



Application of offsets in the prudential margin calculation

Publication of final rule determination and final rule

The Australian Energy Market Commission (AEMC) has made a rule that removes the current restriction on offsetting trading amounts and reallocation amounts in the calculation of a market participant's Prudential Margin.

The prudential margin

The prudential margin is a key component of the National Electricity Market (NEM) prudential settings, which are used by AEMO to determine a market participant's credit support. The prudential margin 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 represent the value of an off-market trading relationship (such as a hedging contract) between two market participants.

The Rules currently restrict offsetting between trading amounts and reallocation amounts in the prudential margin calculation, which therefore impacts on the level of credit support provided by a market participant to AEMO.

The rule change request

On 28 May 2015 AEMO submitted a rule change request to remove the current restriction on offsetting between trading and reallocation amounts in the prudential margin calculation.

Overview of the final Rule

The Commission has made a more preferable Rule, which the Commission is satisfied will, or is likely to, better contribute to the National Electricity Objective (NEO) than the proposed rule. The key features of the Rule are as follows:

- the prohibition in clause 3.3.8(e) of the NER on offsetting of trading and reallocation amounts in the prudential margin calculation will be removed with effect from 20 October 2017;
- a new clause that stipulates that the prudential margin cannot be a negative amount will be introduced in order to eliminate any prudential risks associated with a prudential margin being less than zero;
- the Australian Energy Market Operator's (AEMO) discretion in relation developing the methodology to determine the prudential settings to apply to market participants is retained, including the extent to which it takes account of prospective reallocation amounts in the calculation of the prudential margin; and
- the imposition (through transitional rules) of a requirement for AEMO to amend and publish the Credit Limit Procedures and reallocation procedures, as required, to take into account the final Rule (by 1 July 2017).

The transitional arrangements in the final Rule take into account AEMO's discretion with regard to the extent of offsetting. The final Rule requires that AEMO must amend and publish (as required) the credit limit procedures, reallocation procedures and reallocation timetable to take account of the final Rule.

The final Rule may reduce the level of credit support provided by market participants to AEMO and may result in cost savings for market participants.

The removal of the restriction of offsetting of trading and reallocation amounts is effective from 20 October 2017. The Commission notes AEMO's intention to include offsetting of trading and reallocation amounts in market participants' maximum credit limit (MCL) reviews for the summer 2017/2018 season, which commences on 1 December 2017. The chosen date for when the removal of the restriction of offsetting of trading and reallocation amounts is effective, 20 October 2017, gives AEMO sufficient time to incorporate the final Rule into its MCL reviews for the summer 2017/18 season.

Commission's reasons

This change is intended to enhance the efficient operation of the prudential framework, while maintaining the NEM prudential standard.

The final 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 prospective reallocation amounts in the prudential margin calculation.

Regulatory certainty will be provided to market participants as the final Rule requires that AEMO amend and publish its credit limit procedures and reallocation procedures, as required, to take into account the final Rule. The final Rule also stipulates that the prudential margin cannot be a negative amount. Whilst AEMO cannot determine a prudential margin that is a negative amount under the final rule, AEMO will have the discretion to determine what non-negative amount the prudential margin should be in accordance with the credit limit procedures and in order to meet the prudential standard for the NEM.

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