Q&A

Hedging and the electricity prudential framework: final report

Overview

What is the AEMC review into the role of hedging contracts in the existing National Electricity market (NEM) prudential framework?
The Australian Energy Market Commission (AEMC) initiated this review in January 2009.

This review looked at how futures and other types of contracts can be integrated into the existing prudential framework to improve market operation and efficiency.

In addition it considered issues around the performance target for setting the maximum credit limit (the level of credit support to be provided) for market participants; and investigated the option of using future prices in calculating that amount.

Why did the AEMC initiate this review?
We decided to start this review to develop feasible solutions to risks which had been identified by consideration of an earlier rule change proposal - Futures Offset Arrangements (FOA).

See the draft rule determination on FOA (22 January 2009).

Why is this review important?
This review focussed on balancing two concerns:

- the need to protect NEM prudential standards; and
- the need to address the desire of companies to participate in the market while lowering their costs through the use of financial instruments.

What is the market background to this review?
Australia's wholesale electricity market supplies around eight and half million customers across the nation's eastern seaboard with around $11 billion annual trading turnover.

Because of the nature of electricity demand and because electricity cannot be stored it is a market of highly volatile prices and complex financial arrangements.

The market is finely tuned to service customer demands. Dispatch targets are set every five minutes and prices are set for 30 minute trading intervals.

What are the prudential requirements in this market?
Retailers accrue debts to generators for the power they buy on a daily basis and payments to generators are due four to five weeks later.

The Australian Energy Market Operator (AEMO) collects from retailers and pays the generators (this is called settling the NEM).

Retailers in this market provide between $1.5 to $3.5 billion in bank guarantees – to provide prudential assurances to AEMO.

Retailers also hedge their NEM exposure through 'over the counter (OTC)' and futures contracts to manage their risk.

This can result in duplication of credit support requirements and circular cash flows between the retailers, generators and AEMO.

Integrating options that recognise retailers' futures contracts and OTC contracts into the existing NEM prudential framework can reduce the costs to participate in the wholesale market.

Recommendations

What does this review's final report say?
The final report makes a number of recommendations in relation to reallocation arrangements and FOAs.

It recommends that:

- Existing and proposed reallocation offset arrangements be continued with some enhancements through changes to the National Electricity Rules and AEMO procedures; and
- That an appropriate prudential margin be maintained where load is offset by internal generation;
- FOAs be integrated in the NEM prudential framework, subject to AEMO establishing an appropriate prudential margin and undertaking further assessment of benefits and impact on the prudential quality of the NEM (following AEMO's current review into energy market prudential readiness).
- AEMO continue work in the area of improvements to maximum credit Limit (MCL) methodology as part of its Energy Market Prudential Readiness Review.

AEMO review

AEMO is conducting a broader review of the NEM prudential framework (Energy Market Prudential Readiness Review) which is expected to go to the Ministerial Council on Energy in November 2010.

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Reallocation arrangements should continue with some enhancements.

Futures offset arrangements should be considered for implementation in the National Electricity Market.

The AEMC and AEMO are working together to ensure this review's recommendations in relation to FOAs be re-assessed against any changes to the prudential framework arising from the AEMO review.

The AEMC has asked AEMO to take up consideration of issues around credit support. The AEMC review's final report does not make firm recommendations on the performance target or the manner in which the maximum credit limit (MCL) for participants should be determined.

Who were the members of this review's working group?
A working group provided expert advice to this review:

Energy Retailers Association of Australia (ERAA) – Mr Darryl Flukes, CEO Infratil Energy;

AEMO – Mr Craig Parr, Senior Manager Metering and Settlements;

National Generators Forum (NGF) – Mr Mark Frewin, Senior Regulatory Manager Wholesale TRUenergy;

d-cypha Trade – Mr Dean Price, General Manager and Mr Thomas Schmitz, Executive Manager;

AEMC – Ms Jane Benson, General Counsel;

Australian Securities and Investments Commission (ASIC) – Mr Michael Parker, Senior Specialist, Investment Banks and

Mr Oliver Harvey, Senior Manager, Exchange Market Operators.

Reallocation arrangements

What are reallocation arrangements?
Reallocation arrangements enable market participants to offset their prudential requirements in the NEM based on their OTC contract positions.

Reallocation arrangements enable reduction in credit support requirements and avoid circular cash flows where contracts are in place.

What are the final report's recommendations on reallocation arrangements?
Swap and options reallocation offset arrangements are awaiting a decision by the Australian Securities and Investment Commission (ASIC) on an application by AEMO for exemption from the requirement to hold a clearing and settlement facility licence.

The Commission considers that existing reallocation arrangements and the proposed swap and options reallocation arrangements contribute to the National Electricity Objective and should be continued, with some enhancements.

These enhancements include:

- changes to the electricity rules to require reallocation transactions to be underpinned by contractual arrangements, and for the reallocation transactions not to be available in conjunction with the reduced maximum credit limit;
- changes to AEMO procedures to clarify the process used by the operator to manage load profile risk under reallocation transactions; and
- in relation to internal load and generation offsets by vertically integrated market participants, the Commission recommends a rule change that would require market participants to provide a prudential margin where load is offset internally.

Recommendations on reallocation arrangements and internal offsets, which include changes to the rules and AEMO's procedures, can proceed immediately.

The rule changes may be proposed by the MCE, AEMO or any other stakeholder.

Futures offset arrangements (FOA)

What are FOAs?
Appropriately designed FOAs enable market participants to offset their NEM prudential requirements based on their futures contract positions. FOAs are intended to enable reduction in credit support requirements where futures contracts are in place.

What are the final report's recommendations on FOAs?
The Commission considers that FOAs have the potential to contribute to the National Electricity Objective by reducing costs to participate in the wholesale market without materially reducing the prudential quality of the NEM. FOAs should be considered for implementation in the NEM.

In light of AEMO's review of the NEM prudential framework, the Commission recommends that prior to implementing the final report's recommendations on FOAs, AEMO should:

- establish a prudential margin for the NEM prudential regime that meets an appropriately established performance target for trading amounts over the reaction period;
- re-assess benefits and the prudential quality of the NEM under FOAs against any changes to the MCL methodology arising from AEMO's review; and
- if still appropriate, integrate FOA's in the NEM prudential framework in accordance with the Commission's recommendations (amended as necessary) through rule change proposals from AEMO to the Commission.

The Commission considers that the recommendation relevant to futures offset arrangements, which permits call notices by AEMO to be delayed by one hour, should also be implemented with the reallocation rule changes (described above), and apply generally to all call notices.

This would assist market participants to utilise margins arising under futures contracts to meet their margin payments to AEMO, even in the absence of futures offset arrangements.

Subject to the Ministerial Council of Energy's response we will work closely with the Standing Committee of Officials, MCE and AEMO to progress stage 2 of this review.

Stage 2 will draft rules to support recommendations made in stage 1

Review approach

What was the approach?
The Commission published and sought submissions on a framework and issues paper; draft risk assessment report by PricewaterhouseCoopers; and the review's draft report.

The Commission held two public forums on the framework and issues paper and on its draft report.

Final recommendations were informed by the consultant and advisor reports; stakeholder submissions; and input from the review's working group and the Commission's own analysis.

The FOA rule change proposal

What was the relationship between this review and the earlier FOA rule change proposal?
In January 2008 the AEMC received a joint rule change proposal titled Futures Offset Arrangements from Australian Power & Gas, Infratil Energy Australia and Momentum Energy.

The Commission decided that elements of the proposal had merit in relation to the development of an FOA model with potential to reduce costs for NEM participants and should be investigated by a formal review.

The terms of reference for this review were attached to the draft determination on the FOA rule change proposal (22 January 2009).

What was the outcome of the FOA rule change proposal?

The Commission's final determination of 16 April 2009 did not agree with the proposal because the FOA model as proposed was unlikely to be workable.

The consultation process undertaken for the rule change proposal identified significant risks to be assessed.

The review was initiated to allow these issues to be considered and resolved where feasible.

It also widened public consultation on the range of issues associated with the use of complex financial instruments in the electricity market.

Next steps

Subject to the Ministerial Council on Energy's response to the recommendations, the AEMC will be working closely with the Standing Committee of Officials and the MCE, and AEMO, to progress stage 2 of this review.

Stage 2 of the review will draft rules to support the recommendations made in stage 1.

For more information contact:

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Go direct to the review on our website.

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