AUSTRALIAN **ENERGY** COUNCIL

Australian Energy Market Commission
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Lodged online: www.aemc.gov.au/Contact-Us/Lodge-a-submission

11 August 2016

Application of Offsets in the Prudential Margin Calculation (ERC0188)

The Australian Energy Council (the "**Energy Council**") welcomes the opportunity to comment on the Australian Energy Market Commission's ("**AEMC**") Application of Offsets in the Prudential Margin Calculation Draft Rule Determination.

The Energy Council is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Discussion

Setting the correct prudential framework for the National Electricity Market ("**NEM**") requires balancing the risk of a payment shortfall to nett creditors with the cost to participants of providing the necessary credit support. Within the prudential framework, the prudential margin is the buffer to cover potential losses in the period between a market participant defaulting and it being suspended from the NEM. As it stands, trading amounts cannot be offset against reallocation amounts, thereby increasing the amount of credit support which each market participant must provide to the Australian Energy Market Operator ("**AEMO**").

In 2012 a new prudential standard and framework were implemented. The prudential standard was established as 2% and the maximum credit limit for market participants was revised. AEMO's *"Report: Effectiveness of the NEM Prudential Settings Methodology"* dated March 2016 concluded that the new standard and framework are performing as intended.

The proposed rule change would remove Clause 3.3.8(e) from the National Electricity Rules, thereby allowing market participants to offset trading amounts and reallocation amounts in the prudential margin calculation. This would consequentially reduce the credit support needed to be provided by market participants to AEMO.

The Energy Council agrees that the amount of credit support needed to be provided by market participants is an inefficient use of collateral, and increases the cost of participating in the market for all counterparties.

It expects that implementation of the rule change will provide a benefit to consumers which will markedly exceed the cost of implementation, and on that basis supports the proposed rule change.

The Draft Rule Determination proposes three options to mitigate the risk of including reallocations in the prudential margin that cease to be firm during the reaction period[1] and the Energy Council supports

[1] The period between a market participant's default and its suspension from the market.

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amendments to the rule to address the issue. The Energy Council considers that Option 2 "Implement full offsets and ensure MCL increases are effective after one business day" will enable participants to maximise the efficiency gains of reallocation, and may be a strong option for alleviating the identified risk and maintaining opportunities for shorter qualifying ex ante reallocations. However the Energy Council acknowledges that the timetable which requires the provision of additional credit support within one business day may be difficult for smaller market participants to meet. Option 4 "Partial offsets" is considered to provide limited risk reduction, and on that basis the Energy Council supports Option 3 "Extend the ex-ante reallocation timetable" as a reasonable means of mitigating risks of default within the reaction period. Support for this option is predicated on the understanding that AEMO also shifts its timetable for the release of the initial MCL accordingly. This will ensure that participants still have the same number of days from the date of the initial MCL to finalise their reallocations.

Although the Energy Council also notes that the requirement for earlier lodgement at 14 business days may diminish the choice of reallocation products available, and the flexibility available to market participants to use reallocations as a risk management tool.

Conclusion

In conclusion, the Energy Council supports the proposed preferred draft rule incorporating Option 3 "Extend the ex-ante reallocation timetable", believing it will meet the National Electricity Objective, enhance competition and provide material benefits to the industry.

Any questions about this submission should be addressed to the writer, by e-mail to kieran.donoghue@energycouncil.com.au or by telephone on (03) 9205 3116.

Yours sincerely,

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