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17 February 2016

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Dear Mr Pierce

Rule Change Consultation – Application of Offsets in the Prudential Margin

Thank you for the opportunity to provide feedback to the Australian Energy Market Commission (AEMC) on the rule change request to allow for offsetting between trading amounts and reallocation amounts in the Prudential Margin (PM).

Our latest modelling continues to indicate that if Offsets were allowed as proposed by this rule change, there would be material reductions in the credit support levels required from participants. For example for the years 2014 and 2015, the modelling suggests a 6.3% and 6.5% reduction in aggregate Maximum Credit Limit (MCL) amounts respectively. We believe this efficiency gain is possible without breaching the 2% Prudential Probability of Exceedance (POE) target set as the current prudential standard for the National Electricity Market (NEM).

1. Impact on the Prudential Probability of Exceedance

As stated previously, the MCL reduction calculated for the PM Offsets Rule change scenario does not alter the MCL exceedance value calculated using the POE model, and the Prudential Standard was met with the POE for all regions under 2%.

It is worth noting that the POE calculation forms part of the life of NEM model, which calculates the regional volatility factor (VF) by modelling each region as a retailer, so that the resultant VF can be used to determine the appropriate level of credit support (MCL) required to meet the 2% prudential standard. The POE calculation does not consider the impact of reallocations in the MCL calculation, as debit and credit reallocations is expected to net out within the region.

In practice, the actual credit support collected for each region per season is less than the MCL level predicted by the model, due to reallocation arrangements between participants within the region. This is within expectation, as the life of NEM model is designed to model the amount of credit support (MCL level) required to maintain the 2% Prudential Standard, assuming that the net reallocation within each region is zero.

Also, calculating the actual POE (using existing values of VFs) under the PM offsets scenarios for the life of NEM would not add value to the risk assessment for the proposed Rule. If the existing MCLs (without PM offsets) are conservative, then the reduced MCL levels with PM offsets should not change the POE significantly. In contrast, an increased POE for the proposed Rule change indicates that the VF needs to be adjusted to calibrate the regional MCL to meet the Prudential Standard. This step has already been incorporated in the existing prudential processes.

2. Firmness of reallocations

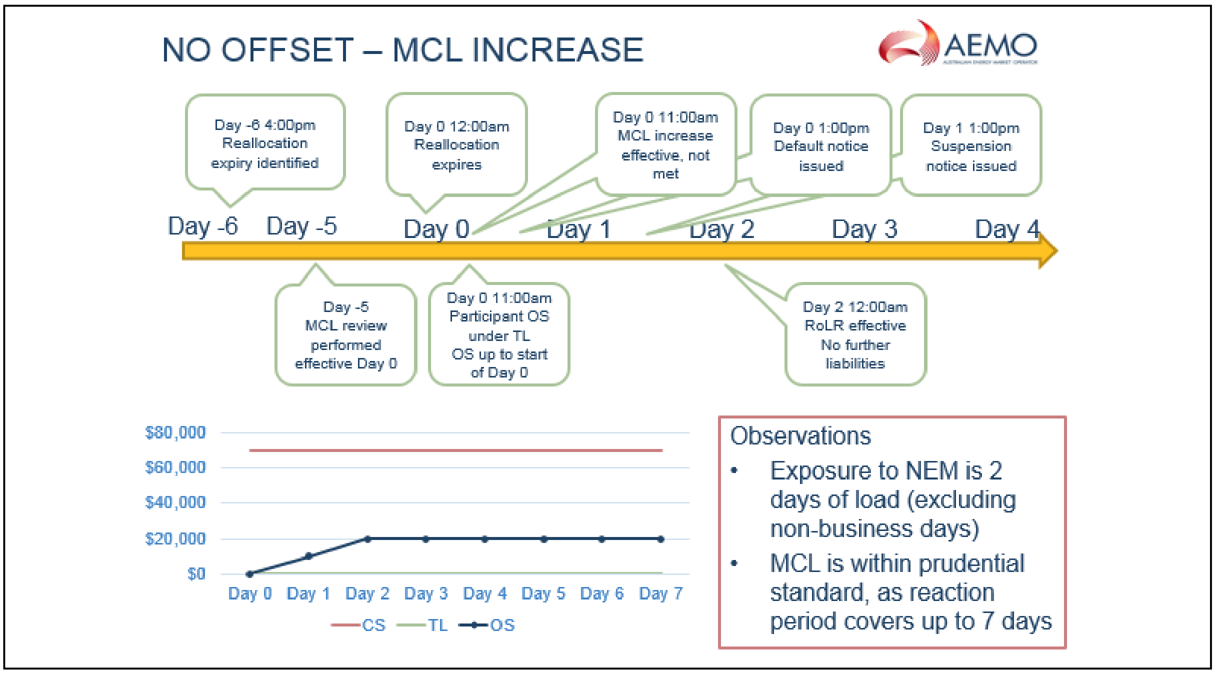
To mitigate the prudential risks due to prospective reallocation expiring, AEMO has adopted a practical approach to qualitative risk assessment. In conjunction with the automation of a number of prudential alerts, we have considered four options for ensuring that reallocations are firm. These options are explained in the following sections. AEMO considers that Option 3 best meets the objectives of the proposed Rule and the National Electricity Objective.

Option 1 - Leave the Rule (no offset) as it is, with the current process of implementing MCL increases to be effective when the reallocation expires

Under the current prudential regime, participants are required to lodge ex-ante reallocation requests seven business days prior to the earliest trading interval specified in the reallocation request, for the prospective (ex-ante) reallocations to be considered in the MCL reviews. As MCLs are calculated per participant (at the company level) for each season, ex-ante reallocations are expected to continue for the whole season.

If prospective reallocation expires before the end of the season, AEMO will conduct a MCL review immediately, and may require increased guarantees to be provided when the prospective reallocation expires (the effective date for the new MCL). This process is illustrated in Figure 1.

Figure 1 Current Rule (no offsets)



This is a low risk option as the MCL will provide coverage for the reaction period up to seven days. However, there is no benefit to be gained from offsetting between the trading amounts and the reallocation amounts.

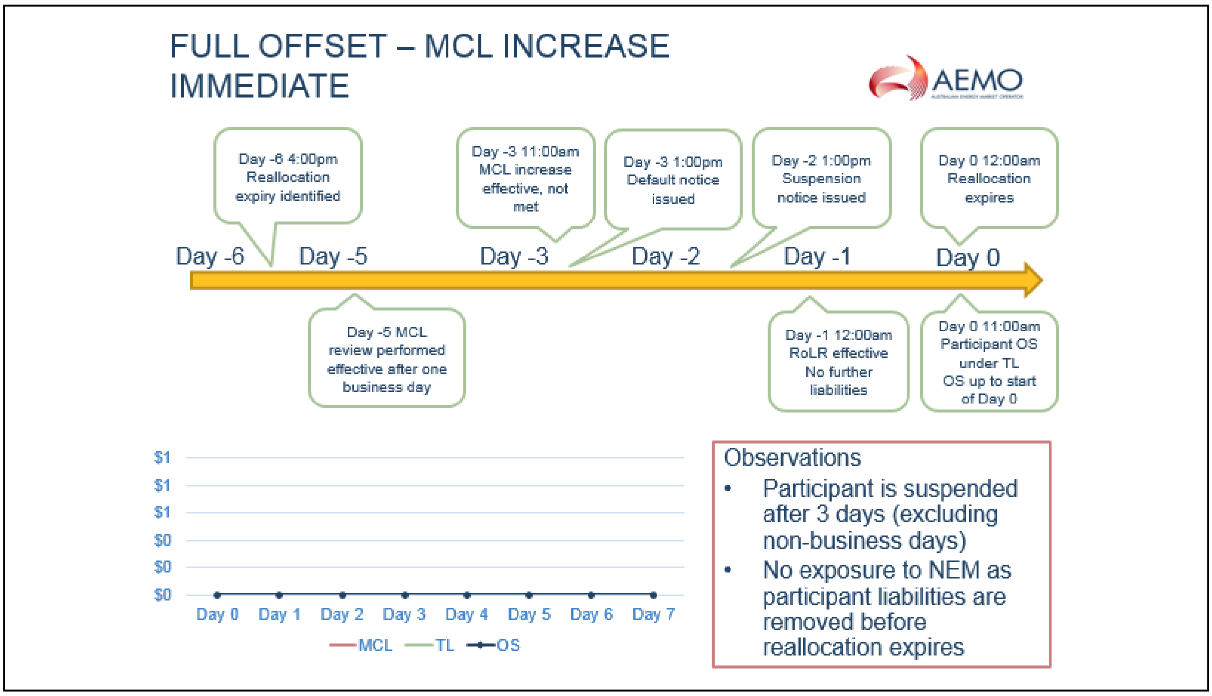
Option 2 - Implement full offsets, but ensure that MCL increases are effective after one business day

While we understand that some participants prefer to lodge reallocation requests one week at a time, AEMO will need to tighten the timeframe for credit support provision if full offset between trading amounts and reallocation amounts is allowed (or required), without extending the ex-ante reallocations timetable, to mitigate the prudential risk of exposing NEM to a potential payment shortfall in case prospective reallocations become unavailable.

Figure 2 shows that to ensure participant exposures are covered before prospective reallocation expires, we may require increased guarantees to be provided within a shorter timeframe in response to changes to MCL, so that the market integrity is maintained.

Alternatively, if the participant informs AEMO of any change to its ex-ante reallocations a few weeks in advance, we would allow more time for the participant to organise appropriate credit support (bank guarantees), if required, following a MCL review.

Figure 2 Enforce the one business day credit support rule



Enforcing the one business day credit support rule could potentially compound the existing advantage conferred to the major Gentailers, as smaller retailers and generators will find it challenging to provide bank guarantees in such short time.

Option 3 - Ensure that the ex-ante reallocation timetable is at least 14 business days in advance

At the time of this submission, approximately 36% of registered market participants in the NEM reallocate. Of these, 40% of participants that reallocate do not always adhere to the current ex ante reallocations timetable, but only 2% of participants always reallocate less than seven business days in advance. In general, participants are able to adhere to the current ex ante reallocations timetable.

An analysis in MWh reallocations at a point in time (as at 16 February 2016) shows the following potential impacts of extending the ex-ante timetable:

- approximately 70% of the energy reallocated is associated with Gentailers reallocating within their company structure
- a very small proportion of reallocations are done on a weekly basis – less than 1% by energy
- a very small proportion of MWh reallocations are authorised after the ex-ante due date – less than 2% by energy, and
- more than 95% of reallocations by energy (MWh) have a term of 3 months or more.

Figure 3 Extend the ex-ante reallocations timetable

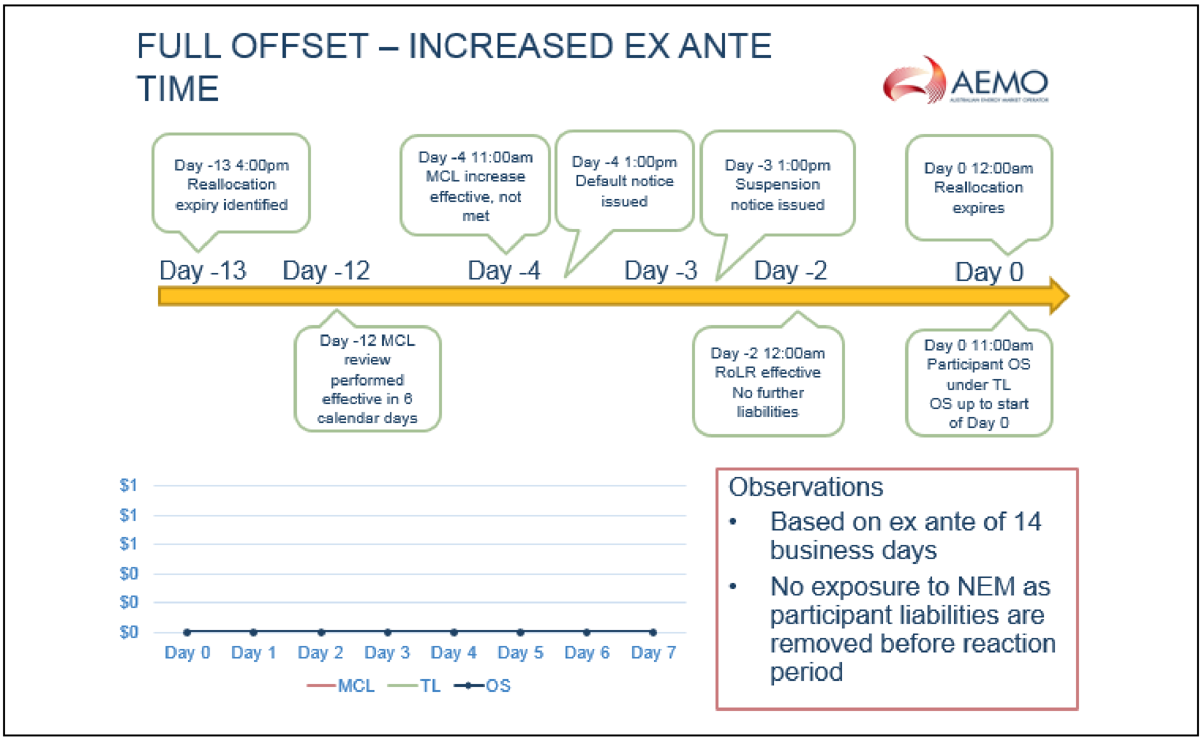


Figure 3 shows that the ex-ante reallocations timetable should be 14 business days to ensure that there are no increased prudential risks to the NEM under the Rule change scenario. Additionally, the average reallocation should be calculated based on multiples of seven days (forward looking) to take account of the ratio of business to non-business days. If the prospective reallocation expires, we will conduct a MCL review immediately. If applicable, the participant will be required to provide increased bank guarantees approximately one week after being notified of the new/increased MCL. This option will give participants sufficient time to provide bank guarantees without increasing prudential risks to the NEM.

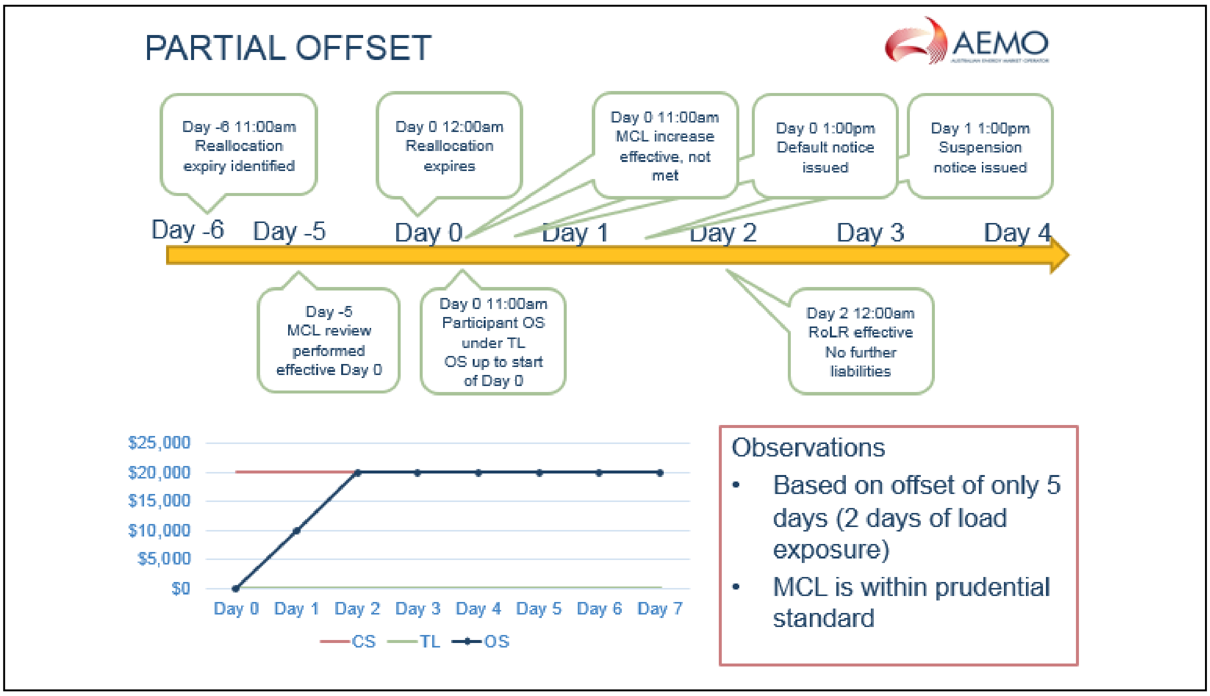
Similarly, offsetting between generation and debit reallocations would result in a reduction in the participant's PM and MCL. To mitigate the risk of exposing the NEM to a payment shortfall due to the loss in generation, AEMO will monitor participants' generation levels. If a potential generation loss is detected, we will conduct a MCL review immediately. Where applicable, the participant must provide a bank guarantee on or before the effective date for the new MCL.

Option 4 - Partial offsets

Our analysis shows that if the Rules allow the offsetting between trading amounts and reallocation amounts as proposed, participants could potentially reduce their MCLs to a very small number (or zero). In these cases, it would be appropriate for AEMO to retain some flexibility, as is implicit in clause 3.3.8(d) as currently proposed, to apply partial offsets in the participant's prudential margin. This would ensure the firmness of participant reallocations and mitigate the risk of exposure of the NEM.

Further assessment shows that we could reduce the risk to a manageable level by allowing up to five days of offsets in the prudential margin. This is illustrated in Figure 4.

Figure 4 Partial offsets



This option will provide regulatory certainty to market participants through appropriate adjustments to the Credit Limit Procedures.

3. Timing for implementation

If the AEMC were to make the Rule, AEMO will require approximately 6 months to consult with stakeholders on the new Credit Limit Procedures (CLP) and to implement the formula change for calculating MCLs in the AEMO systems. Additionally, option 3 would involve consulting on the reallocation procedures. This could be done in parallel with the CLP consultation.

To facilitate stakeholder consultation and implement the required system changes, the effective date for the new Rule should be linked to the time when the new CLP becomes effective. We anticipate the new CLP will take effect in the scheduled MCL reviews for summer 2018.

If you have any questions regarding this submission, please contact Chin Chan, Group Manager – Market Management, on (03) 9609 8345, or Yee Yeng Lambropoulos, A/Manager Prudentials, on (02) 8884 5032.

Yours sincerely

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