

Applications for Authorisation

Amendments to the National Electricity Code - Improvements to Prudential Framework and Changes to Settlement Residue Auctions

Date: 21 January 2004

Authorisation Nos:

A90877

A90878

A90879

File no: C2003/1061

Commissioners:

Samuel

Sylvan

Martin

McNeill

Willett

Contents

1. Introduction	1
2. Statutory test	3
3. Public consultation process	5
4. The Commission’s assessment	6
4.1 The application	6
4.2 Issues for the Commission	8
4.3 What the applicant says	8
4.4 What the interested parties say	9
4.5 Issues arising from the draft determination	9
4.6 Commission’s considerations	10
5. Determination	22

Glossary

ASIC	Australian Securities and Investments Commission
code	National Electricity Code
Commission	Australian Competition and Consumer Commission
MCL	Maximum Credit Limit
NECA	National Electricity Code Administrator
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company Limited
TPA	Trade Practices Act 1974
SRD	Settlement Residue Distribution

1. Introduction

On 14 August 2003, the Australian Competition and Consumer Commission (Commission) received applications for authorisation (A90877, A90878 and A90879) of amendments to the National Electricity Code (code). The applications were submitted by the National Electricity Code Administrator (NECA).

The proposed amendments are to clauses 3.3.8, 3.3.10, 3.3.13, 3.15.11, 3.15.21, and schedule 3.3 of the code, which relate to the prudential framework of the code, and to clause 3.18.2 of the code, which relates to settlement residue auctions arrangements.

NECA is seeking to amend the prudential framework of the code to provide for:

- The option of reducing a participant's maximum credit limit (MCL) by allowing participants to elect to reduce their payment period to 14 days so that the credit period over which the MCL is calculated decreases from 42 to 28 days;
- An extension of the settlement reallocation provisions to allow participants to lodge reallocation requests after, rather than before, the end of the relevant trading interval;
- The option of lodging a reallocation request in satisfaction of a call notice;
- The ability to terminate a reallocation transaction early with the consent of both parties and NEMMCO; and
- A change to the period during which a market participant must remedy a default event before suspension from trade may occur from 24 hours to 1.00pm Sydney time on the next business day following the date of issue of the default notice.

The proposed amendment to the settlement residue auction arrangements allows NEMMCO to exclude certain small players from participation in the settlement residue auctions.

On 17 December 2003 NECA requested interim authorisation of the proposed changes to the prudential framework of the code. The Commission considered this request on 22 December 2003, and interim authorisation was granted to the aspects of the application relating to the prudential framework, i.e. all proposed changes except for the proposed change to clause 3.18.2. The interim authorisation was subject to the following condition:

The Commission requires that the proposed change to the deadline for response to a default event in clause 3.15.21 is reworded to "1pm *Sydney time* the next *day*".

Authorisation under Part VII of the *Trade Practices Act 1974* (TPA) provides immunity from court action for certain types of market arrangements or conduct that would otherwise be in breach of Part IV of the TPA. Authorisation may be granted where the Commission concludes that the public benefits of the arrangements or

conduct would outweigh the anti-competitive detriment of such arrangements or conduct.

The Commission has prepared this determination outlining its analysis and views on the applications for authorisation of the code changes. Chapter 2 of this determination sets out the statutory test that the Commission must apply when assessing an application for authorisation. Chapter 3 contains an outline of the Commission's public consultation process. The Commission's assessment of the proposed code changes is set out in chapter 4 and the Commission's determination is contained in chapter 5.

2. Statutory test

The applications were made under sub-sections 88 (1) and 88 (8) of the TPA.

Applications made under sub-section 88 (1) of the TPA are for authorisation to make a contract or arrangement, or arrive at an understanding, a provision of which would have the purpose, or would or might have the effect, of substantially lessening competition within the meaning of section 45 of the TPA; and to give effect to a provision of a contract, arrangement or understanding where the provision is, or may be, an exclusionary provision within the meaning of section 45 of the TPA. Further sub-section 88 (6) provides that an authorisation made under sub-section 88 (1) has effect as if it were also an authorisation in the same terms to every other person named or referred to in the application.

Applications made under sub-section 88 (8) of the TPA are for authorisation to engage in conduct that constitutes, or may constitute, the practice of exclusive dealing in accordance with the provisions of section 47 of the TPA. Further, sub-section 88 (8AA) provides that where authorisation has been granted under sub-section 88 (8) and this particular conduct is expressly required or permitted under a code of practice, the authorisation applies in the same terms to all other persons named or referred to as a party or proposed party to the code. Authorisations may also apply to any corporation who becomes a party in the future.

The TPA provides that the Commission shall only grant authorisation if the applicant satisfies the relevant tests in sub-sections 90 (6) and 90 (8) of the TPA. While sub-section 90 (6) and sub-section 90 (8) relate to different types of anti-competitive behaviour, the tests are essentially the same.

Sub-section 90 (6) provides that the Commission shall grant authorisation only if it is satisfied in all the circumstances that:

- the provisions of the proposed contract, arrangement or conduct would result, or be likely to result, in a benefit to the public
- the benefit would outweigh the detriment to the public constituted by any lessening of competition that would, or would be likely to result from the proposed contract, arrangements or conduct.

Sub-section 90 (8) provides that the Commission shall grant authorisation only if it is satisfied in all the circumstances that the proposed provision or conduct would result, or be likely to result, in such a benefit to the public that the proposed contract, arrangement, understanding or conduct should be allowed.

The Act specifies that the detriment to be considered is limited to detriment caused by a lessening of competition, however no such limitation is required when considering public benefits.

In considering whether or not to grant authorisation the Commission must consider what the position is likely to be in the future if authorisation is granted and what the future is likely to be if authorisation is not granted.

If the Commission determines that the public benefits do not outweigh the detriment to the public constituted by any lessening of competition, the Commission may refuse authorisation or grant authorisation subject to conditions.

The value of authorisation for the applicant is that it provides protection from action by the Commission or any other party for potential breaches of certain restrictive trade provisions of the TPA. It should be noted, however, that authorisation only provides exemption for the particular conduct applied for and does not provide blanket exemption from all provisions of the TPA. Further, authorisation is not available for misuse of market power (section 46).

A more expansive discussion about the Commission's authorisation process and the statutory test that the Commission applies can be found in: *Guide to authorisations and notifications*, Commission, November 1995.

3. Public consultation process

The Commission has a statutory obligation under the TPA to follow a public process when assessing an application for authorisation.

The Commission received the applications for authorisation of amendments to the code on 14 August 2003. Notification of the applications and a request for submissions was placed in *The Australian Financial Review* on 25 August 2003 and placed on the Commission's web site. Although not required under the TPA, interested parties were invited to make submissions to the Commission regarding their views on the issues of public benefit and anti-competitive detriment arising from implementation of the proposed amendments to the code. The Commission received one submission from Ergon Energy Pty Ltd.

The Commission produced a draft determination on 4 December 2003 outlining its analysis and views on the applications for authorisation. The Commission invited the applicant and other interested persons to notify it within 14 days whether or not they wished the Commission to hold a conference in relation to the draft determination.¹

No pre-determination conference was called, however one written submission on the draft determination was received from NEMMCO on 18 December 2003.

The Commission has released this determination outlining its analysis and views on the applications for authorisation according to the statutory criteria set out in Chapter 2. A person dissatisfied with this determination may apply to the Australian Competition Tribunal for its review.

¹ For the purposes of the conference, an interested person is a person who has notified the Commission in writing that the person, or a specified unincorporated association of which the person is a member, claims to have an interest in the applications and the Commission is of the opinion that the interest is real and substantial.

4. The Commission's assessment

4.1 The application

Optional Reduced Payment Periods and Lower Maximum Credit Limits - Clauses 3.3.8, and 3.3.10

The maximum credit limit (MCL), which is determined by NEMMCO for each participant, is the reasonable worst case estimate in dollars of the aggregate payments to be made by the participant to NEMMCO for the participant's credit period. Participants that do not meet acceptable credit criteria must provide credit support to NEMMCO which is not less than the MCL.

Currently the credit period over which the MCL is calculated is 42 days for all participants. One component of the credit period is the payment period; the typical time from the end of the billing period until the settlement date, which is usually 28 days.²

The code changes to section 3.3 allow participants to elect to reduce their MCL by reducing their payment period to 14 days, such that the credit period over which the MCL is calculated decreases from 42 to 28 days.

The prudential factor, which is used to determine the trading limit, will, unless otherwise determined by NEMMCO, decrease from 84% in the case of calculating the MCL on a 42 day period, to 75% in the case of calculating the MCL on a 28 day period. Thus the trading limit will decrease for participants that opt for a lower MCL calculated on a 28 day period, and accordingly they will receive a call at a lower trading threshold.

Response to Call Notices – Clause 3.3.13

In response to a call, the proposed code changes allow the participant to lodge a reallocation request of an amount which is not less than the call amount and which is acceptable to NEMMCO. A reallocation request is a request for reallocation, which is a process under which two market participants request NEMMCO to make matching debits and credits to the position of those market participants with NEMMCO.

Reallocation Transactions - Clause 3.15.11

Settlement reallocation facilitates the direct settlement of energy between generators and retailers rather than through the pool. A reallocation transaction occurs where NEMMCO credits one participant with a positive trading amount in respect of a trading interval, in consideration of an equal negative trading amount debited to another participant in respect of the same trading interval. Both parties and NEMMCO must

² "Day" is defined in the glossary of the code as "Unless otherwise specified, the 24 hour period beginning and ending at midnight Eastern Standard Time (EST)".

agree to the reallocation transaction. Currently reallocation transactions may only be entered into before the end of the relevant trading interval.

The proposed changes extend the existing arrangements to allow participants to lodge reallocation requests *after*, in addition to the current provision for lodgement *before*, the end of the relevant trading interval. This will allow participants to wait until their contractual obligations are clear before advising the amounts to be netted out of settlements.

The changes also provide for the early termination of a reallocation request where a reallocation termination request is lodged with NEMMCO by or on the behalf of both of the parties to the original reallocation transaction. The amendment provides that NEMMCO has the discretion to accept or reject an early termination request, and such a decision is a reviewable decision.

Increase in Deadline for Response to a Default Event – Clause 3.15.21

Currently a participant is afforded a 24 hour period after the issue of a default notice to remedy the default before NEMMCO may suspend the participant from trading. The proposed change to clause 3.15.21 alters the participant's response time from 24 hours to 1pm Sydney time on the next business day following the date of issue of the default notice.

While “business day” is not italicised in the application, discussions with NECA indicated that the intention was that it be italicised, such that its meaning will be as defined in the glossary of the code. Business day is defined in the glossary of the code as “A *day* other than a Saturday, Sunday or a *day* which is lawfully observed as a national public holiday on the same *day* in each of the *participating jurisdictions*.”

Sydney time is defined in the proposed amendment as “Eastern Standard Time or Eastern Daylight Saving Time as applicable in Sydney”. Currently “time” is defined in the code as “Eastern Standard Time, being the time at the 150th meridian of longitude east of Greenwich in England, or Co-ordinated Universal Time, as required by the National Measurement Act, 1960”.

Sydney time will apply to responding to call notices (clause 3.3.13) and responding to default notices (clause 3.15.21).

Changes to Settlement Residue Auction Arrangements – Clause 3.18.2

Settlement residues may arise where electricity is transmitted from one region to another through regulated interconnectors, and the spot prices of electricity in the two regions differ. Clause 3.18 of the code provides that NEMMCO may enter into Settlement Residue Distribution agreements (SRD agreements) with eligible persons following an auction. Under these SRD agreements NEMMCO agrees to allocate a portion of the settlement residue to the person successful at auction, in exchange for payment to NEMMCO of a fixed amount for a fixed period.

The addition of sub-clause 3.18.2 (g)(6) extends the list of persons NEMMCO may exclude from eligibility for entry into SRD agreements to include “*any person who*:

- (i) *is a small business – a small business is defined as a business employing less than 20 people (or 100 people in the case of a manufacturing business). An electricity generator may be considered a manufacturer of electricity; or*
- (ii) *cannot provide a certificate to the effect that it has net assets in excess of \$2.5 million or its gross income for the past two financial years has exceeded \$250,000.”*

4.2 Issues for the Commission

The proposed amendments must satisfy the statutory test outlined in section 2. The Commission must consider whether the public benefit would outweigh the detriment associated with the amendments.

The Commission recognises the significance of the prudential framework of the code in protecting the financial stability of the market. The prudential framework ensures that participants in the NEM must either meet acceptable credit criteria or must lodge credit support.

In assessing these applications for authorisation of changes to the prudential framework the Commission must consider whether the public benefits arising from the protection of the financial stability of the market outweigh the detriments associated with imposing costs on participants and thus increasing barriers to entry into the NEM.

4.3 What the applicant says

NECA states that the provision for an optional reduction in a participant’s maximum credit limit will improve the efficiency of the utilisation of credit support and reduce the likelihood of participants defaulting due to difficulties in obtaining high levels of credit support.

The extension of the period during which a participant may remedy a default event until 1pm Sydney time the next business day following the issue of a default notice has been advanced by NECA as a pragmatic change necessitated by the fact that the mechanisms for remedying a default are only available on business days.

NECA submits that the provision in the code for settlement reallocation, which can facilitate the direct settlement of energy between generators and retailers rather than through the pool, has been rarely utilised. The proposed extension of the settlement reallocation provisions will allow participants to wait until their contractual obligations are clear before advising the amounts to be netted out of settlements. NEMMCO expects that the proposed amendments will stimulate activity in the settlement reallocation area, which will reduce overall retailer liability to NEMMCO.

NECA submits that the amendment to the eligibility for participation in settlement residue auctions is necessary in order to ensure compliance with the *Financial Services Reform Act 2001*.³

4.4 What the interested parties say

The Commission received one submission on the application from Ergon Energy Pty Ltd (Ergon Energy). Ergon Energy objected to the extension of the period during which a participant must remedy a default in clause 3.15.21, from within 24 hours to 1pm Sydney time the next business day following the issue of the default notice. Ergon Energy submits that this extension has the potential to increase credit risk exposure in circumstances of a default notice being issued on a Friday, or a “prudential event” occurring on a Saturday. In such circumstances it is noted that funds could be at risk for up to 72 hours, rather than the current 24 hour period. Ergon Energy submits that the current timeframe in the code of 24 hours for remedying default events should remain, and that the amendment to increase this timeframe should not be authorised.

Ergon Energy also submitted that as the concept of Sydney time is contrary to the established understanding of time in the code, it has the potential to lead to unnecessary ambiguity and confusion. Ergon Energy submits that the existing definition of time in the code should prevail and the introduction of the concept of Sydney time should be rejected.

4.5 Issues arising from the draft determination

On 18 December 2003 the Commission received a submission on the draft determination from NEMMCO. The submission related to the condition the Commission proposed in the context of the change to clause 3.18.2, which proposes to allow NEMMCO to exclude certain small players from participation in the settlement residue auctions.

At the time the application for authorisation was made, NEMMCO indicated that it appeared likely that ASIC would grant relief from the need to comply with certain obligations imposed by the *Corporations Act 2001* in relation to settlement residue auctions, provided that “retail clients”, as defined by the *Corporations Act 2001*, were expressly excluded by the code from participation in the auctions.

The submission of 18 December 2003 advised that the likelihood of an exemption being granted has become a reality; ASIC has informed NEMMCO of its decision to grant an exemption to NEMMCO under s 911A(2) of the *Corporations Act 2001* from the requirement to hold a licence for dealing, giving general financial product advice, and making a market in relation to Settlement Residue Agreements to wholesale clients.

³ The *Financial Services Reform Act 2001* amends the *Corporations Act 2001*. The *Financial Services Reform Act 2001* commenced on 11 March 2002, with a two year transitional period, therefore all business to which the legislation applies will be required to comply by 11 March 2004.

At the time of making the submission, NEMMCO had not been provided the instrument outlining the precise nature of the relief that ASIC had decided to grant, however NEMMCO submitted that ASIC's decision did not include the imposition of conditions.

NEMMCO submitted that while ASIC's decision effectively meets the proposed sub-conditions (ii) (b) and (c) in the draft determination, the wording of the sub-conditions, particularly sub-condition (ii) (c), does not precisely reflect the form in which relief has been granted. Accordingly, NEMMCO requested that the proposed sub-conditions (ii) (b) and (c) be removed, which would eliminate any doubt as to whether the sub-conditions have been satisfied.

NEMMCO accepted that the proposed sub-condition (ii) (a) more accurately reflected the intended effect of the proposed change to the settlement residue auctions, and thus NEMMCO did not request any change to this condition.

4.6 Commission's considerations

Changes to the Prudential Framework

Optional Reduced Payment Periods and Lower Maximum Credit Limits

The option of lodging reduced payment period requests and hence lowering maximum credit limits will reduce the amount of credit support that participants are required to provide to NEMMCO. As there is a cost associated with obtaining credit support, the reduction in the amount of credit support required will result in cost savings to existing participants, in addition to decreasing prudential barriers to participation in the NEM.

As the prudential factor, and accordingly the trading limit, will decrease with lower maximum credit limits, participants that opt to have lower maximum credit limits will receive calls sooner than they would receive calls with higher maximum credit limits. Thus participants with lower maximum credit limits will be required to manage their cash position effectively in order to respond to the subsequent increase in the likelihood of receiving a call.

Overall, providing for optional lower maximum credit limits will allow participants to reduce their costs of obtaining credit support, while the corresponding decrease in the trading limit will ensure that the financial stability of the market is not compromised. The Commission considers that this code change will lead to a reduction in barriers to participation, which is created by a decrease in the prudential guarantees required by NEMMCO. The Commission considers that this increase in efficiency constitutes a public benefit.

A decrease in the credit period may lead to a situation where a participant could make an early payment when they opt for the shorter payment period in the calculation of their MCL. As there is a delay between NEMMCO receiving payments and paying out to participants owed, there is potential for the accumulation of a substantial amount of money prior to it being paid out. If there is a significant opportunity cost associated with these accumulated funds, this will be reflected in prices in some way. The code stipulates that NEMMCO will treat early payments as security deposits in line with

section 1.11 of the code. These security deposits will earn interest at the 11am cash rate and the Commission is satisfied that this alleviates any concerns associated with the opportunity cost of the funds provided to NEMMCO.

Any anti-competitive detriment in the form of a risk premium for a decrease in the prudential guarantees provided to NEMMCO is mitigated by the decrease in the trading limit. On balance, the Commission considers the public benefit of allowing for lower maximum credit limits outweighs the detriment of providing lower prudential guarantees to NEMMCO.

Response to Call Notices

The Commission considers that the requirements for the lodgement and acceptance of reallocation requests in response to a call would benefit from clarification. Sub-clause 3.3.13(a)(3) refers to the lodgement and acceptance of a reallocation request of a certain “amount” in response to a call, however it is unclear whether an “amount” must be specified in dollars, or whether a quantity reallocation request could be accepted.

The Commission is of the view that reallocation requests lodged in response to calls should be limited to reallocations in respect of past trading intervals. If a reallocation request in respect of a future trading interval was accepted in response to a call, the participant’s current outstandings would be offset by future trading amounts that had not yet been transacted.

NECA has confirmed its intention that reallocation requests in response to calls would only be accepted by NEMMCO in respect of past trading intervals, and is of the view that NEMMCO would have the discretion to reject reallocation requests submitted in respect of future trading intervals in this context.

NECA has indicated that NEMMCO will develop guidelines relating to the procedures for processing reallocation transactions, which will address the meaning of “amount”. The Commission supports the development of such guidelines, and considers that, consistent with NECA’s intention, the guidelines should explicitly state that reallocation requests in response to calls will not be accepted in respect of future trading intervals.

On the understanding that reallocation requests submitted in response to call notices will not be accepted in respect of future trading intervals, the Commission considers that this proposal will provide greater flexibility to participants in responding to call notices, which the Commission considers will constitute a public benefit.

Reallocation Transactions

The Commission accepts the applicant’s claim that the extension of the settlement reallocation provisions to allow participants to lodge reallocation requests after the end of the relevant trading interval is likely to stimulate activity in this previously underutilised area. By allowing NEMMCO to net off amounts owed to and from generators and retailers, rather than requiring participants to pay in and be paid out from cash in the pool, participants’ cash flow positions may be improved. This will also reduce the credit risk to NEMMCO, as the debts owed to NEMMCO will decrease, and accordingly less credit support will be required by NEMMCO.

The changes to the settlement reallocation provisions also provide for the early termination of a reallocation request if both parties to the original request agree to the early termination. The requirement that both parties agree to the early termination may create a disincentive for debited parties to enter settlement reallocation agreements, and accordingly may mitigate the anticipated benefit of allowing participants to lodge reallocation requests after the end of the relevant trading interval.

If the credited party defaulted on the offsetting contract with the debited party, the debited party would presumably seek to terminate the reallocation request, however could not do so without the credited party's agreement. This may create a disincentive to enter into a reallocation request. The Commission considers that debited parties would be more likely to enter into reallocation transactions if they could cancel the transaction unilaterally. Although the termination requirements may inhibit activity to some extent in the settlement reallocation area, the Commission considers that the amendment is likely to encourage at least some activity in this area and accordingly a net public benefit is likely to arise.

The proposed code changes provide that the rejection of a reallocation termination request is a reviewable decision. Should two parties to a reallocation transaction seek to terminate the transaction early NEMMCO may refuse to accept the request, perhaps through concern that termination may both trigger the insolvency of the credited party and remove the credit support provided by that party, resulting in adverse consequences for the market at large. However the parties may appeal NEMMCO's decision to the tribunal. While such an appeal is being determined, the reallocation transactions will continue, but in the event the appeal is successful, those transactions may need to be unwound. Conceivably that may precipitate the type of situation that NEMMCO's original refusal was intended to avoid, where insolvency of the credited party brings adverse consequences for the market as a whole. The situation may be aggravated if the credited party has been allowed to continue trading without supplying additional credit support to replace the reallocation transaction that it and its counterparty applied to terminate.

In light of the above, it may be prudent for NEMMCO to discount the value of a reallocation transaction for the purposes of assessing credit support adequacy where the reallocation is the subject of a rejected termination request.

In summary, while the Commission considers that a public benefit will arise from the proposed changes to the settlement reallocation transaction provisions, the Commission notes that the proposed changes could be improved in the manners discussed above.

Increase in Deadline for Response to a Default Event

(i) The next business day

NECA's Code Change Panel report indicates that the extension of the time during which a participant may remedy a default event from 24 hours to the next business day is "*a pragmatic outcome, based on the reality that market participants have severely restricted access to credit providers outside normal business hours and that existing timeframes for rectifying defaults are unrealistic.*"

The Commission recognises that the costs of obtaining credit support outside of business hours may be high, and that there may be a benefit in allowing participants to avoid these costs in the event that they are issued a default notice requiring them to remedy the default outside of business hours.

While the Commission acknowledges the practical difficulties and the significant costs of obtaining credit support outside of business hours, the timeframes for billing and settlement of accounts seem to be sufficiently lengthy such that it is unlikely that a participant would be unaware of their imminent default.

A preliminary statement for the purchase or sale of electricity is issued by the 5th business day after each billing period, a final settlement statement is issued by the 18th business day after each billing period, and the settlement date is the 20th business day after the billing period. Thus participants have 15 business days from the preliminary statement until the settlement date, during which they may arrange for additional credit support prior if they consider that they will not be able to meet their payment obligations.

Clause 3.15.21 of the code lists fifteen events which amount to default events, some of which may occur due to circumstances beyond the control of the participant, and of which the participant may have no prior knowledge. The Commission recognises that an extension of the deadline for remedying the default for such an event may be warranted.

The code currently confers discretion on NEMMCO regarding the steps to be taken following the occurrence of a default event in a number of respects:

- NEMMCO *may* issue a default notice requiring that the default be remedied within 24 hours, or make claim upon any credit support under sub-clause 3.15.21(b) (emphasis added); it is not *required* to take either of these steps;
- Sub-clause 3.15.21(c) states that suspension may occur if the default event is not remedied “within 24 hours of the default notice *or any later deadline agreed to in writing by NEMMCO*” (emphasis added);
- If the default is not remedied within the required time, NEMMCO *may* issue a suspension notice under sub-clause 3.15.21(c); it is not *required* to do so.

The Commission is concerned that a change from 24 hours to the next business day will in some circumstances allow businesses to trade for a number of days while in default. For example, assuming a default notice is issued on a Thursday in a holiday period during which public holidays fall on the Friday and Monday (as may occur over Easter and Christmas), a participant may be able to trade until 1pm the following Tuesday before they may be suspended from trade.

Under the existing provision, if a default event occurred on a Friday, NEMMCO could agree to an extension until the following Monday. If prices were anticipated to be high and the financial position of the participant was considered dubious, NEMMCO could decline the extension request in order to prevent the participant from incurring large debts it would not be able to pay. Should the amendment be authorised, the party would

automatically be afforded a longer period expiring on the Monday, and NEMMCO would not be able to suspend the participant from trade prior to the end of that period.

There is a risk that a defaulting party will not be in a position to remedy their default at the end of the period afforded to them during which they may continue to trade. During this period in which the participant continues to trade, the participant may increase its outstanding debt.

The increasing cost of financial distress to the market associated with the increase in the credit period will need to be addressed in the calculation of the MCL. If the credit period in the MCL calculation remains unchanged, then the risk premium will be reflected in the spot price.

This raises the issue as to whether the code change is anti-competitive. If the increase in the response time to a default notice leads to an increase in the MCL, participants will be required to lodge greater prudential guarantees which are an obvious barrier to participation. Conversely, if the MCL remains unchanged, participants will be exposed to the increase in credit risk and will require a premium to bear the increased credit risk. This premium will be reflected in the spot price, which will also constitute a barrier to participation. The question remains as to whether these barriers to participation are significant.

The Commission understands that it is difficult for NEMMCO to provide an estimate in absolute terms of the increase in risk associated with the increased credit period.⁴ The risk will depend on expected prices during the extended credit period. If the risk is significant, it has the potential to offset the benefits of lower MCLs.

Overall the Commission considers that the detrimental impact of increasing credit risk by allowing a defaulted participant to continue trading for a number of days outweighs the benefits of the extension. The existing discretion provided for in the code allowing NEMMCO to agree in writing to an extension beyond 24 hours addresses the concerns advanced by NECA that participants face difficulties in obtaining credit support outside of business hours.

The Commission notes that NEMMCO's intention in proposing the code change was to seek clarity with respect to when the deadline for response to the default notice expired. This clarity may be achieved without extending the period until the next business day.

The Commission considers that an extension to the next *calendar* day, as opposed to the next *business* day, would minimise the risk to the market of allowing a defaulted party to continue to trade, such that the detriment of the extension would not outweigh its benefits. Accordingly, the Commission authorises the change to the deadline for participants to remedy a default event in clause 3.15.21, subject to the condition that

⁴ The Commission notes that default has not occurred in five years of operation.

where the proposed amendments refer to the next business day, “business” is removed so that it reads “the next *day*”.⁵

(ii) *1pm Sydney Time*

Discussions with NECA revealed that the motivation for specifying an exact time as a deadline rather than a 24 hour period was to remove uncertainty associated with the exact time at which the 24 hour period commences, and accordingly the time at which the 24 hour period expires. The Commission agrees that a specific time would benefit participants by providing certainty, and accordingly does not object to the imposition of a deadline of 1pm.

NECA submits that the introduction of Sydney time in the settlement provisions of the code is justified on the basis that Austraclear, through which payments are made, operates on Sydney working hours. The amendments involving Sydney time apply only to deadlines for responding to a call and remedying a default event.

Ergon Energy argue that the introduction of Sydney time in the settlements provisions of the code, while leaving the existing definition applicable to other parts of the code, may lead to unnecessary confusion and ambiguity, as some deadlines would be based on Sydney time, while others would be based on Eastern Standard Time.

The Commission does not consider that introducing Sydney time into the settlements provisions of the code will lead to ambiguity. The stipulations in the provisions of the code to which Sydney time will apply are clear in this respect. In the event that the time is not stipulated as Sydney time, the alternate definition of time, Eastern Standard Time, will apply. The Commission considers that participants in the NEM are sufficiently sophisticated to account for different definitions of time.

The Commission does not consider that the introduction of Sydney time will impose a significant burden on any participants within the NEM such that competition is likely be lessened.

The Commission therefore proposes to authorise a change to the deadline before which a participant must respond to a default event in clause 3.15.21, to 1pm Sydney time the next day.

The Commission observes that a 24 hour deadline applies to the procurement of credit support in clauses 3.36 (changes to credit support), 3.37 (drawings on credit support), and 3.3.18 (additional credit support). Given the desire on NEMMCO’s part for certainty as to the commencement and expiry of the 24 hour period, it is curious that a 24 hour deadline would apply for the procurement of credit support in those provisions, but a proposed deadline of 1pm Sydney time the next business day would apply for response to a default event, which in most cases will involve the procurement of credit support.

⁵ “Day” is italicised in order to avoid any ambiguity as to its meaning; its meaning is defined in the glossary.

The Commission notes also that clauses 3.36, 3.37, and 3.3.18 do not confer discretion on NEMMCO to extend the 24 hour deadline applicable to those clauses, thus concerns relating to the costs of obtaining credit support outside of business hours would seem pertinent to those clauses. NECA did not apply for authorisation of changes to clauses 3.36, 3.37 or 3.38 however, and as such the 24 hour deadline for those provisions remains.

Changes to the Settlement Residue Auction Arrangements

The addition of sub-clause (6) to clause 3.18.2(g) extends the list of persons whom NEMMCO may exclude from participation in the settlement residue auctions.

Settlement residue auctions enable participants to manage risks of interregional trading in the NEM. A generator with a financial contract in place that references the spot price in another region faces the risk that the regional spot prices may differ. The rights to receive settlement residue assist generators to manage this exposure. The Commission recognises that the exclusion from participation in settlement residue auctions eliminates a mechanism for managing the risks of interregional trade for the excluded participants, and accordingly may deter interregional trading within the NEM.

NECA advised that the purpose of the addition of sub-clause 3.18.2(g)(6) is to exclude “retail clients”, as defined in the *Corporations Act 2001*, from eligibility for participation in the settlement residue auctions.

Under the *Corporations Act 2001*, parties that provide “financial products” are required to obtain a licence from the Australian Securities & Investments Commission (ASIC), unless granted an exemption by ASIC. NECA submitted that it is likely that SRD agreements will fall within the definition of “financial products” in the *Corporations Act 2001*, and accordingly that NEMMCO will be required to obtain a licence or an exemption in order to continue to operate the auctions.

NEMMCO considers that the costs of obtaining a licence and complying with the licensing regime would be great, and that compliance is neither appropriate nor necessary for the efficient and fair functioning of the settlement residue auctions or the NEM. Accordingly, NEMMCO applied to ASIC for an exemption from the requirement to obtain a licence.

In addition to licensing arrangements, the *Corporations Act 2001* affords certain protection to “retail clients”. The legislation distinguishes between retail and wholesale clients, with the consumer protection provisions applying only to retail clients. It is recognised that wholesale clients are better informed and better able to assess the risks involved in financial transactions, and accordingly that they do not require the same level of protection as retail clients.⁶

Parties that provide financial products or services to retail clients must adhere to requirements in the *Corporations Act 2001*, including the provision of mandated

⁶ Financial Services Reform Bill 2001 Explanatory Memorandum, paragraph 2.27

product advice and information disclosure, internal dispute handling, and membership of an external dispute resolution scheme as approved by ASIC.

Given that a key feature of the *Corporations Act 2001* is consumer protection for retail clients, NEMMCO advised that ASIC had indicated it was unlikely to grant an exemption from the requirement to obtain a licence for the operation of the settlement residue auctions if retail clients could participate in the auctions. Therefore, in order to be exempted from the requirement to obtain a licence, NECA has sought authorisation to exclude retail clients from eligibility for participation in the auctions.

Section 761G of the *Corporations Act 2001* defines “retail client” and “wholesale client”. The section provides that a person is a retail client unless subsection (5), (6) or (7) applies. Subsection (5) deals with general insurance products, subsection (6) deals with superannuation and retirement savings account products, and subsection (7) deals with other kinds of financial products. It is thus subsection (7) that is relevant to the consideration of retail clients in the context of settlement residue auctions.

Subsection 761G (7) provides that a person is a retail client unless one or more of the four sub-paragraphs apply:

- (a) the price of the product or service equals or exceeds the amount in the regulations (this amount is \$500 000);
- (b) the financial product is provided for use in connection with a business that is not a small business (subsection (12) defines *small business* as a business employing less than 20 people or in the case of the manufacture of goods – 100 people);
- (c) the financial product is not provided for use in connection with a business, and the acquiring party gives the provider a copy of a certificate given within the preceding six months by a qualified accountant stating that the person:
 - (i) has net assets of at least the amount specified in the regulations, (this amount is \$2.5 million); or
 - (ii) has a gross income for each of the last two financial years of at least the amount specified in the regulations (this amount is \$250 000);
- (d) the person is a professional investor

NEMMCO submits that the exclusion of retail clients from settlement residue auctions will have no practical effect. The primary reason advanced in support of this assertion is that NEMMCO expects that most participants will satisfy sub-paragraph (d) by the time the provision takes effect i.e. most will be professional investors, which will deem them wholesale. The criterion in sub-paragraph (d), a person that is a professional investor, is defined comprehensively in section 9 of the *Corporations Act 2001*, the definition section of the legislation, and includes a person that is a financial services licensee. NEMMCO has indicated that it expects most auction participants to hold a licence when the provisions take effect.

The practical effect of sub-paragraph (a) may be of limited relevance in the context of settlement residue auctions, as it is questionable whether the price paid will frequently exceed the prescribed amount of \$500 000. Thus assuming a participant is not a financial services licensee, which NEMMCO indicates is unlikely, the relevant exclusionary criteria would likely be sub-paragraphs (b) and (c).

A participant that is sufficiently large in terms of employees will be considered wholesale under sub-paragraph (b) and will be eligible for participation in the auctions, regardless of the size of its assets or the amount of its gross income. Conversely, a participant that is sufficiently large in terms of either assets or gross income will satisfy the test for a wholesale client in sub-paragraph (c), and accordingly will not be excluded from participation in the settlement residue auctions, regardless of the number of employees.

Effectively, this means that only specific small players would be deemed retail in the context of settlement residue auctions; those that are small in terms of employees, and additionally have both assets and gross income below the prescribed amounts.

It is only a party that satisfies *none* of the criteria in s 761G (7) of the *Corporations Act* 2001 that will be deemed retail under that provision of the legislation. Given that most participants in the NEM will satisfy the criterion in paragraph (d), and only a limited number would not pass the criteria in paragraphs (b) and (c), the exclusion of retail clients from participation in settlement residue auctions is fairly narrow in scope.

NEMMCO indicated that the proposed amendment to clause 3.18.2 is necessary in order to satisfy ASIC that a mechanism is in place to prevent retail clients from participating in the settlement residue auctions. Without such a mechanism, NEMMCO submitted it was likely that it would be required to apply for a licence and comply with the obligations imposed on parties dealing with retail clients, which NEMMCO submits could increase the costs of operating the settlement residue auctions from around \$900 000 to over \$1.9 million per annum.

If the amendment is authorised the auctions can continue to operate at approximately the cost at which they are currently operated. The Commission considers that there is a benefit in operating the auctions arising from the provision of a risk management mechanism for interregional trade which may encourage interregional trading.

If the amendment is not authorised NEMMCO will be required to obtain a licence in order to comply with the *Corporations Act* 2001. NEMMCO has indicated that the costs of compliance could exceed \$1 million per annum. These costs will ultimately be borne by market participants. Increasing the costs of participation will increase barriers to entry to the NEM and the Commission considers that preventing such a cost from being incurred constitutes a public benefit.

The Commission considers that the anti-competitive detriment likely to arise from allowing the exclusion of retail clients from settlement residue auctions will be at most minimal, as the scope of the exclusion is fairly narrow and it is unlikely to apply to current or potential participants. Rather than having a detrimental impact on competition, the amendment will allow the auctions to continue, which, as indicated above, may promote interregional trade within the NEM.

On balance the Commission considers that allowing the auctions to continue without imposing additional costs on NEMMCO constitutes a public benefit. The Commission considers that the public benefits of allowing NEMMCO to exclude retail clients from participation in the settlement residue auctions will outweigh the likely detriments of allowing such an exclusion.

While the Commission is of the view that excluding retail clients from the settlement residue auctions is warranted in light of the obligations imposed by the *Corporations Act 2001*, the wording of the clause in the application excludes a wider class of persons than that required by the *Corporations Act 2001*.

Under the legislative definition of retail client, satisfaction of any one of the subparagraphs in s 761G (7) is sufficient to deem a participant wholesale. Therefore a participant is only deemed retail by s 761G (7) if it fails to meet *each* of the criteria in that sub-section. Alternatively, this may be expressed as satisfying the converse of each of the criteria in the legislative definition, i.e.:

- the price of the product or service is less than \$500 000; *and*
- the person is a small business; *and*
- the person does not have either of:
 - net assets in excess of \$2.5 million; or
 - gross income for the past two financial years exceeding \$250 000; *and*
- the person is not a professional investor.

The class of persons in the proposed amendment is defined by reference to the converse of some of the criteria in the s 761G (7) that deem a party wholesale. The effect of the word “or” between (i) and (ii), and in the middle of (ii) of the proposed clause, however, is that satisfaction of any one of the criteria in the proposed amendment is sufficient to exclude a party from participation in the settlement residue auctions. Therefore a party will be excluded from participation in the settlement residue auctions under the proposed amendment if either:

- it is a small business;
- it does not have net assets in excess of \$2.5 million; or
- it’s gross income for the past two financial years has not exceeded \$250,000.

In order to be deemed a retail client under the s 761G (7), a party must satisfy the converse of *each* of the legislative criteria, whereas the definition proposed in the application requires satisfaction of *any* of the categories of person referred to (the converse of some the legislative criteria) in order to be excluded from the settlement residue auctions. Thus the definition in the application excludes a broader class of persons than that required by the legislation.

The Commission does not identify any public benefit in excluding participants that fall outside of the definition of retail client from settlement residue auctions, and accordingly the clause in the application requires refinement.

The Commission therefore authorises these amendments allowing NEMMCO to exclude retail clients from settlement residue auctions, subject to the condition that the words in clause 3.18.2 (g)(6) are deleted and replaced with:

“Any person who would be a “retail client” as defined in section 761G (7) of the *Corporations Act* 2001 if they entered into an *SRD agreement* with *NEMMCO*.”

This condition was condition (ii) (a) in the draft determination.

At the time the application for authorisation was submitted, it was indicated that ASIC was *unlikely* to grant an exemption from the need to comply with certain obligations imposed by the *Corporations Act* 2001 in relation to settlement residue auctions, unless the code expressly permitted the exclusion of retail clients. The Commission was of the view that exclusion of retail clients should only be permitted if such exclusion was *necessary* in order to obtain an exemption from the requirement to obtain a licence.

Condition (ii) in the draft determination therefore also included the following sub-conditions:

(b) ASIC grants an exemption to NEMMCO from the requirement under the *Corporations Act* 2001 to obtain a licence in order to operate the settlement residue auctions; and

(c) A clause in the code specifically permitting the exclusion of retail clients from participation in settlement residue auctions is necessary in order for ASIC to grant that exemption.

The purpose of these sub-conditions was that in the event that ASIC agreed to the exemption from the need to obtain a licence *without* requiring the insertion of clause 3.15.21(g)(6) into the code, or that ASIC decided *not* to grant an exemption and required NEMMCO to obtain a licence, retail clients could not be prevented from participation simply by virtue of the clause.

Subsequent to the release of the draft determination, the Commission received a submission from NEMMCO indicating that ASIC had decided to grant an exemption to NEMMCO under s 911A(2) of the *Corporations Act* 2001 from the requirement to hold a licence for dealing, giving general financial product advice, and making a market in relation to Settlement Residue Agreements to wholesale clients.

At the time of making the submission, NEMMCO had not been provided with a draft of the instrument outlining the precise nature of the relief that ASIC has decided to grant, however ASIC has advised NEMMCO that the exemption is not subject to any conditions.

NEMMCO is of the view that the proposed sub-conditions (ii) (b) and (c) are effectively satisfied, however that in light of the fact that ASIC’s decision does not

include the imposition of conditions, there may be doubt as to whether the sub-conditions (b) and (c) have been satisfied, and accordingly NEMMCO requests that they are removed.

Given that ASIC has decided to grant an exemption to NEMMCO, sub-condition (ii) (b) is no longer necessary, and therefore the Commission does not require its imposition.

Sub-condition (ii) (c) was proposed on the basis of NEMMCO's indication that ASIC was likely to grant the exemption only if a clause specifically allowing the exclusion of retail clients was inserted into the code. The purpose of this sub-condition was to ensure that the exclusion would be authorised only in the event that this indication was proven to be correct. It was relevant only at that time when a decision regarding the grant of an exemption had not been made. As the exemption has now been granted, sub-condition (ii) (c) is no longer necessary, and the Commission does not require its imposition in order to satisfy the statutory test of authorisation.

ASIC has granted an exemption that does not extend to transactions with retail clients. If a retail client was to participate in the settlement residue auctions, NEMMCO would not be exempted from the requirements to comply with the relevant provisions of the *Corporations Act 2001* and would presumably require a licence.

As indicated above, NEMMCO has advised that all current and all likely future participants in the auctions would be considered wholesale under the *Corporations Act 2001*, and therefore the exclusion of retail clients is likely to have little or no practical effect. The exclusion is necessary, however, to ensure that should a retail client wish to participate in the future, NEMMCO will be entitled to exclude such participation so that the costs of compliance with the *Corporations Act 2001* may be avoided. As outlined above, the Commission is of the view that avoidance of these costs constitutes a public benefit, which outweighs the detriment of allowing the exclusion. Therefore the Commission authorises the provision in the code for the exclusion of "retail clients", as defined in the *Corporations Act 2001*, from participation in the settlement residue auctions, and does not require the imposition of sub-condition (ii) (b) or (c) as proposed in the draft determination.

5. Determination

On 14 August 2003, the Commission received applications for authorisation (A90877, A90878 and A90879) of amendments to the code. The applications were submitted by NECA, under Part VII of the TPA. The amendments relate to the prudential framework and the provisions of the code relating to eligibility for participation in settlement residue auctions.

The applications were made under sub-sections 88 (1) and 88 (8) of the *Trade Practices Act 1974* (the TPA) to:

- Make or give effect to a contract or arrangement, or arrive at an understanding, where a provision of that proposed contract, arrangement or understanding would be, or might be, an exclusionary provision within the meaning of section 45 of the TPA (Form A);
- Make or give effect to a contract or arrangement, or arrive at an understanding, a provision of which would have the purpose, or would or might have the effect, of substantially lessening competition within the meaning of section 45 of the TPA (Form B); and
- Engage in conduct that constitutes or may constitute the practice of exclusive dealing, within the meaning of section 47 of the TPA (Form E).

For the reasons outlined in Chapter 4 of this determination, the Commission is satisfied that, in all the circumstances, and subject to the conditions set out below, the making and giving effect to the proposed amendments to the National Electricity Code for which authorisation is sought under subsection 88(1) and 88(8) of the TPA:

- would result, or be likely to result, in a benefit to the public; and
- that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result, or be likely to result, from the proposed amendments.

The Commission is also satisfied that, in all the circumstances, and subject to the conditions set out below, the conduct for which authorisation is sought under subsection 88 (8) of the TPA in respect of proposed conduct to which subsections 47 (6) and (7) apply would be likely to result in such a benefit to the public that it should be allowed to take place.

The Commission is also satisfied that, in all the circumstances, and subject to the conditions set out below, the conduct for which authorisation is sought under subsection 88 (1) of the TPA in respect of provisions which may be exclusionary provisions would be likely to result in such a benefit to the public that it should be made and given effect to.

This determination is made by the Commission on 21 January 2004. The Commission authorises the amendments to the code contained in application numbers A90877, 90878 and 90879. The period of authorisation is to 31 December 2010.

Conditions:

- (i) The proposed change to the deadline for response to a default event in clause 3.15.21 is reworded to “1pm *Sydney time* the next *day*”.**
- (ii) The words in clause 3.18.2(g)(6) in the application are deleted and replaced with:**

“Any person who would be a “retail client” as defined in section 761G (7) of the Corporations Act 2001, if they entered into an *SRD agreement* with *NEMMCO*”.