd (Energy Response);
- Energy Retailers Association of Australia (ERAA);
- Joint Submission from 20 NEM Industry Participants (JS20);
- Australian Stock Exchange (ASX); and
- National Generators Forum (NGF).

The submissions were broadly supportive of the underlying principle for the need for this Rule change, that is, that existing reallocation arrangements are not utilised at a level that has any material effect on prudential requirements in the NEM. However, some of the submissions discussed other financial market arrangements and considerations that are outside the scope of this Rule change proposal. These are discussed further in section 3 of this determination.

The NEL also requires the Commission to have regard to any MCE statements of policy principles in applying the Rule making test. The Commission notes that currently, there are no relevant MCE statements of policy principles for this proposal.

In addition, no public hearing has been held on this Rule change proposal to date.

2.4 Joint submission from 20 NEM participants

In response to the NEMMCO proposal, the Commission received a submission from 20 NEM participants⁵ outlining a range of additional issues relating to the NEM market settlements approach.

The Joint Submission from 20 NEM participants (JS20 submission) proposed Rule changes to define Futures Offset Arrangements. This would enable market participants to have their futures contracts registered with NEMMCO.

⁵ Intergen (Australia) Pty Ltd, EnergyAustralia, Integral Energy, Tarong, Victoria Electricity, Energy One, Jack Green, NewGen, Australian Power and Gas, Westpac, Optiver, AttungaCapital, BGC Partners, ICAP, TFS Australia, Man Financial, Energy Users Association, Zinifex Limited, Coles Myer Limited, and Sydney Futures Exchange Pty Ltd.

The Futures Offset Arrangement would be registered with NEMMCO by a clearing participant of the Sydney Futures Exchange (SFE). The clearing participant would then “pay to NEMMCO cash amounts equivalent to positive futures variation margins attributable to nominated electricity futures contracts held by the SFE Clearing Participant on behalf of the NEM Participant.”⁶

NEMMCO would then reduce the market participant’s maximum credit limit in consideration of the Futures Offset Arrangement, which would mean a reduction in the amount of credit support required by the market participant to be lodged with NEMMCO.

The Commission believes that the Joint Submission raises a number of issues and proposes the inclusion in the Rules of an additional mechanism that is beyond the scope of the NEMMCO proposal being considered. In addition, many of the issues are likely to raise questions relating to the requirements by prudential regulators, amongst others, and it is not clear whether these issues have been sufficiently resolved to allow the Commission to consider the matters raised.

The Commission would encourage NEMMCO and the JS20 signatories to undertake direct consultation with a view to either:

- consider how their requirements may best be incorporated within the reallocation procedures; or
- develop a well formed and articulate Rule change proposal that may be brought to the Commission for consideration in the future.

Finally, the Commission would welcome any further comments from the Joint Submission signatories on how the draft Rule prevents or impedes any future provision for the matters raised in their submission.

⁶ JS20 submission, August 2006, p4

3. Commission's analysis of the Proposed Rule

In this section, the Commission addresses a number of issues that have been raised in submissions or that have emerged during its analysis.

In summary, the Proposed Reallocations Rule has three parts:

- the introduction of a new category of Registered Participant, a Reallocator, whose participation in the NEM would be limited to reallocations;
- the removal of the procedural details of reallocations from the Rules and placing them in separate reallocation procedures, which would be established and maintained by NEMMCO, in accordance with the Rules consultation procedures; and
- the improvement of the prudential requirements of market participants to better manage NEMMCO's credit exposure to those participants who reallocate.

To date, reallocations within the NEM have not been taken up to a level where there is any significant improvement in the efficiency of the NEM prudential framework. The NEMMCO Proposed Rule aims to improve the robustness and flexibility of the reallocations process, which will make it easier for participants to reallocate their bilateral contracts.

The first part of the Proposed Rule would enable a clearing participant of a futures exchange to be a party to a reallocation with NEMMCO.

The second part would create reallocations procedures, outside of the Rules, where the particulars of reallocations would be detailed. This would enable more of the financial market contracts commonly used by participants to hedge their market risk to be reallocated.

The third part aims to tighten up the prudential requirements on market participants so that the prudential requirements of generators who reallocate, or who have load, are adequate to cover their credit risk to NEMMCO.

In developing the draft Rule, the Commission has examined a number of issues. These included:

- the effect of the changes to the prudential requirements on all market participants, not just those who reallocate;
- the likelihood of the changes increasing reallocation in the NEM; and
- the desirability of a Reallocator providing credit support to a market participant.

This section details the Commission's analysis and reasons underlying its draft Rule in relation to each of the issues identified above.

3.1 Status of Reallocator in the NEM

3.1.1 NEMMCO's proposal

Increasingly, NEM participants are using futures contracts traded on the SFE to hedge their exposure to the spot price. These contracts cannot be reallocated within the NEMMCO settlement procedures because a clearing participant of the SFE cannot be a party to a reallocation under the current Rules.

To allow futures contracts to be reallocated within the NEMMCO settlement procedures, NEMMCO has proposed that the Rules provide for a new category of Registered Participant, called a Reallocator. The Reallocator would be limited to trading in reallocations within the NEM. By creating a new category of Registered Participant, clearing participants of a futures exchange can be a party to the reallocation of a futures contract within the NEM.

3.1.2 Submissions

A number of submissions commented on the proposed inclusion of a Reallocator in the Rules.

Energy Response proposed a modification to NEMMCO's definition of Reallocator to include a participant who may be the responsible party in settlements for small unregistered generators. In addition, they proposed to rename the new registered participant a 'Settlements Participant', to reflect this expanded definition.⁷

The reason for Energy Responses modification was to provide for an emerging role for aggregators to bid unregistered small generators into the NEM.

The ERAA indicated that they support "measures to promote the use of futures contracts as a basis for reallocation, including NEMMCO's proposed *Reallocator*, where the integrity of the NEM's credit environment is not put at risk."⁸

The ASX does not support NEMMCO's proposed Reallocator category as it is of the view "that CPs [clearing participants] are unlikely to actively participate in NEMMCO facilitated reallocation dealings on behalf of NEM Participants due to the adverse financial and regulatory risks associated with a NEMMCO reallocation derivative market."⁹ On this issue, the ASX supports the JS20 submission, addressed in section 3.2 of this determination.

The NGF, in response to the concerns expressed in the JS20 submission stated "In our view the case has yet to be made as to why the new Reallocator class of participant proposed by NEMMCO does not allow Futures market positions to be used to back NEM Reallocations."¹⁰

The NGF also raised (see section 3.2 of this determination) a number of issues concerning the impact of the JS20 proposal on the credit quality of the NEM and

⁷ Energy Response submission, 11 August 2006, p3.

⁸ ERAA submission, 11 August 2006, p1

⁹ ASX submission, 16 October 2006, p1

¹⁰ NGF submission, 25 October 2006, p2

believes that many of these risks could be better managed by a clearing participant registered as a Reallocator within the Rules.

3.1.3 The Commission's consideration and reasoning

The growth of futures markets as an approach to managing risks within markets is well recognised. The Commission acknowledges that the Rules do not allow for the reallocation of a futures contract because of the inability for non-market participants to be recognised within the NEM settlement procedures. However, futures contracts are becoming an increasingly common hedging instrument among market participants, as participants seek to manage their financial liabilities within the market. The scope to incorporate futures contracts within the NEM settlement procedures, and thereby allow participants to offset their prudential requirements is a desirable feature for the market.

The Commission therefore believes that it is important to accommodate within the Rules scope for futures contracts to be taken into consideration in the settlements procedure. By creating a new category of registered participant, the Commission agrees with NEMMCO, that it will remove an existing impediment in the Rules to their development.

Section 34(3) of the NEL allows the Commission to confer rights or impose obligations on any person or class of person. This allows the Commission to make Rules that impose obligations and confer rights on a Reallocator as a class of Registered Participant. In addition, a Registered Participant is defined in the NEL as a person who is registered as such by NEMMCO under the Rules or is registered as such by NEMMCO otherwise in accordance with the Rules. The circumstances in which a Reallocator is registered with NEMMCO as a registered participant under the draft Rule means that to the extent that a Reallocator is a registered participant under the Rules, it will be taken to satisfy the definition of Registered Participant under the NEL.

Both the ERAA and the NGF also supported NEMMCO's proposal to create a Reallocator category of registered participant, acknowledging that this would facilitate the development of futures contracts in the NEM settlement procedures.

The Commission is mindful, however, that the creation of a Reallocator category of registered participant does not, in itself, allow for the reallocation of futures contracts within the NEM. For reallocations to occur, the approach to using reallocations needs to be defined and created. NEMMCO proposes to do this through the development of reallocation procedures, as discussed in greater detail below.

NEMMCO's provision for a Reallocator in clause 2.5B(b)(1) of its Proposed Rule indicates that a Reallocator will be treated (amongst other things) as a market participant for the purposes of Rule 3.3 – the prudential requirements in the Rules. However, clause 3.3.2(a) of the Rules, which deals with credit support, does not allow one market participant to provide credit support to another market participant. Since a Reallocator is most likely to be a bank or other financial institution, it is not considered desirable to exclude Reallocators from providing credit support or bank guarantees to other market participants, in accordance with clause 3.3.2(a) of the Rules. For this reason, the Commission has modified NEMMCO's Proposed Rule so

that the draft Rule excludes Reallocators from the restrictions of clause 3.3.2(a) of the Rules.

Finally, the Commission has considered the submission by Energy Response to expand the role of the NEMMCO proposed Reallocator to accommodate parties that are acting as aggregators for unregistered small generators, for the settlements procedures in the NEM. The Commission's preliminary view is that this suggestion would seek to extend the NEMMCO proposal beyond its scope and is consequently not under consideration by the Commission at this stage. However, this matter may more appropriately be presented to the Commission in the form of a separate Rule change proposal.

3.1.4 The Commission's finding in relation to this issue

The Commission has decided to accept NEMMCO's proposal to include a new category of registered participant, called a Reallocator, for the draft Rule, and has modified the proposed Rule so that Reallocators are excluded from the restrictions of clause 3.3.2(a) of the Rules. Comment is sought on whether it is appropriate for a Reallocator to be considered a registered participant for the purpose of rule 2.11 (Participant Fees) as proposed by NEMMCO.

3.2 New reallocation procedures

3.2.1 NEMMCO's proposal

Under the existing Rules on reallocation, many common types of financial market contracts are not accommodated and cannot be reallocated. NEMMCO proposes to remove the procedural details of reallocations from the Rules and place them into new reallocation procedures, which will be developed under the Rules consultation procedures.

By removing most of the procedural details associated with reallocations from the Rules, it will be simpler to create and amend the approach to reallocations in the NEM. This is anticipated to allow the development of approaches to futures contract reallocation within the NEM, through the new reallocation procedures.

3.2.2 Submissions

The ERAA submission asserts the current reallocations process is ineffective and supports NEMMCO's proposal to improve the reallocations process by moving the reallocation Rules to the new reallocations procedures. The ERAA indicates that the NEMMCO proposal will increase reallocation usage.¹¹

The JS20 submission does not directly address NEMMCO's proposal in relation to the removal of the detailed framework for reallocations from the Rules and their inclusion in reallocation procedures. Instead, it proposes a Rule change to define Futures Offset Arrangements. Futures Offset Arrangements would be voluntary arrangements whereby a clearing participant would register with NEMMCO the Futures Offset Arrangement on behalf of a market participant, and then pay to NEMMCO cash amounts equivalent to positive futures variation margins arising

¹¹ ERAA submission, 11 August 2006, p1.

from nominated electricity futures contracts held by the clearing participant on behalf of the participant. These cash amounts would then result in the participant having a reduced Maximum Credit Limit and hence lower prudential requirements.¹²

The NGF submission said there was uncertainty over how the JS20 proposed Futures Offset Arrangements would be treated in the event of insolvency of the participant. It also questioned the effectiveness of Futures Offset Arrangements in reducing the credit exposure of a participant. The NGF submission made reference to the NGF's participation in the NEMMCO Prudential reference group, containing generator and retailer representatives, which "reached a consensus view that the proposals from NEMMCO represented an enhancement to the NEM Rules."¹³

3.2.3 The Commission's consideration and reasoning

The general approach adopted by the Commission to the development of these Rules is to provide for the framework for the operation of the market, or the approach to regulation, in the Rules, with matters of detail being left to guidelines or procedures developed in accordance with requirements in the Rules. In this way, many of the issues of implementation are therefore left to a more flexible guideline or procedures instrument, which can be amended in response to changes in market circumstances, in accordance with the Rules consultation procedures.

The Commission acknowledges that reallocations are currently not used widely by market participants, in part due to the limited forms of reallocation provided within the Rules. It appears that the process for amending the Rules has limited the development of reallocation approaches in the Rules, in response to changes in financial transactions undertaken by market participants.

By removing the procedural details describing reallocations from the Rules, as proposed by NEMMCO, the Commission believes it will allow more financial market contracts to be reallocated, as the new reallocation procedures are created and amended. This is expected, in turn, to lead to more reallocations within the NEM.

The Commission notes the submissions by JS20 and the ASX. However, as stated above, the Commission is reluctant to embed within the Rules complicated procedures to handle the reallocation of a particular financial market contract. It is considered good regulatory practice to provide such detailed matters of implementation in guidelines and procedures, in accordance with framework requirements provided in the Rules. The Commission therefore considers that NEMMCO's proposed reallocation procedures are the appropriate place for procedural details describing the reallocation of futures.

To allow NEMMCO to facilitate the inclusion of the reallocation of futures, draft Rule clause 3.15.11A(a) provides flexibility to NEMMCO to provide procedures that are sufficient to enable the development of alternate reallocation transactions in the NEM settlement mechanism. The existing ex-post and ex-ante reallocations can also be included in these procedures, if desired.

¹² JS20 submission, 11 August 2006, p4.

¹³ NGF submission, 25 October 2006, p2.

NEMMCO's clause 3.15.11(c) of its Proposed Rule refers to the initial reallocation procedures and deems them to be prepared and published in accordance with the Rules consultation procedures. The Commission considers NEMMCO's proposed requirements inadequate and has amended the Proposed Rule to require NEMMCO to develop and publish the first reallocation procedures by 1 January 2008. Comment is sought as to whether this date is appropriate. The Commission has accepted that the reallocation procedures will be developed or amended in accordance with the Rules consultation procedures.

The Commission is mindful of those market participants with existing reallocations. For this reason it has decided to include savings and transitional provisions in the draft Rule at clause 11.7 to allow those market participants with existing reallocations the option of leaving those reallocations under the current arrangements, in the event the existing reallocations types are not included in the new procedures. This will ensure that no participant is disadvantaged by the draft Rule, as a result of the establishment of new reallocation procedures.

As well as providing for transitional arrangements for market participants engaged in reallocations at the time the Rule is made, the Commission has also considered any reallocation arrangements implemented after the draft Rule comes into effect but before reallocation procedures have been developed. In this case, the Commission has decided that the draft Rule will allow the reallocation to occur under the old Rules. However, following the development of the reallocation procedures, any new reallocation arrangements by any participant must be under the provisions of the draft Rule. The draft Rule also provides for any reallocation in place before the reallocation procedures have been developed to be transferred to the new Rules, subject to the consent of both parties to the reallocation.

The Commission is seeking specific submissions on whether the draft Rule will, or is likely to, significantly disadvantage any market participants because of the removal of the reallocations requirements from the Rules to the new reallocation procedures.

3.2.4 The Commission's finding in relation to this issue

The Commission has decided to accept NEMMCO's proposal to develop requirements for reallocations within reallocations procedures, provided for in the draft Rule. The draft Rule requires:

- NEMMCO to develop the first reallocation procedures by 1 January 2008; and
- reallocation procedures to be developed or amended in accordance with the Rules consultation procedures provided in rule 8.9 of the Rules.

In addition, the draft Rule provides transitional arrangements such that:

- for existing reallocations, the current Rule requirements prevail;
- for reallocation arrangements occurring between the making of the Rule and the development of reallocation procedures, the current Rule requirements prevail; and
- there is scope for reallocations under the current Rule to be transferred to the new Rule, with the consent of both parties.

3.3 Changes to existing prudential requirements

3.3.1 NEMMCO's proposal

Under the current Rules, situations can arise where a generator can become a prudential risk to NEMMCO. Consider, for example, a situation where a generator reallocates a substantial portion of its output and subsequently unexpectedly restricts generation to a level where its settlement reallocation liabilities exceed its generation income, perhaps as a result of a forced outage or industrial action. In these circumstances, there is a significant risk of default, borne by NEMMCO, arising from the current approach to calculating the trading limit for each market participant.

NEMMCO's Proposed Rule seeks to address this problem by introducing a 'prudential margin' into the Rules. The prudential margin is proposed to be calculated in respect of the reaction period only, this being the estimated time to remove a defaulting market participant from the market. A market participant's trading limit is proposed to be defined as the difference between any credit support provided and the prudential margin. If the participant's trading limit were then exceeded by its outstandings, then NEMMCO may issue a call notice for additional credit support to cover this exposure.

3.3.2 Submissions

In general, the Commission did not receive many comments on NEMMCO's proposed changes to the prudential requirements in the Rules. The ERAA submission supported NEMMCO's proposal stating that it "...will result in increased settlement reallocation whilst maintaining a sufficiently robust NEM credit environment."¹⁴

While not directly addressing NEMMCO's proposal, both the JS20 and ASX submissions proposed changes to the prudential requirements to accommodate Futures Offset Arrangements.¹⁵ The JS20 submission does agree that the current Rules allow generators to reallocate "without providing NEMMCO with any prudential support other than potential future generation receipts."¹⁶

3.3.3 The Commission's consideration and reasoning

The Commission is satisfied that the existing Rules do not place adequate prudential requirements on generators who reallocate or who have loads. This is because the trading limit is set as a proportion of the maximum credit limit, usually zero for a typical generator. Despite the risk that a generator with substantial reallocation could have plant failure or an industrial dispute, it would not have to provide credit support to NEMMCO as its trading limit would remain zero.

The Commission has undertaken a detailed analysis of the impact of NEMMCO's proposed changes to the prudential requirements on market participants. This analysis indicates that:

¹⁴ ERAA submission, 11 August 2006, p1.

¹⁵ JS20 submission, 11 August 2006, p6; ASX submission, 16 October 2006, p1.

¹⁶ JS20 submission, 11 August 2006, p5.

- generators and retailers with no reallocations and generators with no loads will be unaffected by the proposed changes;
- generators who reallocate, or who have loads, could have prudential requirements after the change where before there were none; and
- retailers who reallocate could face more stringent prudential requirements after the changes than before. This acknowledges the fact that reallocations are firm only up until the default of the reallocating generator.

The impact of the proposed changes to the prudential requirements in a number of example scenarios is provided in Appendix A.

Following the Commission's analysis, and in the absence of submissions expressing concerns about the proposed prudential changes, the Commission has decided to accept NEMMCO's Proposed Rule in relation to prudential requirements.

The Commission welcomes, however, submissions particularly addressing whether the draft Rule in relation to changes to prudential requirements is supported by all market participants.

The analysis in Appendix A shows that NEMMCO's Proposed Rule does tighten the prudential requirements on market participants in circumstances where it is warranted. The Commission believes that this will improve the overall credit quality of the NEM and hence the Rule change promotes the NEM objective.

3.3.4 The Commission's finding in relation to this issue

The Commission has decided to accept NEMMCO's Proposed Rule in relation to the proposed prudential requirements for the draft Rule.

4. Differences between the Proposed Rule and the Draft Rule

As discussed in section 3 of this determination, the Commission has largely adopted the substance of NEMMCO's proposal but has made some amendments to the proposed Rule to enhance and clarify the operation of reallocations in the NEM. These include clarifying how a Reallocator is treated in the NEM, the timing and establishment of new reallocation procedures, and providing transitional arrangements recognising existing reallocations and any reallocations registered while the new reallocation procedures are being developed.

The draft Rule specifies that:

- the new category of registered participant, called a Reallocator, will be excluded from the restrictions of clause 3.3.2(a) of the Rules;
- NEMMCO must develop the first reallocation procedures by 1 January 2008;
- the reallocation procedures are to be developed, or amended, in accordance with the Rules consultation procedures provided in clause 8.9 of the Rules;
- including the category of "Reallocator" in clause 2.12 relating to interpretation of references to various registered participants;
- removing the requirement on NEMMCO to develop reallocation procedures under 3.3.19 and move the requirement to the reallocation procedures in 3.15.11A;
- clarifying the timetable for submissions, and recording of, reallocation transactions that is to be developed by NEMMCO from time to time;
- new definitions of "Reallocator" and "reasonable worst case" to ease understanding of the Rules; and
- the following transitional arrangements will apply:
 - for existing reallocations, the current Rule requirements prevail;
 - for reallocation arrangements occurring between the making of the Rule and the development of reallocation procedures, the current Rule requirements prevail; and
 - there is scope for reallocations under the current Rule to be transferred to the new Rule, with the consent of both parties.

The Commission has also sought to clarify the structure of Reallocation transactions in the draft Rule by separately grouping the Reallocation procedures into a new clause 3.15.11A, which improves the readability and transparency of the draft Rule.

Subject to the above amendments, the Commission has accepted NEMMCO's proposed Rule to introduce robustness and increased flexibility in market settlement reallocations in the NEM.

Appendix A: Analysis of the proposed changes to the existing prudential requirements

To assist understanding of the NEMMCO proposal a number of hypothetical examples have been prepared by the Commission.

In its Rule change proposal, NEMMCO gives examples of the effects of its proposed changes on retailers and generators under a number of scenarios. This appendix expands on that to illustrate the effect the changes would have on retailers and generators in the following circumstances:

- no reallocation;
- 50% reallocation; or
- 100% reallocation.

It is important to understand that these changes do not only apply to reallocation and that the prudential requirements on, say, a generator with 50% reallocation would be the same as for a generator with 50% of its output dedicated to Market Customer load.

For the purposes of this analysis, the following assumptions or simplifications have been made:

- for both the generator and retailer, 42 days of generation/load is equal to \$100, the same simplification that NEMMCO used. A 50% reallocation would then be \$50;
- NEMMCO's examples assumed the methodology for calculating the maximum credit limit (MCL) was modified on the basis of 42 days of debits (including reallocation debits) and energy purchases but giving credit for only 35 days of generation and reallocation credits. It is currently the case that 42 days of credits are used for the calculation of a MCL. This 35 days credit assumption is used here; hence the outcomes would be different if the 35 days of credits were different;
- 35 out of 42 days is rounded to 84% and 7 out of 42 days (the reaction period for which NEMMCO's proposed prudential margin (PM) is calculated) is rounded to 16%;
- under the Rules, a participant's credit support must be at least equal to its MCL, but for this analysis the assumption is that they are equal. That is, the participant has not provided any more credit support than required; and
- the participant has not applied for a reduced MCL.

Note also that the PM applies to load, or reallocated generation, only. That is, positive generation and reallocation credits are not included in the calculation of the PM.

The following tables show the prudential requirements on a retailer and a generator with reallocation (or load for the generator) levels of 0%, 50% and 100%.

A1.1 Prudential Requirements of Generator

Generator with no reallocation/load		
	Current Rules	Proposed Rules
Reallocation/load debit	= \$0	= \$0
Energy credit	= \$100 (42 days)	= 84% * \$100 (35 days) = \$84
Maximum Credit Limit	= max(Reallocation/load debit - energy credit, \$0) = max(\$0 - \$100, \$0) = \$0	= max(Reallocation/load debit - energy credit, \$0) = max(\$0 - \$84, \$0) = \$0
Prudential Margin	N/A	= 16% * Reallocation/load debit = 16% * \$0 = \$0
Trading Limit	= 84% * MCL = \$0	= MCL-PM = \$0

i.e. no change

Generator with 50% reallocation/load		
	Current Rules	Proposed Rules
Reallocation/load debit	= \$50	= \$50
Energy credit	= \$100 (42 days)	= 84% * \$100 (35 days) = \$84
Maximum Credit Limit	= max(Reallocation/load debit - energy credit, \$0) = max(\$50 - \$100, \$0) = \$0	= max(Reallocation/load debit - energy credit, \$0) = max(\$50 - \$84, \$0) = \$0
Prudential Margin	N/A	= 16% * Reallocation/load debit = 16% * \$50 = \$8
Trading Limit	= 84% * MCL = \$0	= MCL-PM = -\$8

i.e. the generator is required to stay in credit of at least \$8

Generator with 100% reallocation/load		
	Current Rules	Proposed Rules
Reallocation/load debit	= \$100	= \$100
Energy credit	= \$100 (42 days)	= 84% * \$100 (35 days) = \$84
Maximum Credit Limit	= max(Reallocation/load debit - energy credit, \$0) = max(\$100 - \$100, \$0) = \$0	= max(Reallocation/load debit - energy credit, \$0) = max(\$100 - \$84, \$0) = \$16
Prudential Margin	N/A	= 16% * Reallocation/load debit = 16% * \$100 = \$16
Trading Limit	= 84% * MCL = \$0	= MCL-PM = \$0

i.e. the generator must supply credit support of \$16 and can trade up to zero credit.

A1.2 Prudential Requirements of Retailer

Retailer with no reallocation		
	Current Rules	Proposed Rules
Load debit	=\$100	=\$100
Reallocation credit	=\$0 (42 days)	=84%* \$0 (35 days) =\$0
Maximum Credit Limit	=max(Load debit - reallocation credit, \$0) =max(\$100 - \$0, \$0) =\$100	=max(Load debit - reallocation credit, \$0) =max(\$100 - \$0, \$0) =\$100
Prudential Margin	N/A	=16%*Load debit =16%* \$100 =\$16
Trading Limit	=84%* MCL =\$84	=MCL-PM =\$84

i.e. no change.

Retailer with 50% reallocation		
	Current Rules	Proposed Rules
Load debit	=\$100	=\$100
Reallocation credit	=\$50 (42 days)	=84%* \$50 (35 days) =\$42
Maximum Credit Limit	=max(Load debit - reallocation credit, \$0) =max(\$100 - \$50, \$0) =\$50	=max(Load debit - reallocation credit, \$0) =max(\$100 - \$42, \$0) =\$58
Prudential Margin	N/A	=16%*Load debit =16%*\$100 =\$16
Trading Limit	=84%* MCL =\$42	=MCL-PM =\$42

i.e. the retailer is required to supply an additional \$8 in credit support.

Retailer with 100% reallocation		
	Current Rules	Proposed Rules
Load debit	=\$100	=\$100
Reallocation credit	=\$100 (42 days)	=84%* \$100 (35 days) =\$84
Maximum Credit Limit	=max(Load debit - reallocation credit, \$0) =max(\$100 - \$100, \$0) =\$0	=max(Load debit - reallocation credit, \$0) =max(\$100 - \$84, \$0) =\$16
Prudential Margin	N/A	=16%*Load debit =16%* \$100 =\$16
Trading Limit	=84%* MCL =\$0	=MCL-PM =\$0

i.e. the retailer is required to supply an additional \$16 in credit support.

Appendix B: Draft Rule