AEMC

RULE CHANGE

Australian Energy Market Commission

RULE DETERMINATION

National Electricity Amendment (Extension of Call Notice Timing) Rule 2014

Rule Proponent

Australian Energy Market Operator

12 June 2014

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

Summary

The Australian Energy Market Commission (AEMC or Commission) has made a rule that improves the prudential arrangements in the National Electricity Market (NEM).

The rule relates to the timing of the issuance of call notices to market participants by the Australian Energy Market Operator (AEMO). A call notice begins the process of suspending a market participant. AEMO may issue a call notice if the market participant's net liabilities are greater than its trading limit in the NEM.

Currently, if AEMO issues a call notice after 12:00 pm (Sydney time) it is taken to have been issued on the next business day, giving the market participant an extra business day to respond. The new rule changes this time to 1:00 pm (Sydney time).

The rule as made will commence on 1 July 2014.

The rule change request was submitted by AEMO. The rule change request:

- raised the concern that Queensland-based market participants can have difficulty managing their prudential position during eastern daylight savings time before AEMO begins the process of drafting and issuing a call notice by 12:00 pm (Sydney time); and
- considered that the proposed rule would allow market participants to access settlements from the Sydney Futures Exchange to help manage their prudential position.[1]

AEMO requested that the rule making process be expedited because it considered the proposed rule was non-controversial. The AEMC agreed that the proposed rule was non-controversial and proceeded with the expedited rule making process.

The Commission is satisfied that the rule as made will, or is likely to, contribute to the achievement of the National Electricity Objective (NEO) because:

- it is likely to reduce the risk that a call notice is issued because a market participant is experiencing administrative rather than financial issues, without impacting the level of risk of a market participant accruing significant liabilities before it is suspended from trading in the NEM; and
- it is likely to reduce costs for AEMO and market participants over the longer term of managing the prudential requirements in the NEM.

The Commission therefore considers that the rule as made will promote the efficient operation of electricity services with respect to the price of supply of electricity.

1 The Sydney Futures Exchange merged with the Australian Securities Exchange in 2006. The merged entity, Australian Securities Exchange Limited, conducts the derivatives trading functions of the old Sydney Futures Exchange on the ASX Trade24 trading platform.

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1 AEMO's Rule Change Request

1.1 The Rule Change Request

On 25 July 2013, the Australian Energy Market Operator (AEMO) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission). The rule change request sought to improve the timing of prudential arrangements in the National Electricity Market (NEM).

1.2 Relevant background for the rule change request

AEMO manages the prudential requirements of the NEM. This includes holding credit support (bank guarantees) posted by market participants to minimise the risk to other participants from a default in payment for the large amounts of energy traded in the NEM.

AEMO may issue a call notice to a market participant if its net liabilities in the NEM are at any time greater than its "trading limit". The trading limit is the level of credit support minus the prudential margin (an estimate of the amount of liabilities a market participant could plausibly incur from the time the call notice is issued to the time it is suspended). A call notice is issued to begin the process to suspend a market participant. To date, AEMO has never issued a call notice.

If a call notice is issued the market participant must reduce its net liabilities to the level of "typical accrued liabilities", which is a significantly greater reduction than if the level of net liabilities are managed below the market participant's trading limit before a call notice is issued. If AEMO issues the call notice after 12:00 pm (Sydney time) the call notice is taken to have been issued on the next business day, giving the market participant an extra day to respond.

In practice, some time is required to draft and approve the issuance of a call notice. AEMO has therefore developed processes to monitor compliance with, and respond to, breaches of the prudential requirements of the NEM. Under these processes AEMO aims to issue a call notice by 12:00 pm (Sydney time) on any given business day. In order to achieve this, AEMO begins the process of drafting and issuing a call notice at 10:30 am (Sydney time).

A detailed outline of the background to the prudential requirements in the NEM is set out in **Appendix A**.

1.3 Rationale for the rule change request

In the rule change request AEMO outlined two concerns with the current rule in the National Electricity Rules (NER) regarding call notice timing:

- during eastern daylight savings time (when 9:00 am Brisbane time is 10:00 am Sydney time), Queensland-based market participants can have difficulty rectifying breaches of their trading limits before 10:30 am (Sydney time) when AEMO begins the process of drafting and issuing a call notice; and
- the Sydney Futures Exchange settles cash margin transactions at 11:00 am (Sydney time), meaning that market participants currently cannot access these settlements to help rectify a trading limit breach until AEMO is well advanced in the process of preparing a call notice.[2]

1.4 Solution proposed in the rule change request

AEMO proposed to resolve the issues referred to above through a rule amending the NER to delay by one hour the time at which a call notice issued by AEMO is taken to have been issued on the next business day. Currently, if AEMO issues a call notice after 12:00 pm (Sydney time) the call notice is taken to have been issued on the next business day. Under the proposed rule this time would be 1:00 pm (Sydney time).

1.5 Commencement of rule making process

On 1 May 2014, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence the rule making process and consultation in respect of the rule change request. A consultation paper identifying specific issues or questions for consultation was also published with the rule change request.

The Commission accepted AEMO's request that the rule change be treated as a request for a non-controversial rule because it did not consider that the proposed rule would be likely to have a significant effect on the NEM. Accordingly, the Commission also advised of its intention to expedite the assessment of the rule change request under section 96 of the NEL, subject to any written requests not to do so. The closing date for receipt of such written requests was 15 May 2014. None were received. Consequently, the rule change request was considered under an expedited process under section 96 of the NEL.

Submissions to the consultation closed on 29 May 2014, with one submission being received. This is available on the AEMC website.[3] The issues raised in that submission and the Commission's response are discussed in section 3.3 below.

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2 Many market participants trade financial products in electricity on the Sydney Futures Exchange in order to hedge their exposure on the wholesale electricity market. By making the rule, the amounts received in settlements from the Sydney Futures Exchange can be aligned with the timing of payments to reduce *outstandings* to comply with the prudential requirements in the NEM.

3 www.aemc.gov.au

2 Final Rule Determination

2.1 Commission's determination

In accordance with section 102 of the NEL the Commission has made this final rule determination in relation to the rule proposed by AEMO. In accordance with section 103 of the NEL the Commission has determined to make the rule proposed by AEMO.

The rule is as follows:

Box 2.1: New rule 3.3.13(b) of the NER

3.3.13(b) - If *AEMO* gives a *call notice* to a *Market Participant* after ~~noon~~ 1:00 pm (Sydney time), then *AEMO* is deemed to have given that *call notice* on the next *business day* for the purposes of this clause.

The Commission's reasons for making this final rule determination are set out in Chapter 3.

The *National Electricity Amendment (Extension of Call Notice Timing) Rule 2014 No 6* (rule as made) is published with this final rule determination. The rule as made commences on 1 July 2014.

2.2 Commission's considerations

In assessing the rule change request the Commission considered:

- the Commission's powers under the NEL to make the rule;
- the rule change request;
- the submission received during consultation; and
- the Commission's analysis as to the ways in which the proposed rule will, or is likely to, contribute to the achievement of the National Electricity Objective (NEO).

There are no relevant Ministerial Council on Energy (MCE) statements of policy principles relating to this rule change request.[4]

4 Under section 33 of the NEL, the AEMC must have regard to any relevant MCE statements of policy principles in making a rule. The MCE is referenced in the AEMC's governing legislation and is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011 the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated Council is now called the COAG Energy Council.

2.3 Commission's power to make the rule

The Commission is satisfied that the proposed rule falls within the subject matter about which the Commission may make rules. The proposed rule falls within the matters set out in section 34 of the NEL as it relates to the operation of the NEM.

Further, the proposed rule falls within the matters set out in items 3 and 4 of schedule 1 to the NEL. Item 3 is relevant as the proposed rule relates to the prudential requirements to be met before and after registration as a registered participant in the NEM. Item 4 is relevant as it relates to the suspension of registered participants from participation in the NEM.

2.4 Rule making test

Under section 88(1) of the NEL the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system.""

The Commission developed its framework to assess the rule change request based on the NEO, considering the most relevant aspect to be the efficient operation of electricity services with respect to the price of supply of electricity.[5] Accordingly, the Commission's assessment focussed on the impact of the proposed rule on the level of risk in the NEM and the costs of supplying electricity in the NEM.

The Commission is satisfied that the rule as made will, or is likely to, contribute to the achievement of the NEO because:

- it is likely to reduce the risk that a call notice is issued because a market participant is experiencing administrative rather than financial issues, without impacting the level of risk of a market participant accruing significant liabilities before it is suspended from trading in the NEM; and

- it is likely to reduce costs for AEMO and market participants over the longer term of managing the prudential requirements in the NEM.

5 Under section 88(2), for the purposes of section 88(1) the AEMC may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.

The Commission therefore considers that the rule as made will promote the efficient operation of electricity services with respect to the price of supply of electricity. Further details on the Commission's reasons for forming this view are set out in Chapter 3 below.

Under section 91(8) of the NEL the Commission may only make a rule that has effect with respect to an adoptive jurisdiction if satisfied that the proposed rule is compatible with the proper performance of AEMO’s declared network functions. The rule as made is compatible with AEMO’s declared network functions because it does not impact on those functions in any way.

3 Commission's reasons and assessment

The Commission has analysed and assessed the issues arising out of the rule change request. For the reasons set out below, the Commission has determined that a rule be made.

3.1 The level of risk in the NEM

The Commission considers that the rule as made is likely to reduce the risk that a call notice is issued because a market participant is experiencing administrative rather than financial issues, without impacting the level of risk of a market participant accruing significant liabilities before it is suspended from trading in the NEM.

Currently, AEMO aims to issue a call notice by 12:00 pm (Sydney time) so that a market participant does not have an additional business day to respond to the call notice and therefore an additional day of trading in the NEM before it is suspended. The rule as made would allow AEMO an extra hour to issue a call notice. This would give market participants an additional hour to manage trading limit breaches before a call notice is likely to be issued by AEMO on any given business day.

The Commission considers that allowing market participants an extra hour to manage their trading limit breaches would reduce the risk that a call notice is issued due to the market participant experiencing an administrative issue, rather than a significant financial issue. In particular, the additional hour would give Queensland-based market participants more time to manage their prudential position during eastern daylight savings time. It would also allow market participants to access settlements from the Sydney Futures Exchange to help manage any trading limit breach.

However, the rule as made would be unlikely to affect the issuance of call notices to market participants experiencing genuine financial distress. Under the revised arrangements, it would be no more likely that AEMO would issue a call notice after 1:00 pm (Sydney time), as compared to after 12:00 pm (Sydney time) at present. Consequently, there would be no appreciable impact on the likelihood of a market participant being able to continue trading for an additional business day before being suspended from trading in the NEM.

The rule as made is therefore likely to allow a better balance between the prudent practice of AEMO aiming to issue a call notice before the time at which it is taken to have been issued on the following business day, and the ability for market participants to find and lodge additional credit support or reduce their outstandings before a call notice is issued. The Commission considers that the impact of the rule as made on the level of risk in the NEM is compatible with the NEO with respect to the price of the supply of electricity in the NEM because it will allow an administratively more efficient way of maintaining a similar level of risk in the NEM.

3.2 The costs of supplying electricity in the NEM

Both AEMO and market participants would incur costs associated with the implementation of the rule as made. There are likely also to be cost reductions for AEMO and market participants in the long-term. These impacts on costs should flow through to consumers because, generally, efficient costs associated with the supply of electricity are paid by consumers in workably competitive markets.

The Commission considers that the likely increased costs resulting from the rule as made will include:

- AEMO's costs of amending its published processes for monitoring compliance with NEM prudential requirements; and
- costs to market participants associated with changing internal prudential obligation management processes in response to any changes that AEMO makes to its processes for monitoring prudential requirements.

The Commission considers that, in accordance with AEMO's statement in the rule change request, these costs will be one-off costs and are not likely to be significant.[6]

The Commission also considers that the rule as made will result in a number of long-term and ongoing cost benefits. These are likely to include:

- reduced costs for AEMO associated with drafting call notices (which AEMO has estimated at approximately $12,000 per year); and
- reduced costs for AEMO and market participants associated with actively managing trading limit breaches in the lead up to the time at which AEMO begins the process of drafting and issuing a call notice.

The Commission understands that AEMO and market participants currently expend resources actively managing trading limit breaches in the NEM as a result of market participants experiencing administrative rather than financial difficulties. This includes AEMO's time spent drafting call notices that are ultimately not issued and time spent by market participants arranging to provide AEMO with additional credit support or security deposits to reduce the level of outstandings below the participant's trading limit. The Commission considers that the rule as made is likely to reduce the resources spent by AEMO and market participants in such circumstances. It is likely that the long-term cost benefits of the rule as made will outweigh the short-term costs of implementation.

The Commission therefore considers that the rule as made will or is likely to promote the NEO with respect to the price of the supply of electricity in the NEM.

6 See rule change request, AEMO, at page 8.

3.3 Stakeholder views

The Commission received one submission in relation to this rule change request. The submission was received from Lumo Energy and was supportive of the rule as made. Lumo Energy agreed that the proposed rule would reduce the risk that a market participant would be unable to respond to a call notice because of administrative issues, highlighting the interaction with the timing of settlements from the Sydney Futures Exchange and the issue for Queensland-based market participants during daylight savings time.

Lumo Energy further noted that, while the proposed rule would extend by one hour the timing for the issuance of a call notice, "market participants would still need to respond to a call notice by 11AM the next day". Lumo Energy suggested that the proposed rule should be revised to give "market participants an additional hour to respond to the call notice on the next day".[7]

Under section 91A of the NEL, the Commission may make a rule different from that proposed if the Commission is satisfied that, having regard to the issue raised by the rule change request, the more preferable rule will or is likely to better contribute to the achievement of the NEO.

The issue raised by this rule change request concerns the risk that a call notice is issued because of administrative issues, rather than due to genuine financial distress. While changing a timing related to the issuance of call notices may impact on the time participants would have to respond to them, it is not clear that the response time forms part of the same issue.

It is also not clear that the change suggested would have an appreciable impact on the level of risk in the NEM. It is likely that an affected market participant will have been experiencing financial difficulties in advance of the call notice having been issued and it may not be appreciably more likely that a market participant in financial difficulty could respond to a call notice by 12:00 pm (Sydney time) any better than by 11:00 am (Sydney time). The Commission notes that, as AEMO has not issued a call notice to date, there is little experience in this regard.

The Commission therefore considers that there is insufficient evidence to allow it to be satisfied that the suggested more preferable rule would be likely to better contribute to the achievement of the NEO, and has determined not to amend the proposed rule in this way.

7 Consultation paper submission, Lumo Energy, page 2.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
Commission	See AEMC
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective

A Background to rule change request

A.1 The NEM wholesale market

In the NEM all purchases and sales of electricity occur through a central platform that is operated by AEMO. On this platform "market participants" trade in half hourly intervals in the wholesale market (also known as the "spot" market).[8] Through that platform, AEMO acts as the principal in each transaction a market participant enters to purchase or sell electricity.

The financial obligation to pay AEMO (or be paid by AEMO) for the electricity purchased or sold, is settled on a seven day billing period. However, the final settlement (taking into account all adjustments) between AEMO and a market participant occurs up to five weeks after a liability is accrued in the wholesale market. This means that large sums can be outstanding between AEMO and a market participant at any given time.

A.2 Prudential requirements in the NEM

Prudential requirements are obligations placed on businesses that operate in certain financial and other markets that are designed to limit the risks to participants in those markets.[9] The NEM has prudential requirements designed to protect AEMO, other market participants and ultimately consumers. These requirements are set out in rule 3.3 of the NER.

There are two broad components of the NEM prudential framework:

- the requirement that certain market participants post "credit support" such as a bank guarantee to AEMO; and
- the process to suspend a market participant that breaches certain limits to its trading in the NEM and cannot sufficiently rectify the breach.

These components are described further below.

8 A market participant is generally a retailer, generator or a transmission or distribution network service provider. Eligibility for registration as a market participant must be in accordance with rule 2.4 of the NER. Market participants must register in one or more of the categories "Market Customer", "Market Small Generation Aggregator", "Market Generator" and "Market Network Service Provider".

9 Such as, the risk that the failure of a business in the market will affect other participants.

A.2.1 Credit support and the maximum credit limit

If a market participant does not meet certain "acceptable credit criteria" it must post an amount of "credit support" to AEMO.[10] The credit support posted must be a bank guarantee or letter of credit provided on behalf of the market participant by an entity that meets the *acceptable credit criteria* (for example, a bank). The amount of credit support posted must not be less than the market participant's current "maximum credit limit", which is an amount determined by AEMO for each market participant.[11]

The *maximum credit limit* is an estimate of the potential exposure to a market participant's liabilities over the "credit period".[12] The credit period is comprised of:

- a period of 7 days of electricity trading during which liabilities are accrued (the "billing period");
- a period of 28 days which includes the number of days in the billing period plus the number of days until payment is due with respect to transactions for that billing period (the "payment period"); and
- a further period of 7 days which represents the time from the day that a market participant could be in breach of a limit to its trading to the time when the market participant could be suspended from trading (the "reaction period").

The *maximum credit limit* therefore represents an estimated value for each market participant of 35 days of electricity trading liabilities.

In the event that the market participant cannot meet its liabilities, AEMO will call upon the bank guarantee or letter of credit. If the *maximum credit limit* is set at the appropriate level, the credit support should in most cases cover the market participant's liabilities up to the date of its suspension, which occurs at the end of the *reaction period*.

The process to suspend a market participant, including the issuance of a "call notice", is described below.

A.2.2 Breach of trading limits and the issuance of a call notice

The beginning of the process of suspending a market participant occurs where the market participant breaches its "trading limit". The *trading limit* is set by AEMO for each market participant and is equal to the actual amount of *credit support* posted for the market participant, less the market participant's "prudential margin". The *prudential*

10 These criteria are set out in clause 3.3.3 of the NER. Broadly it is only financial institutions with existing prudential obligations regulated by the Australian Prudential Regulation Authority and certain government bodies that can meet those *acceptable credit criteria*.

11 See clauses 3.3.5 and 3.3.8 of the NER.

12 The *maximum credit limit* is an amount determined by AEMO for each market participant under procedures that it is required to develop and that must take into account a number of matters set out in clause 3.3.8 of the NER.

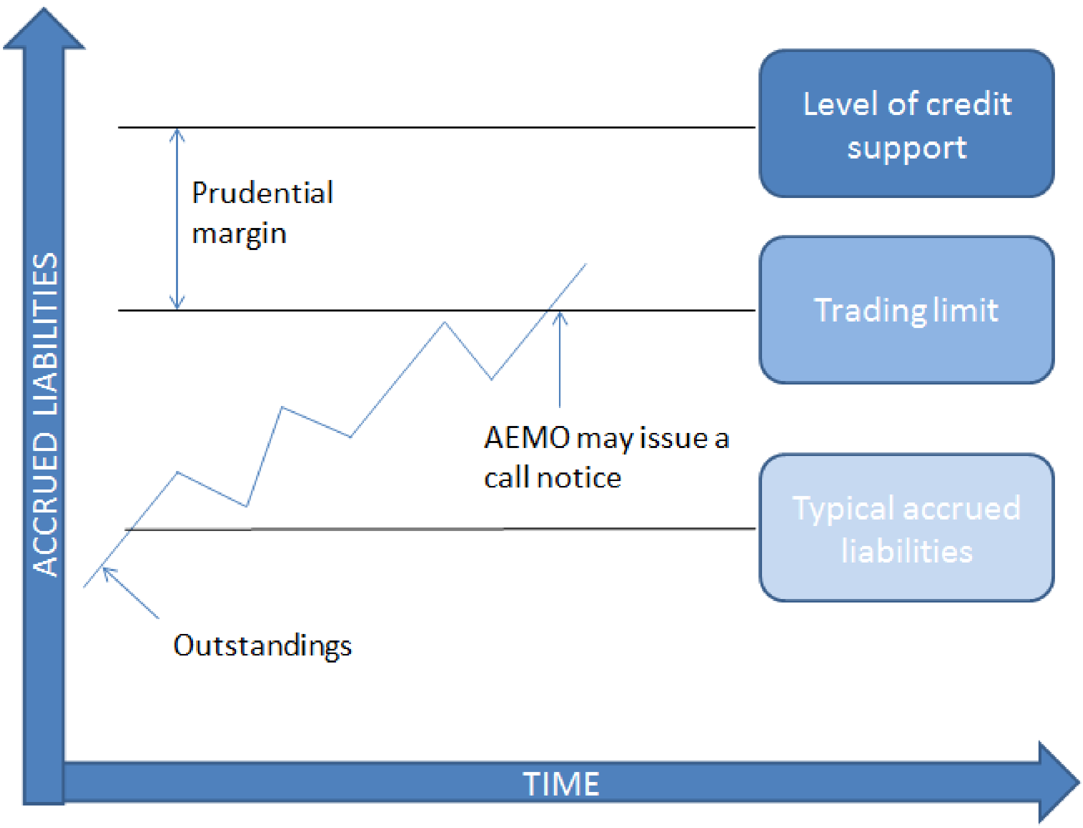
margin is calculated on a similar basis to the *maximum credit limit*, but represents a conservative estimate of potential accrued liabilities during only the 7 day *reaction period*.[13]

The purpose of the *trading limit* therefore is to trigger the process to suspend a market participant at a time where AEMO holds enough credit support to cover the liabilities that the market participant is likely to incur during the period until its suspension (the *reaction period*).

If a market participant's accrued net liabilities in the NEM are at any time greater than its *trading limit* AEMO may issue a *call notice* to the market participant. The net liabilities accrued by a market participant in the NEM are referred to as its "outstandings".[14]

Figure A.1 below shows the *credit support* and *trading limit* concepts in the NEM prudential requirements. The figure also shows a market participant accruing *outstandings* over time and that when those *outstandings* are greater than the *trading limit* AEMO may issue a *call notice*.

Figure A.1 Prudential requirements in the NEM



13 The *prudential margin* is set by AEMO in accordance with clause 3.3.8 of the NER.

14 The level of *outstandings* of a market participant is determined in accordance with clause 3.3.9 of the NER.

A.2.3 Responding to a call notice and the process to suspend a market participant

If a *call notice* is issued to a market participant, the market participant must respond by 11:00 am on the next business day (Sydney time) by reducing its *outstandings* to the level of "typical accrued liabilities". That is, the amount which AEMO determines would have been the *outstandings* of the market participant at that time if the wholesale market prices and the trading amounts of the market participant had been at average levels.[15] This amount is usually around 30 to 40 per cent of the *maximum credit limit*. A market participant may therefore need to significantly reduce its *outstandings* if a *call notice* is issued.[16]

As noted above, if a *call notice* is issued by AEMO the market participant must respond by 11:00 am the following business day. However, if a *call notice* is issued by AEMO after 12:00 pm, the *call notice* is deemed to have been issued on the next business day (so the market participant has an extra business day to respond).[17] It is this deadline that is the subject of this rule change request.

If a market participant does not adequately respond to the *call notice*, AEMO may issue a default notice, which requires the market participant to rectify the default by a particular time, usually 1:00 pm on the following business day.[18] If the default is not rectified to the satisfaction of AEMO within the time prescribed in the default notice, AEMO may issue a suspension notice to the market participant.[19] This notice will set out the time from which the market participant is suspended from trading in the NEM. The suspension is announced publicly and takes effect from the midnight immediately following that public announcement.

A.3 AEMO processes to issue a call notice

The NER provides that AEMO *may* issue a *call notice* to a market participant if its *outstandings* exceed its *trading limit*.[20] The NER does not provide that AEMO *must* issue a *call notice* at any particular time and does not set out any processes for AEMO to monitor the NEM prudential requirements.

Given the importance of prudential supervision of the NEM, AEMO has developed internal processes to monitor compliance with, and respond to breaches of, the

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15 The average levels are determined based on the average levels used by AEMO in the most recent determination of the market participant's *maximum credit limit*.

16 A market participant's *outstandings* can be reduced to the level of typical accrued liabilities by either providing AEMO with additional credit support (if this is agreed with AEMO), paying cleared funds to AEMO as a security deposit, or lodging a reallocations request. See clause 3.3.13(a) of the NER.

17 See clause 3.3.13(b) of the NER.

18 See clause 3.15.21 of the NER.

19 See clause 3.15.21(c) of the NER.

20 However, if a call notice is issued, the NER will determine when the call notice is deemed to have been issued and when the market participant will need to respond to the call notice.

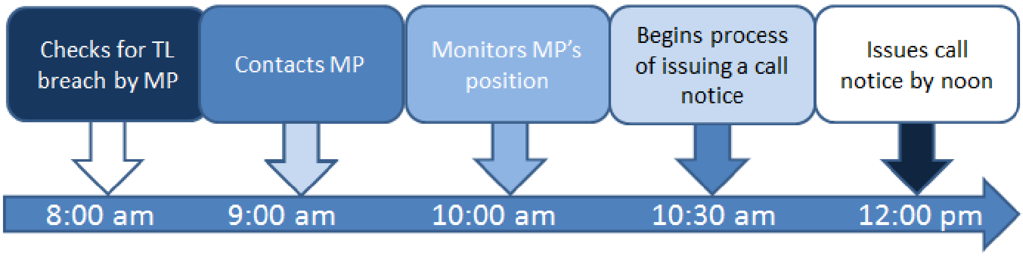
prudential requirements of the NEM. Some of these processes are published, and some are not.[21] AEMO's internal processes are carried out on each business day and those processes relevant to the timing of the issuance of *call notices* are:

- **8:00 am** - AEMO checks for any *trading limit* breaches by market participants;
- **9:00 am** - AEMO contacts any market participants that are in breach of their *trading limit*;
- **9:00 am to 10:30 am** - AEMO monitors the process of market participants in breach bringing their *outstandings* below their *trading limits*; and
- **10:30 am** - AEMO formally assesses the prudential position of all market participants and, for those market participants that are in breach of their *trading limit*, AEMO begins the process of drafting and issuing a *call notice*.

AEMO begins the process of preparing and internally approving the issuance of a *call notice* at 10:30 am (Sydney time). This timing is prescribed to allow AEMO to meet its aim to issue a *call notice* by 12:00 pm (Sydney time) which would mean that the market participant would be required to respond by 11:00 am on the next business day.[22]

To date, AEMO has never issued a *call notice*. However, we understand from AEMO that it is not uncommon for market participants to be in breach of their *trading limits* at the beginning of a business day. This particularly occurs when there has been a series of days in which electricity prices on the wholesale market have been high. We also understand that when this has occurred there has been a small number of occasions where a market participant has had difficulty managing its *outstandings* below its *trading limit* by 10:30 am due to administrative issues (such as, having difficulty contacting and arranging a transfer from its bank).

Figure A.2 AEMO's daily prudential monitoring processes



TL = trading limit
MP = market participant

Figure A.2 above represents the overall process for AEMO's daily monitoring of the prudential requirements of the NEM.

21 Certain parts of AEMO's internal processes are set out in the *NEM Settlement Prudential Supervision Process*, AEMO, 2009 and also in the *NEM Security Deposit Arrangements, version 11*, AEMO, 2011. Additional information in relation to AEMO's internal processes that have not been provided in these documents has been sourced from the rule change request.

22 See rule change request, AEMO, at page 7.