



## Application of offsets in the prudential margin calculation

### Publication of draft Rule and draft Rule determination

**The Australian Energy Market Commission (AEMC) invites submissions on a draft Rule that removes the current restriction on offsetting trading amounts and reallocation amounts in the calculation of a market participant's Prudential Margin. Submissions are due by 11 August 2016.**

#### The prudential framework

The purchase and sale of electricity in the National Electricity Market (NEM) occurs through the spot market. The Australian Energy Market Operator (AEMO) acts as the principal in the settlement of transactions with market participants in the spot market. In the NEM, the settlement of transactions occurs up to five weeks after the transaction occurs, which results in large amounts outstanding and gives rise to the need for a carefully managed prudential framework.

The prudential framework for the NEM is a set of requirements established to minimise the risk of a payment shortfall to net creditors in the NEM, in the event of a default by a market participant, by requiring market participants to provide credit support to AEMO. The prudential framework includes the prudential standard and the prudential settings. The prudential standard sets the risk of a payment shortfall at 2%.

The prudential settings determine the amount of credit support provided by each market participant to AEMO. For each market participant, the prudential settings are such that the amount of credit support is sufficient to cover a market participant's liabilities in 98 out of 100 instances of their default. In the remaining 2% of cases, a market participant's default can result in a payment shortfall to net creditors in the NEM. In this way, the prudential settings are consistent with the prudential standard.

The prudential margin is a key component of the prudential settings, which provides a "buffer" to cover the loss that may occur between a market participant defaulting and its suspension from the NEM. The prudential margin for each market participant is based on that participant's trading amounts and reallocation amounts. Trading amounts are the positive or negative dollar amounts resulting from consuming or generating electricity. Reallocation amounts are the positive or negative dollar amounts, in respect of a market participant's reallocation transaction. A reallocation transaction represents an off-market trading relationship (such as a bilateral hedging contract) between two market participants.

The Rules currently prevent trading amounts to be offset against reallocation amounts, in the calculation of the prudential margin. This restriction on offsetting impacts on the level of credit support provided by a market participant to AEMO.

#### The rule change request

AEMO submitted a rule change request to remove the restriction on offsetting between reallocation amounts and trading amounts. AEMO considers the restriction in the current rule raises two primary issues for the NEM:

- the impact on competition (the restriction affects market participants using reallocations, but does not affect them equally); and
- the current rule results in an inefficient use of (some) market participants' collateral (credit support).

## The draft Rule

The draft Rule amends the NER to remove the prohibition on offsetting of trading and reallocation amounts in the prudential margin calculation. The effect of this amendment is that AEMO may offset between trading and reallocation amounts when determining a market participant's prudential margin. This change is intended to enhance the efficient operation of the prudential framework, while maintaining the NEM prudential standard.

The draft Rule may reduce the level of credit support provided by market participants to AEMO and may result in cost savings for market participants. This supports competition in the NEM by potentially reducing barriers to entry and barriers to expansion for certain market participants.

AEMO will retain its discretion in relation to developing the methodology to determine the prudential settings that apply to market participants. AEMO will have discretion to determine the extent to which it takes account of reallocation amounts in the prudential margin calculation. However, regulatory certainty will be provided to market participants as the draft Rule requires that AEMO amend its procedures to take into account the draft Rule. The draft Rule also stipulates that the prudential margin cannot be a negative amount in order to eliminate any prudential risks associated with a prudential margin being less than zero.

The draft Rule is aligned with the AEMC's strategic priority related to markets and networks by encouraging efficient investment in the NEM.

## Consultation process

The draft determination and draft rule are both available on the AEMC's website. Stakeholders are invited to make written submissions in response to the draft rule determination and draft rule by no later than **11 August 2016**.

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