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Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Lodged (by online/email): <http://www.aemc.gov.au/Contact-Us/Lodge-a-submission>

Application of offsets in the prudential margin calculation

The Competitive Energy Association of Australia (CEA) welcomes the opportunity to make a submission to the AEMC consultation (the Consultation) on the Rule change proposal 'Application of Offsets in the Prudential Margin Calculation'.

The CEA 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.

The CEA is supportive of the Rule change. However, we note the consultation commenced eight months after the AEMC received the proposal. This proposal received some momentum when AEMO widely consulted on it during discussion of the new prudential standard. The delayed commencement of this consultation has slowed down momentum and will defer implementation of the project for a full year.

In summary:

- Rules should only seek to impose credit requirements when a credible risk of default is present and when it does so the capital requirements should reflect the expected loss;
- it is sensible that AEMO takes account of different hedging arrangements in when determining whether a participant must provide collateral to protect creditors from default, and;
- the current Rule requires collateral to be provided in the Prudential Margin as if a participant has not prudently hedged and is therefore not allocatively efficient.

Accordingly, the CEA supports the amendment to the Rules.

The CEA considers AEMO's prudential supervision is very important in order to protect NEM creditors. Due to the offsetting arrangements in the NEM, (vertical integration or electricity derivatives with reallocations), participants can represent a credit risk to the NEM at different times. It is sensible that AEMO takes account of these arrangements in determining whether a participant must provide collateral to protect creditors from the risk of a participant default.

Where possible AEMO should only seek to impose credit requirements when a credible risk of default is present and when it does so the capital requirements should reflect the expected loss. This is to ensure allocative efficiency, so capital is not unnecessarily tied up in credit arrangements.

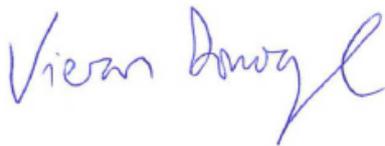
Before considering the proposed Rule, the CEA notes the Prudential Standard includes a number of participant specific assumptions to calculate the Outstandings Limits (OSL) and Prudential Margin (PM). These include the estimations of daily electricity load, daily generation and Participant Risk Adjustment Factors (PRAFs). In addition to improving the allocative efficiency of the Rules in the treatment of offsets in the Prudential Margin, there may be opportunities for AEMO to do the same with its Credit Limit Procedures.

It should be remembered the Rule proponent's justification for using generation (or reallocations) as an offset in the Prudential Margin against debit reallocations (or electricity load) is that it will reduce unnecessary credit support and improve competition for retailers competing against vertically integrated companies¹. The CEA considers AEMO should also review whether it allows an allocatively efficient level of offsetting in positive and negative trading amounts of 'gentailers' as AEMO implies in its Rule proposal.

Answers to specific questions in the Consultation have been provided in Attachment 1. The Association would welcome the opportunity to discuss any of the issues raised in this submission with the AEMC along with any other matters as they arise.

Any questions about our submission should be addressed to Panos Priftakis, by email to panos.priftakis@esaa.com.au or by telephone on (03) 9205 3115.

Yours sincerely



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Question 1: Restricting trading and reallocation amount offsets

Do stakeholders agree that this restriction no longer has any clear reasoning? If so, why? If not, why not?

The CEA agrees this restriction does not have any clear reasoning. A reallocation has to be withdrawn by both party, (or AEMO), and must be accompanied by a derivative contract. The reallocation is therefore 'firm' through the reaction period and should be used as an offset to trading amounts in the Prudential Margin.

Question 2: The Impact of the proposed rule on market efficiency

- (a) Is the proposed Rule likely to result in cost savings for MPs? Are the potential cost savings estimated by the Proponent (\$200,000 - \$500,000 per annum across all Participants) consistent with stakeholders' expectations? How do these savings compare with the costs of implementing such changes?**
- (b) What impact would the proposed Rule have on the ability of AEMO to maintain the prudential standard in the NEM?**

The CEA considers the proposed rule would be allocatively efficient as the current Rule requires collateral to be provided in the Prudential Margin as if a participant has not prudently hedged. We have been advised by members that the values in AEMO's proposal understate the prevailing value of collateral that must be provided for the forthcoming summer season. The benefits, though understated, are clearly more material than the cost of implementation.

We support the analysis in the rule change proposal that AEMO would remain able to maintain the prudential standard under the proposed rule.

Questions 3: Appropriate allocation of risks – part 1

- a) Do stakeholders agree that adequate processes exist to determine the firmness of reallocation? If so, why? If not, why not?**
- b) Do stakeholders agree that adequate processes exist to deregister those reallocations not considered sufficiently firm in a timely manner? If so, why? If not, why not?**

The CEA agrees with the Rule proponent that there are adequate processes to determine the firmness of reallocations.

The Rule proponent has confidence that ex-ante reallocations will stand during the Reaction Period (which is the period of expenses the Prudential Margin is designed to cover). It considers the reallocation cannot be unilaterally terminated and that it has powers to refuse a reallocation termination request or reapplication even if it is lodged with consent of both parties if it has grounds to believe the termination will expose NEM creditorsⁱⁱ.

Question 4: Appropriate allocation of risks – part 2

Have prior concerns raised by stakeholders about the firmness of reallocation offsets and generation offsets during the reaction period been sufficiently addressed to warrant removal of the restriction on these offsets as proposed by AEMO? If not, do these concerns warrant continuation of the existing restriction on offsetting between trading and reallocation amounts?

Yes. AEMO has enough discretion in the offsetting of trading amounts and reallocations in the OSL and PM. It can revise its Credit Limit Procedures should it consider the calculation of participants' debits (electricity load) and credits (electricity generation) does not reflect the credit risk the type of hedging used by a participant.

Question 5: Trade-off between flexibility and regulatory certainty

- a) If the proposed rule were made, AEMO will retain some discretion in relation to the extent it takes account of prospective reallocations in the calculation of the PM (under clause 3.3.8(d)(6)). In this context, have concerns raised in the context of the 2012 rule change proposal about the level of discretion provided to AEMO in relation to the calculation of the prudential margin been addressed?***
- b) Would regulatory transparency be improved by specifying in the Rules that AEMO must allow for offsets of trading amounts and reallocation amounts in the prudential margin calculation?***
- c) Are there other ways in which the offsetting between trading amounts and reallocation amounts can be made more transparent, in a manner consistent with the prudential standard?***

AEMO has enough discretion in the offsetting of trading amounts and reallocations in the OSL and PM. It can revise its Credit Limit Procedures should it consider the calculation does not reflect the credit risk the type of hedging used by a participant. The CEA does not consider it necessary to require AEMO in the Rules to offset prospective reallocations against trading amounts in the calculation of the prudential margin because the proponent has stated that this is what they will do if the Rule is made. The CEA considers therefore concerns over AEMO's discretion in the treatment of prospective reallocations in the Prudential Margin assessment are unwarranted.

Question 6: Competition and barriers to entry

Would the proposed change to the treatment of offsetting trading amounts and reallocation amounts in the prudential margin improve competition in the NEM (by reducing barriers to entry/expansion for smaller MPs)? Would the costs imposed by the revised rules accurately reflect the risks and costs associated with stand-alone retail or generation Market Participants in the NEM?

The Rules and AEMO's implementation through the Credit Limit Procedures should require collateral enough to cover the risk of default. If possible, collateral should be minimised to reflect whether the participant has entered into effective hedges. In this case the current Rule requires excess collateral for a participant that has hedged using an OTC derivative

and a reallocation. This should reduce the capital requirements on participants that tend to use OTC derivatives and reallocations; the CEA considers these are widely used by Market Participants. In order to allow competition to flourish the CEA supports the minimisation of unnecessary overheads.

Question 7 Costs and benefits of the rule change

- (a) Are there any additional costs or benefits to MPs associated with making AEMO's proposed rule change, beyond those identified by AEMO in section 3?**
- (b) Is the modelling approach used by AEMO to estimate the reduction in MCL requirements appropriate? If not, please identify improvements that could be applied the modelling approach.**
- (c) What would be the impact on consumers of an overall reduction credit support costs (as a result of the proposed rule change)?**

Savings will be passed through to consumers in electricity prices as costs are reduced for electricity retailers.

ⁱ Allowing for offset between *trading amounts* and *reallocation amounts* in the PM will remove the unequal treatment of *Market Participants* with equivalent financial exposure in the NEM. It will enhance competition through reducing barriers of entry, specifically for smaller *Market Participants* who do not have *generation* capacity to offset *load* and who currently face higher relative costs for obtaining *credit support* compared to their larger, vertically integrated competitors.

ⁱⁱ 28 May 2015, AEMO Rule Change Proposal: Attachment 1, page 7, paragraph 2