

Australian Energy Market Commission

RULE DETERMINATION

National Electricity Amendment Rule

(Futures Offset Arrangements (FOAs)) 2009

Rule Proponent(s)

Australian Power & Gas
Infratil Energy Australia
Momentum Energy

Commissioners

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16 April 2009

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Chairman

For and on behalf of the Australian Energy Market Commission

RULE
CHANGE

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (Commission) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market and, from 1 July 2008, concerning access to natural gas pipeline services and elements of the broader national gas markets. The AEMC is a statutory authority. Its key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council on Energy as requested, or on AEMC initiative.

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Abbreviations

AEMC	Australian Energy Market Commission
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
Commission	see AEMC
Corporations Act	<i>Corporations Act 2001 (Cth)</i>
CFD	Contracts for Differences
CCP	central counter-party
Deloitte	Deloitte Touche Tohmatsu (consulting firm)
ERAA	Energy Retailers Association of Australia
EUAA	Energy Users Association of Australia
FOAs	Futures Offset Arrangements
FPNP	FOA Party NEM Participant
IPRA	International Power Australia
MCE	Ministerial Council of Energy
MCL	Maximum credit limit
NEL	National Electricity Law
NEO	National electricity objective
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NGF	National Generators Forum
OTC	Over-the counter (bilateral contract)
Rules	National Electricity Rules
SDA	Security Deposit Arrangement
SFE	Sydney Futures Exchange
SFECC	SFE Clearing Corporation

Summary

On 10 January 2008, the Australian Energy Market Commission (Commission) received a joint Rule change proposal from Australian Power & Gas, Infratil Energy Australia and Momentum Energy (Proponents). The proposal essentially consisted of two parts:

- Part 1: Maximum credit limit (MCL) methodology: the Proponents proposed to modify the MCL calculation methodology in the National Electricity Rules (Rules). Rather than the MCL methodology using a backward looking price observation as a basis for predicting future pool prices, it would utilise Sydney Futures Exchange (SFE) electricity futures prices as the key inputs of the model, representing a forward looking view of future pool price outcomes.
- Part 2: FOAs: the Proponents proposed to define and accommodate FOAs within the Rules. An FOA would be a commitment entered into by an SFE Clearing Participant on behalf of a National Electricity Market (NEM) participant to redirect positive cash flows associated with the NEM participant's futures position to NEMMCO (to be held in a Security Deposit Arrangement (SDA)) to protect against the default of the NEM participant. In return, the NEM participant would only provide bank guarantee support to NEMMCO up to a level equivalent to the futures price at which the FOA was initiated and beyond which cash payment obligations from the SFE Clearing Participant to NEMMCO arise under the FOA.

Consistent with the position in its draft Rule determination, Commission has decided not to make a Rule in relation to this Rule change proposal. The Commission makes this final Rule determination under section 102 of the NEL.

In making this final Rule determination, the Commission is mindful of both the benefits and risks associated with the proposed Rule.

Importantly, the Commission did not make a Rule because it is not satisfied that the Rule change would, or would be likely to, contribute to the achievement of the national electricity objective (NEO) due to the risks associated with Part 2 and Part 1 of the Rule change proposal.

The risks arising from Part 2 of the Rule change proposal include:

- the legal rights and obligations of FOA parties are not clear;
- implications of lack of payment surety by the proposed FOAs;
- clawback risks of security deposits paid to NEMMCO as part of the FOA process;
- lack of a dispute resolution process in the proposed FOA; and
- lack of clarity in the Rule change proposal as to whether a futures contract in one NEM region could be used to reduce the MCL in another region.

For Part 1, these risks include:

- the MCL calculated by the proposed methodology is unlikely to be consistently accurate in delivering a prudential support level that is adequate for the efficient operation of the NEM, and therefore does not promote an efficient operation of electricity services to contribute to the achievement of the NEO;
- the volatility factors implied in the futures prices may give rise to MCL levels that are higher than necessary. Again, an inadequate MCL level is unlikely to contribute to the achievement of the NEO;
- lack of clarity in the Rule change proposal as to what point of the futures price trajectory that should be used for the purpose of calculating an MCL; and
- lack of clarity as to how the MCL for participants in NEM jurisdiction with no futures trading (that is, Tasmania) would be calculated.

To develop a feasible solution to address the risks associated with the Rule change proposal (if it is possible), the Commission is conducting a review under section 45 of the NEL to explore the possibility of offsetting the prudential requirement levels of NEM participants. This review also aims to develop a robust model to offset the prudential requirement of a NEM market participant using its futures and other contract positions.

The Commission made the decision to conduct the review in its draft Rule determination on 22 January 2009. The Commission maintains its position in this final Rule determination.

The Commission notes an alternative FOA model was proposed in a submission to address some of the risks associated with the Rule change proposal identified in the draft Rule determination. The Commission also notes that there are requests to make a Rule under sections 91A^a or 91B^b of the NEL.

The Commission, however, has decided to proceed with the review because:

- the complexity of the issues involved and the need to engage with stakeholders, some of whom may not be NEM participants, on a more detailed level means the option of making a more preferable Rule or “consequential Rule” is not appropriate; and
- it may also be necessary to explore the broader issues around the proposed FOA models to consider their impacts on the NEO.

^a The Commission may make more preferred Rule in certain cases.

^b The Commission may make Rules that are consequential to a Rule request.

1 Rule change proposal from Australian Power & Gas, Infratil Energy Australia and Momentum Energy (Proponents)

1.1 Summary of the Rule Change Proposal

On 10 January 2008, the Australian Energy Market Commission (Commission) received a joint Rule change proposal from the Proponents. This request essentially consisted of two parts:

- Part 1: Maximum credit limit (MCL) methodology: the Proponents proposed to modify the MCL calculation methodology in the National Electricity Rules (Rules). Rather than the MCL methodology using a backward looking price observation as a basis for predicting future pool prices, it would utilise Sydney Futures Exchange (SFE) electricity futures prices as the key inputs of the model, representing a forward looking view of future pool price outcomes.
- Part 2: Futures Offset Arrangements (FOAs): the Proponents proposed to define and accommodate FOAs within the Rules. An FOA would be a commitment entered into by an SFE Clearing Participant on behalf of a National Electricity Market (NEM) participant to redirect positive cash flows associated with the NEM participant's futures position to NEMMCO (to be held in a Security Deposit Arrangement (SDA)) to protect against the default of the NEM participant. In return, the NEM participant would only provide bank guarantee support to NEMMCO up to a level equivalent to the futures price at which the FOA was initiated and beyond which cash payment obligations from the SFE Clearing Clearer to NEMMCO arise under the FOA.

On 3 March 2008, Australian Power & Gas, one of the three Proponents, submitted to the Commission to modify an aspect of this Rule change proposal.

1.2 Context and background

1.2.1 Historical development

1.2.1.1 Reallocation Rule determination in February 2007

On 15 February 2007, the Commission determined a Rule amendment in relation to the reallocation arrangements.

Reallocation is a mechanism under the Rules whereby two NEM participants (typically, but not necessarily, a generator and a retailer) can "lodge" a quantity of energy or cash with NEMMCO. Under a reallocation mechanism, NEMMCO recognises that NEM participants enter into over-the-counter (OTC) bilateral contracts, usually Contracts for Differences (CFD), to reduce price risk for specified quantities of energy.

The reallocation mechanism was introduced for two purposes:

- to minimise the settlement risk of circular cash flows; and
- to minimise the prudential support requirements from NEM participants.

Minimise the settlement risk of circular cash flows

A retailer purchases electricity from the NEM at the prevailing pool price, and typically hedges against the potentially volatile pool price by entering into an OTC bilateral contract with a generator (or entering into a futures contract).

In the absence of a reallocation arrangement, the pool settlements and contract settlements of a NEM participant are carried out under two separate processes: the pool settlements in the NEM are performed by NEMMCO, and counter parties of an OTC bilateral contract usually settle amongst themselves outside of the NEM.

This may give rise to the situation of circular cash flows where, on the same day, the retailer will pay NEMMCO for energy consumed, NEMMCO will pay the generator for energy generated, and the generator and retailer will exchange cash representing the CFD contract payments.

One purpose of reallocation is to minimise the settlement risk of circular cash flows. Reallocation eliminates circular cash flows by netting off the pool settlements against the reallocation transaction.

Minimise the prudential support requirements from NEM participants

In the absence of a reallocation arrangement, the amount of prudential support a NEM retailer is required to provide to NEMMCO would be estimated based on its quantity of electricity purchases from the NEM at the prevailing or expected electricity pool price.

In the event of a price spike, a NEM retailer may find itself owing a large amount of money to NEMMCO in order to provide an adequate prudential support from the time of the price spike until settlement occurs (up to 35¹ days).

A purpose of reallocation is to minimise the amount of prudential support requirements from NEM participants. With a reallocation arrangement, the gross pool settlement for a NEM retailer's electricity purchase is netted off against the reallocation transaction. This reduces the amount of money the NEM retailer would owe NEMMCO for prudential support. A reduced prudential support requirement is likely to reduce the retailer's prudential support costs.

Key elements of a reallocation arrangement

The key elements of the reallocation Rule determination were²:

¹ The number of days may vary depending on public holidays.

- providing for a new category of registered participant – a Reallocator: the Rule provides for financial institutions and other entities to become registered participants for the purpose of participating in a reallocations transaction;
- improving flexibility in reallocation procedures: the Rule requires NEMMCO to develop and maintain reallocation procedures, in accordance with the Rules consultation procedures provided in Chapter 8 of the Rules. This will allow reallocation procedures to adapt in response to changing market circumstances; and
- changes to prudential requirements: to better address the prudential risks associated with NEM participants who reallocate, or generators who have market load, the Rule changes the approach to the provision of prudential requirements by providing for a prudential margin according to the anticipated credit risk associated with each market participant.

1.2.1.2 J20 submission – proposal for FOAs

As part of the first round consultation for the reallocation Rule determination, the Commission considered a joint submission by 20 NEM industry participants (J20 submission).

The J20 submission, prepared by d-cyphaTrade, recommended that FOAs be defined within the Rules to offset a NEM participant’s prudential requirement using the cash flow generated by its futures contracts.

The Commission was reluctant to embed within the Rules complicated procedures to handle the reallocation of a particular financial market contract. It considered that it is a good regulatory practice for such detailed matters of implementation to be contained in guidelines and procedures, in accordance with framework requirements provided in the Rules. The Commission therefore concluded that the reallocation procedures were the appropriate place for procedural details describing the FOAs.

The Commission encouraged NEMMCO and the J20 signatories to undertake direct consultation with a view to either:

- consider how the requirements of J20 may best be incorporated within the reallocation procedures; or
- develop a well formed and articulate Rule change proposal that may be brought to the Commission for consideration in the future.

² Further details are available on the Commission’s website:
<http://www.aemc.gov.au/electricity.php?r=20060425.162734> (Final determination)

1.2.1.3 NEMMCO and the Australian Securities Exchange (ASX) were to develop and FOA procedure

As part of the second round consultation for the reallocation Rule determination, the Commission received a joint submission from NEMMCO and the ASX outlining a process where the issues raised in the first round J20 submission can be addressed by utilising the provisions for reallocations in the Rules, subject to an independent assessment of legal and risk issues.³ The Commission acknowledged this proposed approach and commended the joint initiative of the respective parties to accommodate the concerns raised.

1.2.1.4 ASX withdrew from the FOA development work in January 2008

In January 2008, the ASX advised NEMMCO that it would no longer be participating in the development work to finalise the FOA procedure due to a preference to pursue a single licensed clearing and settlement facility for the spot and forward markets.

1.2.1.5 Proponents proposed FOAs in January 2008

On 10 January 2008, the Commission received this joint Rule change proposal from the Proponents which sought to define and accommodate FOAs within the Rules. This proposal also sought to modify the MCL methodology.

Appendix 7 of the Rule proposal document⁴ contains the proposed marked-up changes to the Rules (Proposed Rule).

The Commission notes that this Rule proposal shares many common features with the FOA proposal contained in the J20 submission.

The Commission understands that d-cyphaTrade contributed significantly to this Rule change proposal.

1.2.2 Part 1 of the Rule change proposal: MCL methodology

The MCL is part of the NEM's prudential arrangements.

The MCL of a NEM participant is a "reasonable worst-case" estimate of its potential financial exposure to NEMMCO. The potential financial exposure is based upon the

³ AEMC, 2007, *Amendment to National Electricity (Reallocations) Rules: Joint Submission from ASX and NEMMCO*, <http://www.aemc.gov.au/electricity.php?r=20060425.162734>, viewed 30 March 2009

⁴ AEMC, 2008, *National Electricity Rule Change Proposal – Futures Offset Arrangements January 2008*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152> (hyperlink: Rule Change Proposal), viewed 30 March 2009

aggregate payments the NEM participant is to make to NEMMCO over the participant's credit period (credit period is around 35⁵ days).

The MCL for a participant is determined by NEMMCO after considering its reallocation arrangements.

NEM participants are required to lodge credit support with NEMMCO to the level of at least its MCL.

Schedule 3.3.1 of the Rules sets out the principles to be followed by NEMMCO in determining the MCL for a NEM participant.

Under clause 3.3.8(d) of the Rules, NEMMCO is responsible for developing the methodology to determine the MCL of each NEM participant. The MCL methodology is contained in NEMMCO's procedure entitled *Method for Determining Maximum Credit Limit & Prudential Margin* (MCL Procedure).⁶

Essentially, the key parameters of the MCL for each NEM Participant in a region are:

MCL =

The average regional pool price for the previous 12 months

× a volatility factor based on pool price volatility during the previous 12 months

× the NEM participant's likely average daily demand consumption during the quarter

× 42 days of potential energy consumption⁷

The Proponents proposed to revise the current MCL methodology. Rather than the MCL methodology using a backward looking price observation as a basis for predicting future pool prices, the Proponents proposed that the MCL methodology should utilise SFE electricity futures prices as the key inputs of the model. This would represent a forward looking market consensus view of future pool price outcomes.

1.2.3 Part 2 of the Rule change proposal: FOAs

The proposed Rule change defines and accommodates FOAs within the Rules. Important elements of FOAs include:

- the futures market and the Sydney Futures Exchange (SFE);

⁵ The number of days of each settlement cycle may vary depending on public holidays.

⁶ NEMMCO, 2008, *Method for Determining Maximum Credit Limit & Prudential Margin*, Version 5.1, http://www.nemmco.com.au/met_sett_sra/prudentials.html#MethodofDeterminingMaximumCreditLimits, viewed 30 March 2009

⁷ The 42 days consists of approximately 35 days of credit period and 7 days of reaction period (the period of removing a participant from the NEM when it does not meet the prudential requirements).

- SFE electricity futures contracts;
- the SFE Clearing Corporation (SFECC) and SFE Clearing Participants; and
- the NEM participant who is a party to a futures contract and uses it to enter into an FOA (FOA Party NEM Participant, or FPNP). An FPNP is typically, but not always, a retailer in the NEM.

1.2.3.1 The Sydney Futures Exchange

A futures market is a venue for buyers and sellers to transact futures contract. The SFE has important roles in this market which include⁸:

- offering a futures trading facility to the public;
- acting as the first line of supervision on behalf of the corporate regulator Australian Securities and Investments Commission (ASIC); and
- providing price and data dissemination to end users.

1.2.3.2 SFE electricity futures contract

A futures contract is a contractual agreement, generally made on the trading floor of a futures exchange, to buy or sell a particular underlying commodity or financial instrument in the future at a pre-determined price. Futures contracts detail the quality and quantity of the underlying asset; they are standardized to facilitate trading on a futures exchange.

An SFE electricity futures contract is a futures contract in which the underlying commodity is “electrical energy bought and sold in the NSW, Victorian, South Australian and Queensland wholesale pool markets conducted by the National Electricity Market Management Company (NEMMCO)”⁹.

SFE electricity futures contracts are operated by the SFE.

FOAs were designed to facilitate the prudential support management of NEM participants who hold SFE futures contracts.

1.2.3.3 The SFECC and SFE Clearing Participants

The SFECC provides a central counter-party (CCP) clearing service for all futures and options contracts traded at the SFE, between SFE Clearing Participants.

⁸ ASX, *A brief overview of Sydney Futures Exchange*, http://www.asx.com.au/resources/education/audio_visual/futures/module003.htm, viewed 15 January 2009

⁹ Base Load Electricity Futures, dcypha-Trade, http://www.d-yphatrade.com.au/products/electricity_futures, viewed 13 January 2009

Central to CCP clearing is the process of “novation”, which involves the SFECC interposing itself between buyers and sellers of futures contracts (represented by SFE Clearing Participants) and becoming the central counterparty or principal to all trades.¹⁰

Through the novation process the SFECC is liable to perform against all contracts to which it is a party and effectively “guarantees” the performance of SFE Clearing Participants. Novation and thus the clearing guarantee become effective on registration of the contract between buyers and sellers.¹¹

Risk exposures are managed by the SFECC in a number of ways, including but not limited to¹²:

- the margining process where the SFECC collects various margins from SFE Clearing Participants: the collection of these margins prevents SFE Clearing Participants from accumulating large unpaid losses. The large unpaid losses (especially when there is an extreme price movement) could potentially impact on the financial position of other market users; and
- setting up a Clearing Guarantee Fund for use in the event of default of one or more SFE Clearing Participants: the adequacy of the Clearing Guarantee Fund is regularly assessed by comparing it with the SFE Clearing Participants’ potential loss exposures as determined by an approved stress testing process.

Through the margining process, when the price of a futures contract increases relative to its last price, a margin payment is collected from the party who holds a short position¹³ in the futures contract (through its SFE Clearing Participant). In addition, a margin payment is paid to the party, through its SFE Clearing Participant, who holds a long position¹⁴.

Similarly, the reverse payments would apply if the price of the future contract decreases relative to the last price.

¹⁰ d-cyphaTrade, Guide to SFE Clearing, http://www.d-cyphatrade.com.au/clearing/a_guide_to_sfe_clearing, viewed 15 January 2009

¹¹ The ASX, *Benefits of ASX Listed CFDs*, http://www.asx.com.au/products/cfds/getting_started/benefits_of_asx_listed_cfds.htm, viewed 15 January 2009

¹² The ASX, *SFE Clearing Guarantee and Capital Adequacy, Mutualisation of Risk*, http://www.asx.com.au/professionals/clearing/financial_integrity/guarantee.htm, viewed 15 January 2009

¹³ The seller of a futures contract holds a short position. A short position means a promise to sell a certain quantity of electricity at a particular price in the future. Typically, but not always, generators hold futures contracts in short positions.

¹⁴ The buyer of a futures contract holds a long position. A long position means a promise to buy a certain quantity of electricity at a particular price in the future. Typically, but not always, retailers hold futures contract in long positions.

1.2.3.4 FOAs: how do they work?

The proposed FOA is a commitment entered into by an SFE Clearing Participant on behalf of an FPNP to redirect positive cash flows associated with its futures position (cash flow generated by the SFECC's margining process) to NEMMCO. The cash flows directed to NEMMCO are to be held in an SDA to protect NEMMCO against the default of the FPNP.

In return, the FPNP only provides bank guarantee support to NEMMCO up to the level (in \$/MWh) equivalent to the futures price at which the FOA was initiated (known as the Futures Lodgement Price) and beyond which cash payment obligations from the SFE Clearing Participant to NEMMCO arise under the FOA.

The way an FOA may operate is illustrated in Figure 1.

The Proponents proposed that an FOA be a voluntary arrangement which involves the following steps in the process¹⁵:

1. An FPNP and an SFE Clearing Participant submitting a Notice of Futures Offset Arrangement to NEMMCO¹⁶.
2. Upon registration of the FOA by NEMMCO, the SFE Clearing Participant pays to NEMMCO cash amounts equivalent to positive futures variation margins¹⁷ attributable to nominated electricity futures contracts held by the SFE Clearing Participant on behalf of the NEM Participant.
3. Whenever the futures price increases:
 - (a) using the fund generated by the margining process, the SFE Clearing Participant pays cash to NEMMCO of amount calculated in accordance with the formula defined under section 5.1, clause 3.15.11B of the Proposed Rule. This is shown as item 3 of Figure 1;
 - (b) the remaining cash is distributed to the FPNP. This is shown as item 4 of Figure 1;
 - (c) NEMMCO applies amounts received under the FOA to the FPNP's SDA (or as otherwise agreed between NEMMCO and the FPNP). This is shown as item 5 of Figure 1;
 - (d) NEMMCO reduces the spot market credit support required from the FPNP via a reduced MCL in consideration of the FOA.

¹⁵ Deloitte advised the Commission that "the understanding [amongst stakeholders] of how the proposed rule change would operate in practice varied significantly."

¹⁶ The Commission understands that the FPNP needs to have bought and holds an underlying futures contract to enter into an FOA.

¹⁷ In per futures contract term, this is equivalent to the difference between the Futures Lodgement Price and the prevailing futures contract price when the term of the FOA starts. The difference must be larger than or equal to zero.

4. When the futures price decreases, which may give rise to the FPNP having contributed excess fund to the SDA, the FPNP is able to access a part of this fund (this is an amendment to the original Rule proposal. See section A1.1).
5. NEMMCO would release the proceeds from the FOA from the SDA when the FOA expires or is terminated (as shown as item 6 in Figure 1).
6. The FPNP continues to make spot market settlement payments to NEMMCO as per existing settlement arrangements, while potentially benefiting from a reduced MCL and a reduced likelihood of being required to make payments to NEMMCO in response to a spot market margin call.

1.3 Risk assessment by Deloitte Touche Tohmatsu (Deloitte)

The Commission engaged risk consultants Deloitte to assess the financial risks to the NEM associated with this Rule change proposal.

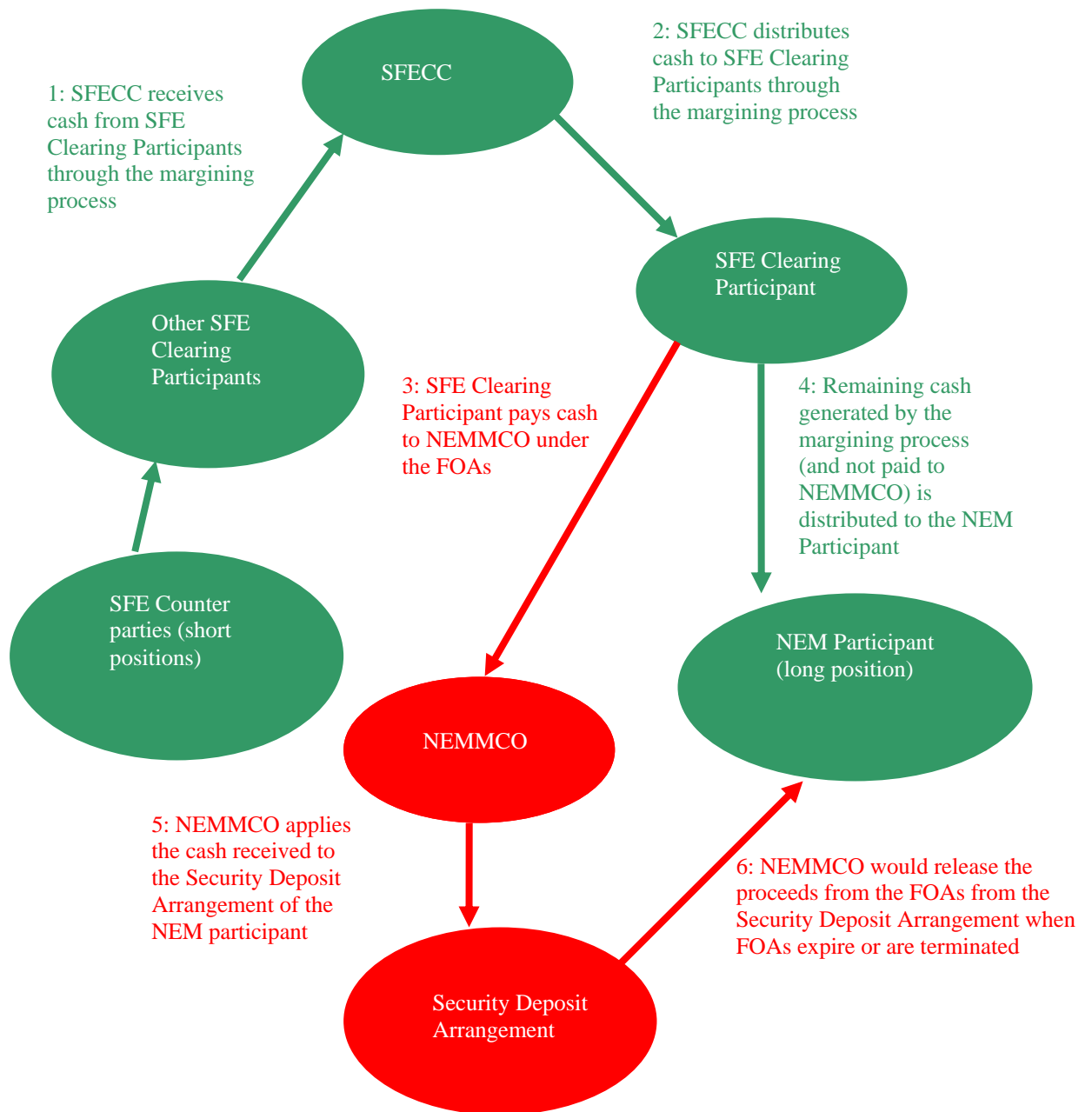
Deloitte's assessment of the risk is contained in its report "Proposed Rule Determination - MCL and FOA Prudential Supervision Risk Analysis".

In addition, Deloitte presented its key findings during a workshop on 30 September 2008 (see section 1.4.3).

A copy of this report has been published on the Commission's website.

As part of the first round consultation for the Proponent's Rule change proposal, the Commission invited comments on this report.

Figure 1: Flows of cash – margining process and the FOAs (when the futures price increases)



Note:
 The SFECC's margining process is shown in green.
 The FOAs process is shown in red.

1.3.1 Deloitte's key findings

In its report, Deloitte identified a number of risks associated with the Rule change proposal. In particular, Deloitte identified the following issues as high risks:

- NEMMCO may have insufficient prudential coverage if an FOA is sold or terminated by the NEM market participants;
- NEMMCO may not have a legal right to keep the funds provided under an FOA contract by a NEM participant in normal, settlement or credit default (clawback risks);
- the SFE Clearing Participant can not be required to pay in a timely manner as they are not bound by the NEM rules;
- FOA contracts may not be paid to NEMMCO by SFE Clearing Participants/Counterparties;
- NEMMCO may not receive FOA payments due to the SFECC not being able to isolate daily movements in underlying electricity futures contracts;
- NEMMCO may not receive funds due to SFE Clearing Participants withholding payment from their clients;
- NEM Participants, NEMMCO and SFE Clearing Participants do not fully understand the proposed MCL calculation and FOA process;
- Proposed Rule and Procedures do not adequately define the processes and requirements. In particular, it is unclear what will be defined in Rules compared to procedures; and
- the MCL might not be accurate as it is calculated with a volatility factor determined quarterly per region, and this volatility factor might have already been implied in the price of futures.

1.4 Consultation on the Proponent's proposal

As part of this final Rule determination process, the Commission held the first round consultation. This is discussed further in section 1.4.1 of this final Rule determination.

The Commission received a supplementary submission from d-cyphaTrade following the first round consultation. This is discussed further in section 1.4.2 of this final Rule determination.

The Commission also held a stakeholder workshop as part of the consultation process for this Rule change proposal. This is discussed further in section 1.4.3 of this final Rule determination.

On 22 January 2009, the Commission gave notice under section 99 of NEL advising of the making of the draft Rule determination, and commenced the second round consultation, on the Rule change proposal.

The submissions received are discussed further in section 1.4.5 of this final Rule determination.

On 12 February 2009, the Commission held a pre-final Rule determination hearing in accordance with section 101 of the NEL. This is discussed further in section 1.4.6.

1.4.1 First round consultation

On 14 February 2008, under section 94 of the NEL, the Commission decided to commence a first round consultation on the Rule change proposal and published a notice under section 95 of the NEL. Under this consultation, the Rule change proposal was open for public consultation for four weeks. Submissions closed on 14 March 2008.

The Commission received ten submissions on the Rule change proposal at the first round of consultation, which are available on the AEMC website.¹⁸ The Commission received submissions from:

- Australian Power & Gas;
- d-cyphaTrade (2 submissions, one of them was a presentation¹⁹);
- EnergyAustralia;
- ERM Power;
- Energy Users Association of Australia (EUAA);
- Integral Energy;
- International Power Australia (IPRA);
- NEMMCO; and
- the National Generators Forum (NGF).

Australian Power & Gas, one of the three Proponents, submitted to the Commission to modify an aspect of the Proposed Rule.

IPRA opposed both Part 1 and Part 2 of the Proposed Rule.

EnergyAustralia was supportive of Part 2 of the Rule proposal, but opposed Part 1.

¹⁸ These submissions can be found on <http://www.aemc.gov.au/electricity.php?r=20080204.095152>

¹⁹ Australian Power & Gas and d-cyphaTrade made a joint presentation to the Commission on 4 March 2008.

Most of the other submissions were broadly supportive of the Proposed Rule. However, some of them have raised risks that require the Commission's consideration before a Rule determination can be made.

These submissions are discussed further in Appendix A of this final Rule determination.

1.4.2 Supplementary submission

In addition to the submissions discussed in section 1.4.1 above, on 11 September 2008, d-cyphaTrade provided a supplementary submission to the Commission.

This submission suggested a modification to the proposed Rule. This is discussed further in Appendix A of this final Rule determination.

1.4.3 Stakeholder workshop and the associated submissions

On 30 September 2008, the Commission held a workshop with key stakeholders in relation to the Rule change proposal.

During this workshop, Deloitte presented its key findings of the risks associated with the proposal, and attendees were invited to provide comments on the presentation.

In addition, the Commission invited the attendees to provide submissions in response to this presentation.

It should be noted that the workshop held was not intended to be a public hearing for the purpose of section 98 of the NEL.

The Commission received three submissions from the following parties:

- The Australian Securities Exchange (ASX);
- d-cyphaTrade; and
- the NGF.

These submissions are discussed further in Appendix A of this final Rule determination.

1.4.4 Time extensions under section 107 and report under section 108A of the NEL

Due to the complex nature of this Rule change proposal and its associated risks, the Commission issued three notices under s107 of the NEL to extend the time for publication of the draft Rule determination.²⁰

On 19 February 2009, the Commission published a report²¹ under section 108A of the NEL because it did not publish the final Rule determination within 12 months of public notification of request.

1.4.5 Submissions from the second round consultation

On 22 January 2009, the Commission published a draft Rule determination, and commenced the second round consultation, on this Rule change proposal. A copy of the draft Rule determination is available on the Commission's website.²²

In its draft Rule determination, the Commission decided not to make a Rule and to commence a review process to examine the issues associated with the Rule change proposal.

The Commission has commenced this review process, and have published the Framework and Issues Paper for this review.²³

The submissions for the second round consultation on this Rule change proposal closed on 6 March 2009.

The Commission received six submissions. These submissions were received from:²⁴

- AGL Energy;
- ERAA;
- NEMMCO;
- the NGF; and
- d-cyphaTrade (two submissions received. One on 6 March 2009, and the other one on 16 March 2009).

²⁰ The notices are available on the Commission's website, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>

²¹ AEMC, 2009, *Futures Offset Arrangements (FOAs) - Rule Change Proposal – Section 108A Report*,

²² AEMC, 2009, *Draft Rule Determination – National Electricity Amendment (Futures Offset Arrangements (FOAs)) Rule 2009*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

²³ AEMC, 2009, *Framework and Issues Paper - Review into the role of hedging contracts in the existing NEM prudential framework*, <http://www.aemc.gov.au/electricity.php?r=20090303.112859>, viewed 30 March 2009

²⁴ These submissions can be found on <http://www.aemc.gov.au/electricity.php?r=20080204.095152>

AGL Energy, ERAA, and the NGF supported the Commission's decisions in the draft Rule determination to not make a Rule and conduct a review.

NEMMCO supported the Commission's decision to conduct a review but requested the terms of reference of this review be amended to consider the MCL performance target (see Appendix A for further discussion).

In its submission to the Commission on 6 March 2009,²⁵ d-cyphaTrade proposed a "Direct Retailer FOA" model. d-cyphaTrade contended that this model "would address concerns raised in the Draft Rule Determination, is more efficient than the original FOA proposal and could be implemented under the current Rule Change process." d-cyphaTrade also submitted that "implementation via the current Rule Change process would avoid further delays in significant efficiency benefits flowing to Market Participants."

In its submission to the Commission on 13 March 2009,²⁶ d-cyphaTrade proposed a draft Rule for the Direct Retailer FOA model. d-cyphaTrade submitted that the Commission should "make the Direct Retailer FOA as an alternative to the Initial Rule proposed (and which was rejected) as part of the FOA Rule change proposal rather than considering this alternative as part of the market review that has recently commenced on the same issue."

Appendix A discusses the Direct Retailer FOA model in further details.

1.4.6 Pre-final Rule determination hearing

On 29 January 2009, the Commission received a request from Australian Power & Gas to hold a hearing in relation to the draft Rule determination.²⁷

On 30 January 2009, the Commission also received a request from d-cyphaTrade to hold a pre-determination hearing in relation to the draft Rule determination.²⁸

Therefore, on 12 February 2009, the Commission held a pre-final Rule determination hearing in relation to the Proponent's Rule change proposal under section 101 of the NEL.

The record of hearing is available on the Commission's website.²⁹

²⁵ d-cyphaTrade, 6 March 2009, *Futures Offset Arrangement Rule Change Proposal 2008 - Submission to Draft Rule Determination (22nd January 2009)*,

<http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

²⁶ d-cyphaTrade, 13 March 2009, *Futures Offset Arrangement Rule Change Proposal 2008 - Submission to Draft Rule Determination (22nd January 2009)*,

<http://www.aemc.gov.au/electricity.php?r=20080204.095152>, 30 March 2009

²⁷ Email from Australian Power & Gas to the Commission, 29 January 2009, *Hearing request*,

<http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

²⁸ d-cyphaTrade, 30 January 2009, *Request for Pre-Determination Hearing - Project No. ERC0056*,

<http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

During this hearing, d-cyphaTrade contended that the Commission should draft a Preferred Rule under section 91A of the NEL, rather than conduct a review under section 45 of the NEL.

Further details in relation to this hearing are discussed in Appendix A of this final Rule determination.

1.5 Summary of the timetable

The timetable for considering the Rule change proposal, including those steps discussed in sections 1.4.1 to 1.4.6, are set out in Table 1.

²⁹ AEMC, 12 February 2009, *Record of hearing – Pre-determination hearing of the Australian Energy Market Commission*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

Table 1: Timetable for the Rule determination

Date	Determination process
14 February 2008	The Commission published a notice under section 95 of the NEL advising of its intention to commence the Rule change process and initial consultation on this Rule proposal.
14 March 2008	Close of first round consultation.
15 May 2008	The Commission published a notice under section 107 of the NEL to extend the period for publication of the draft Rule determination to 2 October 2008.
30 September 2008	The Commission held a workshop to present the key findings by Deloitte.
2 October 2008	The Commission published a notice under section 107 of the NEL to extend the period for publication of the draft Rule determination to 11 December 2008.
11 December 2008	The Commission published a notice under section 107 of the NEL to extend the period for publication of the draft Rule determination to 22 January 2008.
22 January 2009	Draft Rule determination published under section 99 of the NEL.
12 February 2009	The Commission held a pre-final Rule determination hearing under section 101 of the NEL.
6 March 2009	Close of second round consultation.
16 April 2009	Final Rule determination under section 102 of the NEL.

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2 Final Rule determination

2.1 Commission's final Rule determination

The Commission makes this final Rule determination in accordance with section 102 of the NEL.

In making this final Rule determination, the Commission is mindful of both the benefits and risks associated with the Proposed Rule.

Consistent with the position in its draft Rule determination and having considered submissions, the need to achieve a balance between the risks and the benefits, the Commission is not satisfied the Rule change proposal would or is likely to contribute to the achievement of the national electricity objective and therefore has determined not to make the proposed Rule.

2.1.1 The Commission supports elements of the Proposed Rule in principle

Consistent with its draft Rule determination, the Commission considers elements of the Rule change proposal have merit which warrant further review. In particular:

- the futures price information could be valuable in providing a forward looking view to determine an adequate MCL level; and
- a robust FOA model could potentially reduce prudential costs of NEM participants.

2.1.1.1 Futures price information could be valuable in an MCL methodology

A robust prudential regime is critical to the operation of the NEM. If retailers do not pay NEMMCO in full, then that shortfall will be borne by generators. Given the compulsory pool arrangements in the NEM, generators do not control who purchases electricity from NEMMCO or the credit risk associated with those retailers. Accordingly, the prudential guarantee funds are typically contributed by the retailers³⁰ for the benefit of generators. The existence of this prudential support is designed to ensure that generators do not factor credit risk into their bids to NEMMCO.

An MCL which is perceived to be too low could lead to higher generation bids to factor in credit risk. On the other hand, retailers incur a cost in providing prudential support which is ultimately passed on to customers. Therefore, an MCL level that is too high or too low will have impacts on the efficient operation of the NEM.

An adequate MCL level is likely to balance the needs of retailers and generators in the NEM, and therefore maintains the prudential costs at an optimal level. This

³⁰ Retailers generally contributes to the fund of amount equivalent to its MCL.

could contribute to the achievement of the national electricity objective (NEO) by promoting efficient operation of electricity services for the long term interests of consumers with respect to price.

Incorporating the futures price information would take a forward looking view of the pool outcome into account in estimating the MCL. In some circumstances, a forward looking view is likely to be more accurate in predicting the pool price outcome of the NEM compared to a backward looking view (see Figure 2.3.4 of Deloitte's report), and could therefore be valuable in determining an adequate MCL level.

2.1.1.2 An FOA would potentially reduce prudential costs

An FOA is expected to offset the prudential requirements of NEM participants, and hence reduces the quantity of prudential support the NEM participants are required to provide the NEMMCO.

This would potentially reduce the NEM participant's prudential costs. Reducing these costs is likely to reduce the costs of providing electricity services, hence contributes to the achievement of the NEO by promoting efficient operation of electricity services for the long term interests of consumers with respect to price.

The Commission notes that there may be costs associated with an FOA, and the costs may outweigh the prudential cost saving. The Commission will investigate this matter in its review process (see section 2.1.3 - the Commission is conducting a review).

2.1.2 The Commission's view on the Rule change proposal

Although the Commission believes elements of the Rule change proposal have merits, on 22 January 2009, it decided not to make a draft Rule. This is because the Commission was not satisfied that the Rule change proposal would or would be likely to contribute to the achievement of the NEO.

The Commission maintains this position in this final Rule determination.

Section 2.1.2 discusses the reasons which prevent the Proposed Rule from contributing or being likely to contribute to the achievement of the NEO, in greater detail.

2.1.3 The Commission is conducting a review

To develop a feasible solution to address the risks associated with the Rule change proposal (if it is possible), in its draft Rule determination on 22 January 2009, the Commission decided to conduct a review under section 45 of the NEL to explore the possibility of offsetting the prudential requirement level of NEM participants using their contract positions.

In this final Rule determination, the Commission maintains its decision to conduct this review (see section 2.1.3.3 for further discussion). On 26 March 2009, the Commission published the Framework and Issues Paper for this review.³¹

The objective of this review would be to provide advice to the Ministerial Council of Energy (MCE) on ways in which NEM participants' futures and other types of contracts can be integrated into the NEM prudential framework with the objective of enhancing the operation and efficiency of that regime.

This review will also aim to develop a robust model to offset the prudential requirement of a NEM market participant using its futures and other contract positions.

The terms of reference of this review can be found on the Commission's website.³²

It is the Commission's intention to consider elements in the Rule change proposal in the review process.

The Commission also anticipates that further issues may be identified as part of the review process, and intends to address them as part of this review.

2.1.3.1 Section 45 of the NEL

Under section 45 of the NEL, the Commission may conduct a review into:

- the operation and effectiveness of the Rules; or
- any matter relating to the Rules.

This section of the NEL makes provisions for the Commission to, as part of the review process:

- consult with any person or body that it considers appropriate;
- establish working groups to assist it in relation to any aspect, or any matter or thing that is the subject, of the review;
- commission reports by other persons on its behalf on any aspect, or matter or thing that is the subject, of the review; and
- publish discussion papers or draft reports.

At the completion of a review, the AEMC must:

³¹ AEMC, 2009, *Framework and Issues Paper - Review into the role of hedging contracts in the existing NEM prudential framework*, <http://www.aemc.gov.au/electricity.php?r=20090303.112859>, viewed 30 March 2009

³² AEMC, 2009, *Review into the role of hedging contracts in the existing NEM prudential framework - Terms of Reference*, <http://www.aemc.gov.au/electricity.php?r=20090303.112859>, viewed 30 March 2009

- give a copy of the report to the MCE; and
- publish a report or a version of a report from which confidential information has been omitted in accordance with section 48 of the NEL.

2.1.3.2 Review versus a more preferable Rule

Under section 91A of the NEL, the Commission “may make a Rule that is different (including materially different) from a market initiated proposed Rule (a more preferable Rule) if the AEMC [Commission] is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed Rule (to which the more preferable Rule relates), the more preferable Rule will or is likely to better contribute to the achievement of the national electricity objective.”

The Commission has decided not to make a preferable Rule under this section of the NEL. Rather, it has initiated a review process under section 45.

The issues involved in this review are highly complex. The Commission therefore considered it is important to carry out extensive consultation with relevant stakeholders in order to achieve a robust outcome for this review. In addition, it is also important to set up working groups to ensure that the all relevant issues in the review process are properly dealt with by persons with the relevant expertise.

Section 45 enables the Commission to carry out the extensive consultation and establish working groups and offers:

- appropriate flexibility to consider a broader set of issues than those raised by the Rule change proposal; and
- opportunities for rigorous investigation and in-depth discussion and consultation over a longer time period.

Therefore, in its draft Rule determination on 22 January 2009, the Commission decided to initiate a review rather than making a more preferred Rule under section 91A of the NEL.

In this final Rule determination, the Commission has decided to maintain its decision to conduct the review for reasons discussed in section 2.1.3.3 below.

2.1.3.3 The Commission maintains the decision to conduct the review

During the pre-final Rule determination hearing (see section 1.4.6 of this final Rule determination), d-cyphaTrade contended that the risks associated with the Proposed Rules can be readily addressed. Therefore, d-cyphaTrade requested that the Commission makes a preferable Rule under section 91A of the NEL in relation to the Proposed Rules.

The Commission also notes that d-cyphaTrade, in its submissions to the Commission on the draft Rule determination, proposed a “Direct Retailer FOA” model (see section 1.4.5 of this final Rule determination).

d-cyphaTrade submitted that the Commission “should make the Direct Retailer FOA as an alternative to the Initial Rule proposed (and which was rejected) as part of the FOA Rule change proposal rather than considering this alternative as part of the market review that has recently commenced on the same issue.”

d-cyphaTrade also submitted that “[s]ection 91B of the National Electricity Law gives the AEMC the power to make the Direct Retailer FOA instead of the Rule proposed by the FOA Rule change proposal. In addition, if the AEMC considers further consultation is required, section 102A of the National Electricity Law empowers the AEMC to issue another draft Rule determination and conduct another round of consultation to give stakeholders the opportunity to comment on the Direct Retailer FOA prior to AEMC determining to make the Rule.”

Section 91B of the NEL states that: “

- (1) Despite section 91(2), the AEMC may, having regard to a request to make a Rule under section 91(1), make a Rule that is necessary or consequential to the Rule that is to be made on that request.
- (2) For the purposes of this Part, the AEMC must treat a Rule it may make under subsection (1) as if it were part of the Rule to be made on that request.”

Section 102A of the NEL states that: “

- (1) This section applies if the AEMC proposes to make a more preferable Rule.
- (2) Without limiting this Part, the AEMC may take action again under sections 99 to 101³³ in respect of the proposed more preferred Rule before making a final Rule determination in respect of that Rule.
- (3) Sections 99 to 101 apply as if, in section 99(1a), for “the date specified in a notice under section 95” there were substituted “the date of the previous Rule determination”.”

The Commission decided not to make a preferable Rule or a Rule that is “consequential to a Rule request”, or make a further draft Rule determination, for the following reasons:

- it is necessary to explore the broader issues around the proposed FOA models to consider their consistency with the NEO;
- the issues involved in the proposed FOA models are likely to be highly complex and the complexity is best dealt under a review process ; and
- the issues associated with Part 1 of the FOA Rule change proposal (the MCL methodology) were not addressed by d-cyphaTrade’s submissions.

³³ Section 99 of the NEL – “Draft Rule determinations”; Section 100 of the NEL – “Right to make written submissions and comments in relation to draft Rule determination”; Section 101 of the NEL – “Pre-final Rule determination hearings”.

Further, while the Direct Retailer FOA model proposed by d-cyphaTrade was designed to address some aspects of the threshold issues raised in the draft Rule determination with the original FOA model proposed, it does not address all of them. This is discussed further below in 2.2.2.

Broader issues outside the FOA models

An FOA, if implemented, will operate interdependently with the existing NEM prudential framework and/or the current reallocation provisions in the Rules.

The Commission therefore considers it is important that an FOA model be considered in conjunction with the prudential framework and the reallocation provisions, and this would require the Commission to consider issues outside the proposed FOA models.

The issues concerning the interrelationships between an FOA model, the existing prudential framework and the reallocation provisions are potentially highly complex.

Issues associated with FOA models can be complex

To ensure the robustness of its analysis, it is anticipated that the Commission would need to consider and/or compare at least three FOA models. These include:

- the original FOA model proposed by the Proponents;
- the FOA model proposed jointly by NEMMCO and ASX (see section 1.2.1.3 of this final Rule determination); and
- the Direct Retailer FOA model.

Comparing and analysing the issues associated with these models are likely to be highly complex. The Commission considers that a robust analysis is required to ensure that an FOA would contribute to the NEO, and this is best carried out under a review.

Further, a review process involving working groups is a better forum to enhance these models or develop new ones.

Part 1 of the Rule change proposal (MCL methodology)

The Commission notes that d-cyphaTrade's submissions on the draft Rule determination deal with Part 2 of the Rule change proposal (FOAs), but do not address the issues associated with Part 1. These issues relating to Part 1 are discussed in section 2.2.1 of this final Rule determination.

The issues associated with this part of the Proponent's Rule change proposal can be potentially complex.

In addition, the Commission considers it would be necessary to consider Part 1 and Part 2 of the Proponent's Rule change proposal in conjunction of each other. This is

likely to add to the complexity of the Commission's analysis in relation to the Proponent's Rule change proposal.

Commission maintains its decision to conduct the review

Given the potential complexity of the issues associated with this Rule change proposal, the Commission considers it is not appropriate to make a final Rule determination under sections 91A or 91B of the NEL.

In this final Rule determination, the Commission therefore maintains its decision in the draft Rule determination to conduct a review to address the issues associated with the Proponent's Rule change proposal.

To address the complexity of the issues involved, the Commission considers it is important to carry out extensive consultation with relevant stakeholders in order to achieve a robust outcome for this review. In addition, it is also important to set up working groups to ensure that the all relevant issues in the review process are properly dealt with by persons with the relevant expertise.

As discussed in section 2.1.3.2, this is likely to be best achieved by conducting a review under section 45 of the NEL.

2.2 Commission's consideration of Rule change proposal

2.2.1 Part 1 of the Proposed Rule: MCL methodology

In its draft Rule determination on 22 January 2019, the Commission considered that the proposed MCL methodology does not contribute to the achievement of the NEO for the reasons discussed below in sections 2.2.1.1 to 2.2.1.4.

The Commission maintains this position in this final Rule determination.

2.2.1.1 Accuracy of the proposed methodology in calculating the MCL

There is not sufficient evidence to demonstrate that the proposed methodology would consistently deliver an MCL that is reflective of the prudential requirements adequate for the efficient operation of the NEM. This is because, as noted by Deloitte, the liquidity of the futures markets in some of the NEM jurisdictions is low and changes from time to time. In particular, Deloitte noted that the liquidity of the South Australia electricity futures market has been low.

A futures market with low liquidity is likely to create pricing and concentration risks, which may in turn result in an inaccurate MCL calculation. Low or fluctuating liquidity in the electricity futures markets therefore means the proposed MCL methodology can not be guaranteed to be consistently accurate.

An inaccurate MCL methodology is unlikely to deliver a prudential support level that is reflective of the prudential requirements adequate for the efficient operation

of the NEM, and therefore does not promote an efficient operation of electricity services to contribute to the achievement of the NEO.

The issue of futures market liquidity does not arise under the current MCL methodology. The current MCL methodology uses the historical pool price as the input proxy. The accuracy of the historical pool price in predicting the future pool outcome is independent of the liquidity in the futures market.

Whilst using historical pool prices is advantageous in predicting the future pool price outcome due to the lack of liquidity issues, pool price information is still deficient because it does not represent a forward looking view of the market outcome.

The Commission therefore notes the advantages and disadvantages of using historical pool and futures prices for MCL methodology, and concludes that using futures prices, in predicting the pool price outcomes, is not necessarily any more appropriate than using historical pool prices.

The Commission will further examine this issue as part of its review process, and will consider how futures price information can be best utilised in an MCL methodology.

2.2.1.2 MCL level may be too high

Whilst changes to the MCL methodology were proposed, the Proponents did not recommend an alternative formula to compute the MCL.

The Commission's interpretation is that the Rule change proposal is intended to maintain the broad structure of the current MCL methodology, but to require the use of a relevant futures price in lieu of the historical average method currently used by NEMMCO to determine the forecast average price for the quarter in the MCL calculation. Other aspects of the MCL calculation framework would remain unchanged under the proposal.

The proposed MCL methodology would therefore contain a volatility term calculated using the relevant historical pool price data, as in the case for the current MCL methodology.

Deloitte reported that there is a considerable risk that the proposed MCL methodology would bring about levels of credit support requirements that are too high. This is because volatility factors may have already been implied in futures prices. Applying a volatility factor in addition to the futures price, under the proposed methodology, is likely to overstate the required MCL.

The Commission considers the issue of overstating the MCL is not likely to be addressed by simply eliminating the volatility factor. This is because it is still not clear whether the volatility factor implied in the futures price is adequate to ensure MCL levels that are adequate for the efficient operation of the NEM. The Commission will investigate this matter in its review process.

As discussed in section 2.2.1.1, an inadequate MCL level is unlikely to contribute to the achievement of the NEO.

2.2.1.3 Lack of clarity on the futures price to be used to calculate the MCL under the proposed methodology

The Commission notes that a futures price may fluctuate from time to time, and there is a lack of clarity in the Proposed Rule as to what point of the futures price trajectory that should be used for the purpose of calculating the MCL.

The lack of clarity creates uncertainty in the NEM. The uncertainty does not promote efficient investment in, or efficient operation and use of, electricity services for the long term interests of consumers, hence does not contribute to the achievement of the NEO.

Where appropriate, the Commission considers clarity on this matter would need to be ascertained in its review.

2.2.1.4 No futures market in Tasmania

The Commission notes that there is no futures market in Tasmania and the Rule change proposal does not clearly explain how the MCL for participants in this NEM jurisdiction would be calculated under the Proposed Rules.

The lack of clarity in the proposed MCL model creates uncertainty in the NEM. The uncertainty does not promote efficient investment in, or efficient operation and use of, electricity services for the long term interests of consumers, hence does not contribute to the achievement of the NEO.

The Commission intends to address this matter in its review.

2.2.1.5 Review of the MCL methodology

The Commission considers that resolving the issues discussed in sections 2.2.1.1 to 2.2.1.4 requires a more detailed analysis, and such analysis has not been undertaken by the Proponents. It is also not clear what modifications to the Rules would be required to refine the proposed MCL methodology, taking into account the issues discussed above and other relevant issues.

The Commission therefore considers that Part 1 of the Rule change proposal does not contribute to the achievement of the NEO.

For the reasons discussed in section 2.1.1.1, the Commission will undertake a detailed review process to explore the possibility of developing a more robust MCL methodology.

2.2.2 Part 2 of the Proposed Rule: FOAs

In its draft Rule determination on 22 January 2009, the Commission did not make a draft Rule in relation to Part 2 of the Proponent's Rule change proposal.

The Commission maintains this position in this final Rule determination for the reasons discussed in this section.

The Proposed Rule did not address the threshold issues the Commission considers to be of fundamental importance.

These threshold issues include:

- the legal rights and obligations of FOA parties are not clear;
- implications of lack of payment surety of FOAs;
- clawback risks of security deposits;
- lack of a dispute resolution process in the proposed FOA; and
- lack of clarity in the Rule change proposals to whether a futures contract in one NEM region could be used to reduce the MCL in another region.

Not addressing these threshold issues means the proposed FOA model is unlikely to be workable, and therefore not contribute to the achievement of the NEO.

2.2.2.1 The legal rights and obligations of FOA parties are not clear

The Commission considers that the legal rights and obligations of the parties to an FOA are not clear under the Proposed Rule. There is therefore a risk that the rights and obligations of parties to an FOA can not be enforced, particularly the rights and obligations of SFE Clearing Participants. If SFE Clearing Participants were not bound by the Rules, this would be a major departure from the current design of the Rules' prudential regime.

The Commission considers clarity in relation to the rights and obligations of relevant parties is critical for an FOA to be operational in an effective manner, particularly to ensure enforceability of payments under the FOA.

The structuring of an FOA arrangement needs to take into account the regulatory and SFE obligations of SFE Clearing Participants, the NEM prudential regime and the insolvency regime under the *Corporations Act 2001 (Cth)* (Corporations Act). The interactions are complex and need to be carefully considered.

In addition to this, there is also a significant commercial question as to whether SFE Clearing Participants would agree to accept some of the obligations or risks which are necessary or desirable for the Proposed Rule to be operational. Some of the obligations or risks include:

- an SFE Clearing Participant may need to agree to restrict its existing rights, for example, to not net off a positive margin against other negative margins owing by an FPNP; and
- an SFE Clearing Participant may have significant exposures to an FPNP where the clearing participant fails to comply with obligations which lead to call notices against the FPNP by NEMMCO.

A thorough analysis of the rights and obligations of relevant parties of an FOA is imperative. It is also important that the rights and obligations under an FOA are enforceable, particularly to ensure that the prudential quality of the NEM is protected.

While the Proponents have proposed a contractual based arrangement, the Commission notes that the Proponents have not undertaken sufficient analysis in their Rule change proposal of the legal and commercial issues relating to such an approach.

The Commission notes that the Direct Retailer FOA model was proposed to address this issue. It appears to do so by moving to a Rules based model which does not directly impose any obligations on the SFE Clearing Participant. While this may be an option, it raises further issues as discussed below. The Commission would consider the merits of this model in its review.

2.2.2.2 Implications of lack of surety of FOA payments

Under the Proposed Rule, the SFE Clearing Participant can terminate an FOA for any reason and at any time before making payments to NEMMCO at 11 am. There can therefore be no certainty that a future FOA payment would be made.

The Commission considers that the implications of the lack of surety of an FOA needs to be more carefully examined, which involve the following matters of concern:

- First, there is no requirement to provide additional bank guarantees before an FOA is cancelled. Moreover, there is a risk that a financially distressed FPNP will not be able to provide additional bank guarantees. In such case, the NEM would lose the benefit of the future FOA payment stream and would not receive replacement bank guarantees. This raises the issue of whether NEMMCO would hold sufficient bank guarantees in the circumstances. This risk does not arise under the current Rules which rely on bank guarantees or reallocations, neither of which can be terminated unilaterally.
- Second, the Proposed Rule provides for the prudential margin³⁴ to be reduced to reflect FOAs. In some cases, the prudential margin may be reduced to zero. This raises a significant concern if a financially distressed FPNP has difficulties meeting its NEM or SFE obligations. If the SFE Clearing Participant then terminates the FOA before or early in the reaction time, there would be no prudential coverage for the FPNP's electricity purchases during the reaction time. Such a risk does not arise under the current Rules.

³⁴ A prudential margin represents the buffer below the MCL which sets the limit under which a NEM participant is permitted to trade. Its purpose is to ensure that NEMMCO is not exposed to a prudential risk during the reaction time - the period of removing a Market Participant from the NEM.

The Commission considers these risks, and other possible risks associated with the feature of an FOA which allows it to be unilaterally terminated, have not been addressed by the Proponents.

The Commission notes that the Direct Retailer FOA model was proposed to address this issue. It seeks to address the first matter of concern by making NEMMCO the only party who is able to terminate an FOA. If the NEM participant (who is a party to the FOA) wishes to terminate, it can only do so if sufficient alternative credit support is provided. In addition, the Direct Retailer FOA model involves the NEM participant, rather than the SFE Clearing, being responsible for making or procuring the payments to NEMMCO. This proposed model, however, does not resolve the issue of lack of payment surety, compared to a bank guarantee in which there is certainty of payment from established financial institutions. To the extent that the Direct Retailer FOA model involves the prudential regime relying on a future stream of margin payments, the implication of this approach would need to be considered. The Commission will consider the merits of this model in its review.

2.2.2.3 Clawback risks of security deposits

The Commission understands an FOA would generally result in NEMMCO holding less bank guarantees and more security deposits than currently applies. To the extent this does occur, this would create an incremental risk for the NEM in that security deposits may be more susceptible under the Corporations Act to clawback by a liquidator of an insolvent NEM participant than a payment made under a bank guarantee. Even if the risk were low, the consequences of any such occurrence are high. The issue remains under the Direct Retailer FOA model.

2.2.2.4 Lack of clear dispute resolution procedure

The Commission considers the dispute resolution process that applies FOA payments is not clear. This may lead to a dispute not resolved in a timely manner to satisfy the tight timeline of the NEM prudential procedure. This could result in an FOA party not paying NEMMCO a significant amount of margin payment in a timely manner to satisfy the NEM prudential requirement.

The Commission considers such non-payment would deteriorate the prudential quality of the NEM.

This financial risk creates uncertainty in the NEM. The uncertainty does not promote efficient investment in, or efficient operation and use of, electricity services for the long term interests of consumers, hence does not contribute to the achievement of the NEO.

The Commission notes that the Direct Retailer FOA model was proposed to address this issue by having a Rules based model and therefore the Rules govern disputes. The Commission would consider the merits of this model in its review.

2.2.2.5 Inter-regional FOA offset

The Commission considers it is not clear in the Proposed Rule whether a futures contract in one NEM region could be used to reduce the MCL in another region.

The lack of clarity in the proposed FOA model creates uncertainty in the NEM. The uncertainty does not promote efficient investment in, or efficient operation and use of, electricity services for the long term interests of consumers, hence does not contribute to the achievement of the NEO.

The Commission intends to address this issue as part of its review.

The Commission notes that the Direct Retailer FOA model was proposed to address this issue. The Commission would consider the merits of this model in its review.

2.2.2.6 Review to explore the possibility of offsetting the prudential requirement level of NEM participants

The Commission considers that the Proposed Rule has not comprehensively considered or addressed all relevant issues. The lack of comprehensive consideration of all relevant issues results in a lack of clarity on some aspects of the proposed FOAs. The Direct Retailer FOA model addresses some of these issues in part but a number of issues remain.

The Commission considers that more detailed analysis is required to address the issues discussed in sections 2.2.2.1 to 2.2.2.5, and such analysis has not been undertaken by the Proponents. The Commission therefore considers that Part 2 of the Rule change proposal does not contribute to the achievement of the NEO.

As discussed in section 2.1.3, the Commission decided to conduct a review to explore the possibility of offsetting the prudential requirement level of NEM participants.

It is the Commission's intention to address these issues in the review.

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3 Methodology for developing the final Rule determination

In making its final Rule determination to not make a Rule, the Commission has taken into account:

1. the Commission's powers under the NEL to make the Rule (see section 3.1);
2. the Proponent's Rule change proposal and the Proposed Rule;
3. submissions received in the first round consultation (see section 3.2);
4. issues raised during a workshop with key stakeholders on 30 September 2008 (see section 3.2);
5. risk assessment report by Deloitte "Proposed Rule Determination - MCL and FOA Prudential Supervision Risk Analysis";
6. submissions received in the second round consultation, including the Direct Retailer FOA model proposed by d-cyphaTrade (see section 3.3);
7. issues raised during the pre-final Rule determination hearing (see section 3.4); and
8. the Commission's analysis of the ways in which the Proposed Rule will or is likely to contribute to the achievement of the NEO, so that it would satisfy the statutory Rule making test (see sections 3.5 and 3.6).

3.1 The Commission's power to make the Proposed Rule

The Commission is satisfied that the Proposed Rule falls within the subject matters for which the Commission may make Rules, as set out in section 34 of the NEL.

The Proposed Rule relates specifically to item 34(1) of the NEL, which states that:

"...the AEMC, in accordance with this Law and the Regulations, may make Rules, to be known, collectively, as the "National Electricity Rules", for or with respect to—

(a) regulating—

(i) the operation of the national electricity market;

....

(iii) the activities of persons (including Registered participants) participating in the national electricity market or involved in the operation of the national electricity system;"

The Proponent's Rule change proposal sought to address issues concerning the prudential regime of the NEM and therefore relates to: (a) the operation of the NEM; and (b) the activities of persons participating in the NEM or involved in the

operation of the national electricity system. Specifically, the Rule change proposal is within matters set out in Schedule 1 to the NEL, as it relates to the prudential requirements to be met by a Registered Participant.

3.2 Submissions and stakeholder workshop (first round consultation)

The Commission has regard to the submissions received in the first round consultation in making this final Rule determination.

In addition, the Commission held a workshop with key stakeholders regarding this Rule change proposal on 30 September 2008. The issues raised during this workshop were also taken into account in this final Rule determination.

The Commission's analysis of the submissions, and the issues raised during the workshop, is set out in Appendix A of this document.

Where appropriate, the Commission would take these submissions, and the issues raised during the workshop, into account in its review.

3.3 Submissions received in the second round consultation

The Commission has regard to the submissions received in the second round consultation in making this final Rule determination.

The Commission's analysis of the submissions is set out in Appendix A of this document.

The Commission notes that d-cyphaTrade proposed a Direct Retailer FOA model in its submission. As discussed earlier in this final Rule determination, this proposed model will be considered by the Commission as part of its review.

3.4 Pre-final Rule determination hearing

The Commission had regard to the issues raised during the pre-final Rule determination hearing held on 12 February 2009.

The Commission's analysis of the issues raised in this hearing is set out in Appendix A of this document.

3.5 Assessment of the Proposed Rule: the Rule making test and the national electricity objective

The NEO is the basis of assessment under the Rule making test and is set out in section 7 of the NEL:

“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 Rule making test states:

“(1) The AEMC may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity objective;

(2) For the purposes of subsection (1), the AEMC may give such weight to any aspect of the national electricity objective as it considers appropriate in all circumstances having regard to any relevant MCE statement of policy principles”³⁵

Section 3.6 of the this final Rule determination contains the Commission’s assessment of the extent to which the Rule contributes to the achievement of the NEO.

In addition, the NEL requires the Commission to have regard to any relevant MCE statements of policy principles in applying the Rule making test. The Commission notes that currently there are no relevant MCE statements of policy principles that relate to the issues contained in this Rule change proposal.

3.6 The Commission’s test of the national electricity objective

The Commission considers that the Rule change proposal will not contribute to the achievement of the NEO due to the reasons discussed in section 2.2 of this document.

For this reason, the Commission considers that the Rule making test under section 88 of the NEL is not satisfied.

³⁵Section 88 of the National Electricity Law.

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A Submissions and workshop and hearing

As part of the first round consultation process, the Rule change proposal was open for public consultation for four weeks. Submissions closed on 14 March 2008.

The Australian Energy Market Commission (Commission) received ten submissions on the Rule change proposal at this first round of consultation process. These submissions are discussed in section A.1 of this Appendix.

In addition to these submissions, on 11 September 2008, d-cyphaTrade provided a supplementary submission to the Commission. This submission is discussed in section A.2 of this Appendix.

On 30 September 2008, the Commission held a workshop with key stakeholders in relation to the Proposed Rule. During this workshop, Deloitte Touche Tohmatsu (Deloitte) presented its key findings on the risks associated with the Rule change proposal, and attendees were invited to provide comments on the presentation. In addition, the Commission invited the attendees to provide formal submissions in response to this presentation.

It should be noted that the workshop held was not intended to be a public hearing for the purpose of section 98 of the NEL.

The Commission received three submissions in relation to this workshop, which are discussed in section A.3 of this Appendix.

On 22 January 2009, the Commission gave notice under section 99 of NEL advising of the making of the draft Rule determination, and commenced the second round consultation, on the Rule change proposal. Submissions closed on 6 March 2009.

The Commission received six submissions in this round of consultation. They are discussed further in section A.4 of this final Rule determination.

On 12 February 2009, the Commission held a pre-final Rule determination hearing in accordance with section 101 of the NEL. This is discussed further in section A.5.

The Commission has decided not to make a Rule in this final Rule determination and instead decided to undertake a review. The Commission will have regard to these submissions, workshop and hearing in this review.

In this final Rule determination, the Commission refers to a National Electricity Market's (NEM's) market participant, who has bought a futures contract and uses it to enter into an Futures Offset Arrangement (FOA), as an FPNP (FOA Party NEM Participant). The Commission notes that an FPNP would typically, but not necessary, be a retailer in the NEM.

The Commission notes that most submissions refers to an FPNP as a "retailer". The Commission therefore uses the term "retailer" and "FPNP" interchangeably in this chapter.

A.1 Submissions on first round consultation

A.1.1 Australian Power & Gas

Australian Power & Gas is one of the three Proponents of this Rule change proposal.

Australian Power & Gas provided a submission to make an adjustment to section 8 of the proposed clause 3.15.11B of the Rules.

This clause requires NEMMCO to deposit payments from SFE Clearing Participants into the Security Deposit Arrangements (SDAs) of the relevant NEM participants (unless otherwise agreed between NEMMCO and the NEM participants).

When the futures price decreases after an earlier rally, the funds in a NEM participant's SDA may exceed the amount required to meet NEMMCO's prudential requirements. Under the original Proposed Rule, NEM participants are not able to access the excess fund in the SDA.

Australian Power & Gas submitted to the Commission to change this aspect of the FOA design. Under the amended Proposed Rule, a NEM participant will be able to access its fund in the SDA, on the condition that the NEM participant always maintains an SDA balance (in \$/MWh term) equals to the difference between the most recent futures price and the Futures Lodgement Price of the FOA.

A.1.2 Integral Energy, d-cyphaTrade and ERM Power

Integral Energy, d-cyphaTrade and ERM Power were supportive of the Rule change.

d-cyphaTrade submitted that FOAs "would greatly support liquidity in the transparent financial energy market, while increasing flexibility and competition in the supply of credit support offset arrangements for NEM Participants."

ERM Power submitted that "this potential rule change can only improve the supply of available credit support amongst the NEM, therefore increasing flexibility and competition in the market."

A.1.3 d-cyphaTrade's presentation

On 4 March 2008, Australian Power & Gas, accompanied by d-cyphaTrade, made a presentation to the AEMC on behalf of all three Proponents.

This presentation essentially summarised the Proposed Rule.

A.1.4 EnergyAustralia

EnergyAustralia supported the proposal to define and accommodate FOAs within the Rules (Part 2 of the Rule proposal). EnergyAustralia submitted that these arrangements will provide those retailers, who elect to enter into FOAs, some

additional protection from incurring unnecessary credit support costs for their spot market obligations.

EnergyAustralia did not, however, support the proposed amendments to the maximum credit limit (MCL) calculation methodology (Part 1 of the Rule proposal). EnergyAustralia believes that the historical pool prices and volatility are a more stable reflection of the likely pool price outcomes in the NEM, compared to forward futures price outcomes as proposed.

EnergyAustralia believes SFE electricity futures prices should not be a parameter of the MCL calculation. This is because such amendments may result in more volatile prudential requirements. Thus, this may unnecessarily increase the prudential requirements for those retailers who do not solely use FOAs for managing their credit support costs in the NEM.

The Commission considers whether the volatility of NEM prudential requirements is an issue depends on how often the MCL is reviewed. The Commission considers this aspect of the Proposed Rule is not clear.

A.1.5 National Generators Forum (NGF)

The NGF submitted that confidence in the credit quality of the NEM pool needs to be maintained. It also supported measures that will result in more efficient and effective prudential management in the NEM.

The Commission noted this point and subsequently rejected Part 2 of the Rule change proposal. The Commission considered the proposed FOAs do not maintain the credit quality of the NEM because the surety of payments under this proposal cannot be guaranteed.

A.1.5.1 Reallocation Rule change

The NGF understands that the “reallocation” Rule package in 2007 was intended to facilitate FOA-style transactions through the introduction of a Reallocator participant category, and empowering NEMMCO to make procedures to implement this approach. Work had also been progressing in this regard.

In this context, the NGF was not clear as to why the proposed Rule change is required, as it would seem the current Rules allow for FOAs.

The NGF was aware that the MCE has launched a Financial Markets Working Group (FMWG). The objectives of the FMWG were focused on reviewing prudential management in the NEM, in an effort to increase their efficiency and effectiveness.

The NGF submitted that the FOA Rule change was being considered by this group, along with a number of other proposals to improve NEM prudential management. The NGF therefore submitted that it may be beneficial for this current Rule change to be deferred until that review is completed.

The Commission noted that NEMMCO was working with the Australian Securities Exchange (ASX) to develop a possible FOA mechanism, suitable for implementation under the current Rules, using the "Reallocator" classification of NEM participant and procedures developed under clause 3.15.11A of the Rules.

The Commission also noted that, in January 2008, the ASX advised NEMMCO that it would no longer be participating in the development work due to a preference to pursue a single licensed clearing and settlement facility for the spot and forward markets.

The Commission has received a copy of the work-in-progress FOA procedure document jointly developed by NEMMCO and the ASX, and will consider elements in this document in the Commission's review process.

The Commission anticipates that the FMWG's work will be informed by the outcome of the Commission's review.

A.1.5.2 Risks associated with the Proposed Rule

The NGF was concerned that the Proponents have failed to adequately address the risk impacts associated with this Rule change proposal. Given the importance of NEM credit quality to the market objective, the NGF believes a very thorough review of potential risks associated with this proposal is required.

With respect to Part 1 of the Rule change proposal, the NGF raised the following issues:

- The proposal to use the futures price would have the benefits of providing a market consensus expectation of prices (which could then be adjusted to factor in a reasonable worst case expectation). However, as futures prices represent a 91³⁶ day average, such a change may result in the MCL inadequately modelling price volatility for the shorter term (credit time period of 42 days³⁷). This impact may require additional compensation to ensure credit quality is maintained.
- There is a need to ensure that NEMMCO's discretion is minimised so that prudential procedures can be applied robustly even in times of market credit stress.
- There is a need to consider the potential impacts on MCL volatility from this proposal, and the ability of NEM participant's to manage frequently fluctuating prudential requirements.

With respect to Part 2 of the Rule change proposal, the NGF raised the following issues:

³⁶ The number of days may vary depending on the months of the year which the futures contract relates.

³⁷ The number of days in each settlement cycle may vary marginally.

- NEMMCO may not have sufficient legal claim over an SFE Clearing Participant who had participated in FOAs.
- There is a need to ensure that FOAs can not be withdrawn prior to alternate security being lodged with NEMMCO.
- Futures contracts should only be allowed to offset MCL calculations in the same region to which the contract is referenced.

A.1.6 NEMMCO

NEMMCO supported the development of further alternatives³⁸ for the management of credit support costs in the NEM. NEMMCO also submitted that the FOA mechanism provides a means for users of electricity futures contracts to reduce their spot market credit support requirements, and may therefore have value in the NEM as a means of reducing prudential risks for NEM participants.

In its submission, NEMMCO indicated that it had been working with the ASX to develop a possible FOA mechanism, suitable for implementation under the current Rules, using the "Reallocator" classification of NEM participant and procedures developed under clause 3.15.11A of the Rules. That work included the preparation of a detailed draft procedure and explanation document, discussions with some SFE Clearing Participants, and the identification of a number of risk factors associated with the FOA mechanism that need to be quantified.

In January 2008, the ASX advised NEMMCO that it would no longer be participating in the development work due to a preference to pursue a single licensed clearing and settlement facility for the spot and forward markets.

Attachment B of NEMMCO's submission contains the documentation of FOA development work carried out by NEMMCO and the ASX to date.

The Commission noted that the ASX and NEMMCO have made significant progress on this procedure to define the FOAs, and will therefore consider elements of this work in its review.

A.1.6.1 Part 1 of the Rule change proposal: MCL methodology

With respect to Part 1 of the Rule change proposal, NEMMCO raised the following issues:

- NEMMCO's understanding was that the Rule change proposal was intended to maintain the broad structure of the current Rules-based MCL methodology, but to require the use of a relevant futures price in lieu of the historical average method currently used by NEMMCO to determine the forecast average spot price for the quarter in the MCL calculation. NEMMCO's understanding was that other

³⁸ Proponents proposed that FOAs are alternative means for a NEM participant to manage its credit support costs.

aspects of the MCL calculation framework would be retained unchanged under the proposal. NEMMCO submitted that this was unclear in the Rule change proposal.

- NEMMCO submitted that the Proposed Rule did not address the issues relating to regions where no futures contracts are traded.
- NEMMCO submitted that the Proposed Rule did not address the issues relating to regions where the liquidity of futures is insufficient to set a reliable forward price.
- NEMMCO submitted that that it is difficult to conceive in any way the volatility factor could be forward looking. Thus, it will need to be determined on the basis of historical spot price data and the desired performance target.

Performance target defined in the Rules

In its submission, NEMMCO also raised that the performance target³⁹ defined in the Rules is imprecise and requested the Commission to further clarify this target. In its draft Rule determination on 22 January 2009, the Commission considered clarifying the performance target defined in the Rules is outside the scope of this Rule proposal and should be only considered under a separate Rule change request.

The Commission also determined that will consider the merits of clarifying this target, as part of its review process, if it forms a relevant part of the scope of the review.

In the Framework and Issues Paper for the review, the Commission considered that interpretation of the performance target is fundamental to the determination of the MCL, and hence would clarify this performance target as part of the review.⁴⁰

NEMMCO's analysis

Based on NEMMCO's understanding of the proposal, it carried out an assessment of the likely performance of the proposed MCL methodology in comparison to the current approach to MCL calculation. The comparison sought to evaluate the correlation between the forecast average price for a quarter, as determined from a 12 months historical data on the one hand and from futures prices on the other, with the actual average spot price for the same quarter.

³⁹ The MCL approach in the current Rules revolves around a performance target called the "reasonable worst case", which is defined as "a position that, while not being impossible, is to a probability level that the estimate would not be exceeded more than once in 48 months". This performance target is defined in the Rules.

⁴⁰ AEMC, 2009, *Framework and Issues Paper - Review into the role of hedging contracts in the existing NEM prudential framework*, <http://www.aemc.gov.au/electricity.php?r=20090303.112859>, viewed 30 March 2009

Using a sample of data, NEMMCO observed that:

- base futures settlement prices were a superior predictor of average quarterly spot prices when compared to the 12-month historical average price;
- there may already be an allowance for volatility in the futures price; and
- the revised MCL methodology would contain the effect of a high price event within the relevant quarters only. In contrast, the effect of the event would last the full 12 month period under the current MCL methodology.

The Commission notes that parts of the results above are largely consistent with those reported in Deloitte's report.

A.1.6.2 Part 2 of the Rule change proposal: FOAs

With respect to Part 2 of the Rule change proposal, NEMMCO identified some issues of concern in its submission. They include:

- The timing of FOA payments, in combination with the ability of an SFE Clearing Participant to terminate FOAs at short notice, give rise to material payment risks for the market. These risks need to be quantified and managed.
- The Proposed Rule requires NEMMCO to keep the FOA margin payments for longer than is necessary to secure payment for the NEM settlement process.
- NEMMCO, not SFE Clearing Participant, should calculate the daily FOA margin.
- The proposed Rule change requires NEMMCO to register the FOA within one hour of nomination by NEM participants. This requirement may not be feasible.
- The Rules applying to SFE Clearing Participants are not clear.
- An implementation timeframe needs to be considered.

A.1.7 International Power Australia (IPRA)

IPRA opposed both Part 1 and Part 2 of the Proposed Rule because it considered the Proposed Rule will not advance the achievement of the NEO. Furthermore, IPRA considered the Proposed Rule would advance the position of retailers in a way that necessarily increases generators' credit risks.

A.1.7.1 Part 1 of the Rule change proposal: MCL methodology

IPRA did not share the Proponents' view that SFE electricity futures prices represents a better basis for the future determination of retailers' MCLs relative to the current approach. IPRA also questioned whether those prices provide a better price signal to potential investors in electricity generation.

IPRA noted that the current MCL methodology, which is based on the “reasonable worst case” approach, is not faultless where it left NEMMCO with a significant exposure to retailers in Q2 2007. IPRA, however, did not consider this event to be a sufficient reason to abandon this approach and adopt the proposed approach based on the SFE futures contract price. IPRA submitted that the current approach should be maintained while improving the methodology drawing on the experience in Q2 2007.

IPRA considered that the Proponents may have overstated their concerns about generators who have reallocated then suffer from an outage (and thus become a creditor of NEMMCO) and liable to meet prudential additional requirements.

IPRA considered the possibility of an outage is a matter that NEMMCO is able to consider in calculating an MCL for a reallocating generator under the “reasonable worst case” approach.

At this stage, the Commission considers that it is not clear as to how NEMMCO is able to consider the possibility of an outage in calculating an MCL for a reallocating generator under the “reasonable worst case” approach. The Commission intends to clarify this matter to the extent that it is relevant in the review process.

IPRA also requested the Commission to consider whether, “with the increasing number of bank and non-bank financial traders, offshore hedge funds and other speculators the Proponents anticipate entering into the market, SFE electricity futures prices may become increasingly affected by market manipulation and other distortions, or at the very least, how electricity futures prices may be affected by the involvement of participants not directly concerned with the underlying primary energy market.”

The Commission considers manipulation and other price distortions of the futures markets are less likely in the case where the markets are sufficiently liquid. The Commission has considered the issue of market liquidity in the draft and final Rule determinations.

A.1.7.2 Part 2 of the Rule change proposal: FOAs

IPRA questioned whether the outcomes similar to those sought by the Proponents under FOAs could be achieved using the reallocation mechanism.

In addition, IPRA identified design issues associated with the FOAs as follows:

- The FOA design needs to avoid the outcome where a retailer facing financial difficulties terminates its FOAs without having a realistic prospect of providing NEMMCO with a replacement bank guarantee.
- It is not clear on what basis the SFE Clearing Participants’ obligations arise.
- IPRA questioned how NEMMCO can be satisfied that it would receive the adequate payments under the FOAs without reviewing the retailers’ contracts with SFE Clearing Participants and, presumably, understanding the relevant SFE’s rules.

- The SFE Clearing Participants' obligations to NEMMCO should not be contractual only, but also be enforced under the Rules.
- Any reduction in a retailer's MCL, for an FOA involving an SFE electricity futures referenced to a particular region, should only be allowed by NEMMCO in respect of the corresponding exposure of NEMMCO to that retailer in respect of the spot price for that region.
- Under the Corporations Act, the payments to NEMMCO under FOAs may be subject to clawback - in the case where the party entered into FOAs (with an SFE Clearing Participant) becomes insolvent.

A.1.8 Energy Users Association of Australia (EUAA)

The EUAA supports both Part 1⁴¹ and Part 2⁴² of the Rule change proposal, although it expressed concerns about some aspects of the proposal.

A.1.8.1 Part 1 of the Rule change proposal: MCL methodology

The EUAA submitted that this part of the Rule change proposal should be considered a substantive Rule change in its own right, not an ancillary proposal supporting Part 2 of the Rule change proposal.

The EUAA submitted that it would support the proposed changes to the MCL methodology if further analysis confirms its beneficial nature.

The EUAA considered the revised MCL methodology would involve a fundamental structural shift in the way that market risk is assessed and managed. The impacts were yet to be thoroughly investigated and evaluated.

The EUAA was not clear whether the proposed MCL methodology would add significant incremental value to NEMMCO's prudential exercise, over the prudential methods currently employed. This is because there are uncertainties introduced by the proposed methodology that may outweigh the certain knowledge that accompanies the existing methodology. Therefore, the EUAA submitted that further modelling and analysis is required to better understand the true effect of this Rule change proposal.

The EUAA suggested that, at the minimum, the Commission "undertakes a statistical review of the correlation error between the initially traded SFE price (on the day of the trade) relative to the actual settlement price (looking forward) and NEMMCO's present methodology."

⁴¹ In this final Rule determination, Part 1 of the Rule change proposal refers to the part regarding the MCL methodology. This part was referred to as "the Second Rule Change" in the EUAA's submission.

⁴² In this final Rule determination, Part 2 of the Rule change proposal refers to the part regarding the FOAs. This part was referred to as "the First Rule Change" in the EUAA's submission.

In the interim, the EUAA proposed that a way forward could be that the Rules be amended to change the MCL formula to use a proxy price that is the higher of either the relevant historical average pool price or the relevant SFE futures price. The EUAA submitted that such a change would allow the SFE market price to be used while ensuring that the credit quality of generators is not reduced.

A.1.8.2 Part 2 of the Rule change proposal: FOAs

The EUAA identified the following risks associated with the proposed FOAs:

- Retailers and NEMMCO may need to make information technology and other process/system changes to facilitate the FOA operation. These changes may result in new operational and implementation risks.
- The FOAs may enable entry into the NEM of retailers who would previously have been unable to enter the market due to the rigidity of NEMMCO's current prudential requirements, including those retailers with lower credit standings. This would appear to undermine the overall credit quality of the NEM, and may have a reputational effect on the NEM.
- If the FOAs were to result in increased risks that had political implications, the efficient operation of the NEM would need to be assessed in relation to this.
- The FOAs' impacts on the level of absolute credit risks across the NEM, rather than specifically retailers' credit risk, should be considered.
- The costs of NEMMCO developing the necessary systems to implement the FOAs should be consistent with the "user-pay" philosophy, and avoid cost smearing.

A.2 Supplementary submission by d-cyphaTrade

On 11 September 2008, d-cyphaTrade provided a supplementary submission to the Commission to amend the Proposed Rule as follows:

- d-cyphaTrade submitted that the Proposed Rule be modified to enable SFE Clearing Participants to enter into standalone commercial arrangements with NEMMCO in much the same way as a "Credit Support Provider" does currently, without being a Rule participant. d-cyphaTrade provided further information in relation to this proposed modification in its additional submission on 20 October 2008 (see section A.3.3.1).
- d-cyphaTrade also commented on the submission by Australian Power & Gas on 3 March 2008 (see section A.1.1). This comment suggested a modification to the Proposed Rule in light of the revised Rule change proposal contained in the March 2008 submission.

A.3 Stakeholder workshop and the associated submissions

On 30 September 2008, the Commission held a workshop with key stakeholders in relation to the Rule change proposal.

During this workshop, Deloitte presented its key findings of the risks associated with the proposal, and attendees were invited to provide comments on the presentation.

In addition, the Commission invited the attendees to provide formal submissions in response to this presentation.

It should be noted that the workshop held was not intended to be a public hearing for the purpose of section 98 of the NEL.

The Commission received three submissions in response to the workshop. One from each of the following parties:

- the Australian Securities Exchange (ASX);
- d-cyphaTrade; and
- the NGF.

A.3.1 Stakeholder workshop

Deloitte presented the results of its preliminary risk analysis during this workshop. Relevant comments on this presentation from the attendees include the following:

- The NGF advised that generators are generally comfortable with a forward looking MCL methodology.
- IPRA commented that the futures price is subject to manipulation and may therefore be not suitable as a proxy for an MCL calculation.
- ERM Power commented that the relative performance results between the proposed and existing MCL methodologies may vary depending on the set of data used, and therefore did not consider the results demonstrated during the presentation were meaningful.
- ERM Power, however, preferred the proposed methodology over the existing one. This is because the proposed methodology uses futures prices as a proxy, which it considered to be a more realistic representation of the expected price outcome of the of NEM compared with the historical pool prices.

In addition, the participants and the Commission offered the following comments during the workshop:

- NEMMCO raised that there is a lack of clarify about the firmness of an FOA, and this would make a significant difference in terms of the FOA's risk impact on the prudential quality of the NEM.

- The ASX noted that there is a risk of insufficient NEMMCO's prudential coverage when the SFE Clearing Corporation does not pay its clearing participants.
- The Commission advised that the risks of non-payment should be subjected to a legal review. The scope of legal review would be broad, and examine all factors that may have an impact on the legal status of the cash flow surety of an FOA.
- The Commission advised that a legal review is a fundamental component in the its assessment on this Rule change proposal. In particular, the legal analysis would need to assess the FOA's impact on the potential interactions between the Rules, the NEL, the Corporations Act and other relevant legislations.
- d-cyphaTrade advised that SFE Clearing Participants are generally comfortable with the proposed FOAs at a conceptual level, but may lack the understanding over the details of the model.
- NEMMCO raised that the FOA model needs to make provisions to ensure that SFE Clearing Participants are not only bound by their obligations, but also be operationally responsive.
- SFE Clearing Participants may not be willing to be NEM Market Participants, and the final design of the FOA model should take this into account.
- An FOA can serve as a competitive alternative to the reallocation arrangement.

The Commission noted the discussion during this workshop and, where appropriate, has taken them into account in the draft and final Rule determinations. The Commission will, where necessary, take this discussion into account as part of its review process.

A.3.2 Submission from the ASX in response to the workshop

The ASX noted that the drafting of the Rule change proposal may be ambiguous, and clarified that an FOA:

- has been - for over 3 years of discussions between NEMMCO, ASX and its clearing participants and their customers - on the basis that it would be a contractual relationship between an SFE Clearing Participant and NEMMCO on behalf of a client; and
- does not directly involve SFE Clearing House or its clearing guarantee, margining processes or systems.

The ASX submitted that several of the higher rated risks identified by Deloitte for further analysis should be considered by the Commission in the context of the above points.

A.3.3 Submission from d-cyphaTrade in response to the workshop

A.3.3.1 Modification to the Proposed Rule

In this submission, d-cyphaTrade suggested a revision to the Proposed Rule. Under the revised Proposed Rule, FOAs could be accompanied by two separate contractual agreements:

- a Letter of Futures Offset Support between NEMMCO and the SFE Clearing Participant; and
- the existing Futures Clearing Agreement between the SFE Clearing Participant and its client (for example, an electricity retailer).

Under the revised Proposal Rule, SFE Clearing Participants do not become NEM Participants and “this structure involves no assignment of monies”. d-cyphaTrade submitted that this proposed framework is broadly consistent with the existing arrangements for Credit Support Providers (that is, entities who currently provide bank guarantees to NEMMCO are not NEM Participants).

A.3.3.2 Risks associated with the ex-ante reallocation arrangement

d-cyphaTrade submitted that there are three potential risks to NEM generators arising from the existing ex-ante reallocations. These risks include:

- the ability for NEM retailers to use off-peak reallocations to arbitrage NEMMCO’s prudential arrangements;
- reallocations result in substantially less MCL bank guarantee protection compared to an FOA when they are terminated;
- termination of a reallocation contract potentially exposes the generator to a substantial financial loss.

d-cyphaTrade submitted that these risks would be entirely or partially eliminated to the extent that FOAs displace the future growth of the NEMMCO reallocation market, if permitted to compete openly in the supply of offsets for retailers.

A.3.4 Submission from the NGF in response to the workshop

In this submission, the NGF noted that:

- as part of its determination, the Commission needs to take into account the outcomes of the reallocation Rule change in 2007 (this includes the reallocator procedure previously considered by NEMMCO and the ASX);
- withdrawal of an FOA without placement of an alternate security, as provided for in the Proposed Rule, is a major risk for the NEM; and

- the NGF supports a legal analysis on the ability of NEMMCO to recover FOA payments from SFE Clearing Participants.

A.4 Submissions on second round consultation

A.4.1 AGL Energy

AGL Energy supports the intent of the FOA Rule change but shares the concerns identified by the Commission in its draft Rule determination, in particular:

- the ability of FOA's to be unilaterally terminated by clearing members prior to a replacement security being lodged;
- concerns over clawback risks for the security deposits placed with NEMMCO; and
- lack of a clear dispute resolution process.

AGL Energy supported the Commission's decision of not making a draft Rule.

AGL Energy noted that the Direct Retailer FOA has been canvassed. AGL Energy considers this model is worthy of consideration but raised the following concerns:

- the model appears to pass the risk back to the market via the retailers; and
- is still not clear how NEMMCO would be guaranteed access to the futures asset if required.

A.4.2 ERAA

In its submission, ERAA expressed support for the Commission's decisions of not making a Rule and undertaking a review to examine the relevant issues in more detail and seek to identify a mechanism by which efficiency potential of the FOA proposal is to be realised.

A.4.3 NEMMCO

NEMMCO supports the Commission's draft Rule determination to undertake a review to ensure decisions in respect of the FOA mechanism are well informed.

However, NEMMCO submitted that the terms of reference for the review be modified to include consideration of the MCL performance target as part of the scope of the review.

The MCL performance target relates to NEMMCO's requirement under the Rules to determine an MCL based on the reasonable worst case criteria.

The reasonable worst case criteria is defined in the Rules as “a position that, while not being impossible, is to a probability level that the estimate would not be exceeded more than once in 48 months.”

The Commission considers that this definition may not have been sufficiently clear and clarifying it is fundamental to the determination of an MCL.

The Commission has therefore decided to clarify this performance target as part of the review.

The Commission has advised its intention to clarify this target in the Framework and Issues for the review,⁴³ and considers it is therefore no longer necessary to revise the terms of reference.

A.4.4 The NGF

The NGF also supports the Commission’s decisions to not make a Rule in relation to this Rule change proposal and to conduct a review to work through the complex issues identified in the draft Rule determination.

The NGF also submitted that, in pursuing any efficiency benefit to the NEM offered by an FOA, “any cost savings identified to NEM debtors, should not come at the cost of increased risk of short payment to NEM creditors (typically generators).”

A.4.5 d-cyphaTrade

d-cyphaTrade provided two submissions to the Commission for the second consultation, one was received on 6 March 2009, and the other one on 13 March 2009.

In its submission to the Commission on 6 March 2009,⁴⁴ d-cyphaTrade proposed a “Direct Retailer FOA” model.

Essentially, a under the Direct Retailer FOA model:

- the SFE Clearing Participant will not be a party to the FOA;
- a Direct Retailer FOA is between NEMMCO and a NEM participant;
- only NEMMCO can terminate the FOA;
- dispute resolution process is governed by the Rules; and
- interregional offset not permitted.

⁴³ AEMC, 2009, *Framework and Issues Paper - Review into the role of hedging contracts in the existing NEM prudential framework*, <http://www.aemc.gov.au/electricity.php?r=20090303.112859>, viewed 30 March 2009

⁴⁴ d-cyphaTrade, 6 March 2009, *Futures Offset Arrangement Rule Change Proposal 2008 - Submission to Draft Rule Determination (22nd January 2009)*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

d-cyphaTrade contended that this model “would address concerns raised in the Draft Rule Determination, is more efficient than the original FOA proposal and could be implemented under the current Rule Change process.” d-cyphaTrade also submitted that “implementation via the current Rule Change process would avoid further delays in significant efficiency benefits flowing to Market Participants.”

In its submission to the Commission on 13 March 2009,⁴⁵ d-cyphaTrade proposed a draft Rule for the Direct Retailer FOA model. d-cyphaTrade submitted that the Commission should “make the Direct Retailer FOA as an alternative to the Initial Rule proposed (and which was rejected) as part of the FOA Rule change proposal rather than considering this alternative as part of the market review that has recently commenced on the same issue.”

The Commission has considered d-cyphaTrade’s request to make a Rule under the currently Rule change process. However, due to the potential complexity of the issues involved, the Commission maintains its position and will proceed with the review (see section 2.1.3.3 for further discussion).

A.5 Pre-final Rule determination hearing

On 29 January 2009, the Commission received a request from Australian Power & Gas to hold a hearing in relation to the draft Rule determination.⁴⁶

On 30 January 2009, the Commission also received a request from d-cyphaTrade to hold a pre-determination hearing in relation to the draft Rule determination.⁴⁷

Therefore, on 12 February 2009, the Commission held a pre-final Rule determination hearing in relation to the Proponent’s Rule change proposal under section 101 of the NEL.

During this hearing, d-cyphaTrade requested that the Commission should draft a Preferred Rule under section 91A of the NEL, rather than conduct a review under section 45 of the NEL.

The Commission has considered this request but decided to proceed with the review due to the potential complexity of the issues involved.

d-cyphaTrade also expressed concern that the scope of the review may be too wide such that it unnecessarily delays the implementation of an FOA. The Commission

⁴⁵ d-cyphaTrade, 13 March 2009, *Futures Offset Arrangement Rule Change Proposal 2008 - Submission to Draft Rule Determination (22nd January 2009)*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>, 30 March 2009

⁴⁶ Email from Australian Power & Gas to the Commission, 29 January 2009, *Hearing request*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

⁴⁷ d-cyphaTrade, 30 January 2009, *Request for Pre-Determination Hearing - Project No. ERC0056*, <http://www.aemc.gov.au/electricity.php?r=20080204.095152>, viewed 30 March 2009

has outlined the scope for this review in the Framework and Issues Paper for this review,⁴⁸ and invites comments on the adequacy of the scope.

During the hearing, the NGF advised that:

- It is important that the prudential regime is robust. This is a pre-requisite to the NGF accepting any proposed changes.
- The draft Rule determination report has noted the relevant issues raised by the NGF.
- Conducting a review is a pragmatic approach to address the issues relating to the FOA Rule change proposal.
- While the review process is preferred, if the Commission were to make a preferable Rule as proposed by the proponents, the Commission should publish another draft Rule determination for consultation before finalising the Rule determination.
- Non-firmness of an FOA is an important issue that needs to be addressed, amongst others identified by the Commission.

During this hearing, Infratil Energy Australia:

- expressed concerns in relation to the Deloitte's report; and
- expressed the view that reallocation arrangements and FOAs are not competing products and can co-exist with other arrangements in the NEM and welcomed an overall review.

⁴⁸ AEMC, 2009, *Framework and Issues Paper - Review into the role of hedging contracts in the existing NEM prudential framework*, <http://www.aemc.gov.au/electricity.php?r=20090303.112859>, viewed 30 March 2009

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