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Submitted via e-mail to: prudentials@aemo.com.au

Credit Limit Procedures – Modelling Parameters & MNSP Prudential Requirements Changes

The Australian Energy Council (the “**Energy Council**”) welcomes the opportunity to make a submission in response to the Australian Energy Market Operator’s (“**AEMO**’s”) *Credit Limit Procedures – Modelling Parameter and MNSP Prudential Requirement Changes Issues Paper*.

The Energy Council is the industry body representing 21 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over ten million homes and businesses.

Introduction

AEMO proposes increasing three “Life of the National Electricity Market” parameters in the Credit Limit Procedures from 10% to 20%, being:

- the weighting factor for average regional price ($W_{P,R}$);
- the weighting factor for volatility factors for the outstandings limit and prudential margin ($W_{VF,R}$); and
- the capping factor for price and volatility factors¹.

The Energy Council suggests that doing so will markedly increase prudential costs for market participants.

Discussion

AEMO currently determines a market participant’s Maximum Credit Limit (“**MCL**”) (and hence its credit support requirements) based on a statistical analysis of a range of factors including seasonal differences in regional reference prices and smoothing techniques such as weighting and capping factors. The aim of the analysis is to limit the changes in MCLs, while simultaneously responding to long-term trend changes. The benefit to market participants is that volatility in credit support obligations is reduced, but the detriment is that in a rising or volatile wholesale market, market participants’ MCLs may lag behind market conditions, resulting in the possibility that the 2% prudential standard may be exceeded. To counter this problem, AEMO proposes that parameters used to calculate the MCL be increased from 10% to 20%, thereby increasing the weighting given to actual figures from the previous corresponding season. The justification for doing so is that this will cause fewer prudential exceedances.

While the Energy Council is supportive of efforts to limit prudential exceedances, in this specific case, it is concerned that doing so will increase prudential costs to industry. By increasing MCLs, members’ credit support requirements will be (in some cases) materially increased, which will have a tangible cost, in the form of higher bank guarantee fees, business imposts from increased reallocation arrangements, and/or the opportunity cost on funds deposited with AEMO. While these additional costs will affect all market participants, the burden will fall more heavily on smaller entities, which endure a higher risk premium applied to them in financial markets. The effect of this change will be to make smaller entities less competitive and heighten the barrier to entry for new participants.

¹ Note that this factor is proposed to be changed from $\pm 10\%$ to $\pm 20\%$.

In addition, further analysis of current market data suggests that the proposed parameter increases are unnecessary. Firstly, since the closure of the Hazelwood Power Station while average price outcomes have increased, price volatility compared to the same period in 2016 has reduced. Secondly, forward prices show that future regional reference prices are expected to decline, therefore the justification for increasing MCLs (which is based on one year of data) is lessened.


Conclusion

In conclusion, the Energy Council does not support the proposed increase in the Life of the National Electricity Market parameters from 10% to 20%, and suggests that AEMO investigate ways to make the MCL more dynamic and responsive to short-term market conditions, such as high prices during the summer period.

Whilst exploring a more dynamic response may take some time, in the interim the Energy Council suggests additional modelling of market parameters scenarios could be undertaken, such as a 15% weighting.

Any questions about this submission should be addressed to the writer, by e-mail to Duncan.MacKinnon@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Duncan MacKinnon', with a long horizontal flourish extending to the right.

Duncan MacKinnon
Wholesale Policy Manager
Australian Energy Council