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## Wholesale Electricity Market Rule Change Submission Form

### RC\_2012\_23 Prudential Requirements

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#### Submitted by

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#### Submission

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- 1. Please provide your views on the proposal, including any objections or suggested revisions.**

#### *Background*

The prudentials regime in the Wholesale Electricity Market (WEM) is designed to ensure that sufficient protection is provided to the market where a Market Participant may find itself in a default position where it cannot settle its Short Term Energy Market (STEM) or Non-STEM invoices on time. That is the prudentials regime attempts to mitigate against the risk of a short payment to Market Participants occurring. Consequently there are a number of safe guards for the market built into the current prudentials regime, including:

- Requiring a Credit Support of an amount sufficient to cover a Market Participants anticipated market exposure (Credit Limit) to be provided prior to competing in the WEM;
- Monitoring by the IMO of whether a Market Participants Outstanding Amount (aggregate of amounts payable to the IMO less amount to be paid to the participant by the IMO) is reaching the participant's Trading Limit (set as a ratio of 0.87 of the participants Credit Limit);
- Requiring Market Participants to provide additional Credit Support where its Trading Limit reaches zero (Margin Call) or alternatively setting the participants Credit Limit higher.

### ***Proposed changes***

The prudentials regime that currently applies in the WEM has not been changed since market start in 2006. Since that time the IMO has encountered a number of issues with the application of the relevant rule requirements that it considers require clarification in order to ensure that there is no ambiguity around the prudential obligations of either Market Participants or the IMO. Alinta understands that some of these ambiguities under the current Market Rules have resulted in compliance issues for the IMO.

The IMO subsequently proposes a suite of changes to the rules around prudentials to bring the rules in line with its current practices and remove any ambiguity. Additionally the IMO proposes to remove any prescriptive details in the Market Procedure for Prudential Requirements consistent with its broader moves towards principles based drafting.

An overview of the changes is provided below:

- ***Credit Limit determination (Issue 1)***: The IMO proposes to clarify that a participant's Credit Limit will be set at a value that which will not be exceeded over a 70 day period (*presumed to be over the last 24 months*). This is intended to reflect a participant's maximum exposure to the market as reflected by historical data, though there is an ability for the IMO to use its discretion to consider other factors such as default of payments. This amended to the methodology will reflect the IMO's current practice.

The IMO also proposes to outline the principles taken into account in determining a participant's Credit Limit in the rules, with the prescriptive detail of the calculation to be moved to the Market Procedure. The factors currently prescribed in the rules to be taken into account have not proven to be practical to date. The proposal will remove those subjective factors such as past breaches of the Market Rules (for which it is unclear how exactly the IMO would amend the Credit Limit) and unnecessarily complex calculations which the IMO considers would be unlikely to improve the overall calculation.

- ***Notification of any change in circumstances affecting a Market Participant's Credit Limit (Issue 2)***: The IMO proposes changes to more broadly require notifications to be provided to the IMO where a Market Participant experiences a change in circumstances that could impact on its Credit Limit. Currently the rules only require notifications to be provided where a Market Customer experiences a change in its circumstance. The rules do not consider the fact that Market Generators may experience changes in behaviour where it needs to vary its bilateral contract position in the market.
- ***Determining the expected value of transactions (Issue 3)***: The IMO proposes to amend clause 2.37.9 to specify that instead of guidelines, a list of factors to be taken into account in determining the expected value of a transaction is provided in the Market Procedure.
- ***Inclusion of voluntary prepayments in the calculation of Outstanding Amount (Issue 4)***: The IMO proposes to amend the calculation of a participant's Outstanding Amount to directly apply any prepayments made by a participant to increase its Trading Margin. This will reduce the risk of needing to issue a Margin Call to a participant.

- **Typical Accrual and the amount of the Margin Call (Issue 5):** The IMO proposes to remove the concept of Typical Accrual and directly link the IMO's determination of whether a Margin Call should be issued to the amount of Trading Margin at the time when the Margin Call is made. The IMO also proposes to require the IMO to re-determine a Credit Limit following a Margin Call being made and to ensure that any responses from a Market Participant (as required under the clause 2.42.2) are completed within 24 hours of the Margin Call being issued.
- **Credit support arrangements (Issue 6 and 8):** The IMO proposes clarifications to a number of the obligations for Market Participants relating to the provision of a Credit Support and Reserve Capacity Security including clarifying that:
  - All participants must provide a Credit Support, regardless of whether they meet the Acceptable Credit Criteria;
  - Move the obligations to provide updated Credit Support within a defined timeframe into the Market Procedure;
  - Specify the situations where a replacement Credit Support must be provided in the Market Procedure; and
  - Make similar amendments to the obligations around Reserve Capacity Security (where relevant).
- **List of entities meeting Acceptable Credit Criteria (Issue 7):** The IMO proposes to amend this clause to state that only Market Participants can provide the IMO with evidence that a Credit Support provider continues to meet the Acceptable Credit Criteria.

### **Alinta's views**

While generally supportive of the intention of the majority of the IMO's proposed amendments, Alinta does not support the amendments to:

- use the highest value of transactions owed to determine a Market Participant's Credit Limit (*Issue 1*);
- expressly require notifications to the IMO where a Market Participants market exposure decreases under clause 2.37.8 (*Issue 2*); and
- amend the timing for providing updated Credit Support where a Margin Call is issued to 24 hours (*Issue 5*).

Further details of Alinta's views on each of the specific issues being addressed by the IMO are outlined below.

### **Issue 1: Calculation of Credit Limits**

The prudentials regime should be attempting to ensure participants who are short in the market (i.e. are a net purchaser of energy) do not take on too much risk by purchasing more

than they can afford. Arguably without this incentive, as is created by ensuring that each participant is exposed the cost of managing the risk of their non-payment, participants may be willing to risk failure where the financial reward was significant. This incentive inadvertently provides a protection to those participants who are long in the market (i.e. are a net seller of energy) by ensuring that they are not exposed to short payment. Under the Market Rules the right behaviour from Market Participants is incentivised by requiring them to provide a Credit Support equivalent to its Credit Limit. This precludes them from purchasing in the market above the level which is affordable to the relevant business.

The question of at what level the Credit Limit should be set to incentivise the right behaviour is vital to the actual design of the prudentials regime. The costs to short participants (buyers) should not be excessive and do not necessarily have to guarantee payment to long participants (sellers) 100% of the time. Rather the costs need to simply incentivise the right behaviour.

Currently the calculation of a Market Participant's Credit Limit is based on a "reasonable worst case scenario".

"The Credit Limit for each Market Participant is a the dollar amount determined by the IMO as being equal to the maximum net amount that the Market Participant is expected to owe the IMO over any 70 day period where this amount is not expected to be exceeded more than once in a 48 month period..."

This same approach was also adopted in the National Electricity Market (NEM) originally but has recently been revised following the Market Prudential Readiness Review's contention that the "reasonable worst case" definition is unclear.

The IMO's proposed revision on clause 2.37.4 would change that basis of the calculation of a participant's Credit Limit. In particular the IMO proposes the following:

"The Credit Limit for each Market Participant is a the dollar amount determined by the IMO as being equal to the maximum net amount over any 70 day period that the IMO reasonably expects will not be exceeded, when this amount is determined..."

The result is a change from the expectation that the Credit Limit would not be exceeded more than once to never being exceeded (guaranteeing 100% payment to long participants). That is the IMO proposes moving from the second highest value owed to the highest value owed during the period taken into account in determining the Credit Limits<sup>1</sup>. Alinta notes that there could be significant differences between these values depending on the purchasing behaviour of a participant. To demonstrate these potentially significant differences refer to **CONFIDENTIAL** Appendix A.

The proposed approach is highly conservative and ultimately increases the prudential standards in the WEM<sup>2</sup>. There appears to have been little consideration of whether the proposed amendments appropriately account for the important trade-off between protecting the market and holding excessive amounts of participants' capital in the form of Credit Support. The experience of the NEM would suggest that even the current less conservative

<sup>1</sup> Alinta notes that simply removing \$1 from the highest value is not the same as the second highest value.

<sup>2</sup> Alinta acknowledges that as this approach has been applied since market start there will not be an "actual" financial impact resulting from the change. However for the purposes of assessing this rule change it is appropriate that the actual impact is compared to the current intended impact from applying the rules.

approach (as is imbedded in the Market Rules) is inefficient, capital intensive and ultimately increases prices to end consumers (inconsistent with market objectives (a) and (d))<sup>3</sup>. Alinta notes that nowhere else in the Market Rules, including for the purposes of procuring sufficient capacity to cover the Reserve Capacity Target (which is acknowledged to be a conservative approach) is a level of 100% coverage prescribed.

Alinta does not support the IMO simply enshrining the existing approach into the Market Rules.

The proposal to change the amount of Prudential coverage in the Market from the second highest value in a given period to the highest value is a fundamental change to the principles underlying the amount of prudential risk that the market is prepared to bear. This change in principle has not been adequately supported by the IMO nor evidence provided which substantiates the claims made that the current process has “proven to be a robust, predictable and repeatable”. Simply because the IMO has been unable to implement the previous approach prescribed in the rules is not sufficient rationale for the changes to be made. Alinta considers that the justification provided by the IMO to date is overly operational in nature and does not appropriately consider the broader market implications of the prudentials regime.

Furthermore Alinta is concerned that there doesn't seem to have been adequate consideration of the risk to the market of the default of a participant with and without these proposed changes. There is no argument made as to why the market should be prepared to pay an additional risk premium, nor why the current level of premium specified in the Market Rules is inadequate. It is simply not clear why Market Participants should be required to provide the level of Credit Support proposed<sup>4</sup>.

Alinta considers that whether such a conservative approach should be adopted for the purposes of prudentials in the WEM is a matter of policy which requires further consideration by the market and ultimately a policy direction from the Public Utilities Office (PUO). Alinta recommends that:

- The amendments to how the Credit Limit are calculated are not further progressed until a policy direction from the PUO has been sought on the intention of the prudentials regime and in particular what behaviour it is trying to encourage.
- If the PUO determines to not issue a policy direction on this matter then at the very minimum a more detailed consideration of the relevant costs and benefits (with reference to the Market Objectives) needs to be undertaken by the IMO and presented for consultation with industry.

#### Time period for historical data

Alinta considers it is unclear in the Rule Change Proposal what time-period for historical data will be used in determining the Credit Limit for a Market Participant. In particular, Alinta notes that in previous incarnations of this proposed change there was a proposed decrease in the time period from 48 months to 24 months. While this has been discussed with industry to

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<sup>3</sup> Alinta suggests that the IMO refers to the work done to date in the NEM with respect to assessing the appropriateness of setting credit limits in accordance with a “reasonable worst case scenario.”

<sup>4</sup> Alinta acknowledges that this is current practice and so there will be no “real” financial impact as a result of this proposed amendment.

date and appears to be generally supported this is not apparent in the proposed Amending Rules put forward by the IMO.

Alinta also notes that clause 2.37.4 as proposed to be amended appears to cover any 70 day period which Alinta understands is not the intention (nor would Alinta support this if it was the intention). To cover any 70 day period would mean that exposure during events such as Varanus Island would be potentially forever taken into account in setting a participant's Credit Limit. While detail that the 70 day period is from the last 24 months is provided in the potential changes to the Market Procedure (as presented at Meeting 63 of the Market Advisory Committee (MAC)), Alinta suggests that this is an important consideration that should be included into the Amending Rules to avoid any confusion.

#### Ability to request a review of a Credit Limit

Alinta maintains its position that an ability for a Market Participant to request a review of its Credit Limit should be included into the Market Rules (not just the Market Procedure) given the potentially significant financial implications. Alinta does not consider that this is "prescriptive detail" that is appropriate to only appear in the Market Procedure.

#### **Issue 2: Notification of change in circumstances affecting Credit Limits**

Alinta supports the general intention of this proposed amendment which addresses the concerns it raised during the consultation process for RC\_2011\_09: Prudential Requirements (which was subsequently rejected by the IMO). In particular Alinta considers it is important that all changes in behaviour that increase a participant's exposure are notified to the IMO (from both customers and generators). This obligation is currently a civil penalty (clause 2.37.5).

Currently clause 2.37.5 appears to focus on changes in a Market Customers position while not directly considering that changes in a Market Generators position may occur. For example a Market Generator who purchases energy from the market to cover its bilateral position while on an outage would create a similar market risk of default. It is therefore appropriate that there is a more general requirement for Market Participant's to notify the IMO of a change in circumstance.

Within the proposal the IMO notes that it has received requests from participants to "...enable increases and decreases in a Market Participant's Credit Limit"<sup>5</sup>. Alinta however wishes to clarify that it was not suggesting that it is similarly important that decreases in a participant's exposure to the market are notified to the IMO.

Given the situation where a participant's exposure will decrease, the IMO would already hold sufficient credit support and it is unclear how this would pose a risk to the market such that it would warrant the application of a civil penalty<sup>6</sup>. While this information may be valuable to the IMO, Alinta opposes it being subject to a civil penalty given it's not necessary for the protection of the market and creates additional unnecessary regulatory burden. Alinta

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<sup>5</sup> Alinta notes that this statement appears out of context (i.e. should be relating to an express ability for a participant to request a revision to its Credit Limit under the rules) but however has interpreted this to relate to the proposed requirement for notifications of changes in circumstances that would increase or decrease exposure in the market given the broader proposed changes to clause 2.37.8 (previously clause 2.37.5).

<sup>6</sup>Alinta presumes that amendments to the Regulations to reflect its renumbering (clause 2.37.8) will be required.

requests that the IMO amends this aspect of the proposal to make it optional for decreases in exposure to be notified to the IMO (and not subject to a civil penalty).

***Issue 3: Guidelines for determining the expected value of a transaction***

Alinta notes the IMO's issues with developing definition guidelines to calculate the expected value of a transaction and supports the IMO in proposing a set of factors to be taken into account when determining the expected value of a transaction, rather than guidelines.

***Issue 4: Accounting for voluntary prepayments in the calculation of the Outstanding Amount***

Alinta supports the IMO in better defining the current processes for accounting for voluntary prepayments from Market Participants who may be reaching their Trading Limit. In particular, the IMO proposes to amend the current calculation of the Outstanding Amount to take into account any prepayment amounts. Alinta agrees that these changes are necessary for reducing the financial risk to the market and providing greater assurance to participants that prepayments will apply immediately thereby ensuring their ability to continue trading in the market.

***Issue 5: Typical Accrual and the amount of Margin Call***

Alinta acknowledges the IMO's concerns that the concept of Typical Accrual is complex and may produce a more reliable estimate compared to the Outstanding Amount. Alinta is therefore supportive of the IMO's proposed amendments to remove the concept of Typical Accrual.

Alinta does not however support amending the rules to require additional credit to be provided within 24 hours where a Margin Call has been issued. The ability to provide additional monies through to the IMO in this circumstance is heavily reliant on banking cut off times and working days. For example, in the circumstances where a Margin Call is issued post pm ACST on a Friday or any time on a Saturday it is simply not possible to acquire additional monies by 24 hours later. Alinta strongly opposes this obligation being incorporated into the Market Rules given it will be impossible to ensure compliance.

***Issue 6: Credit Support arrangements***

Alinta notes that the rationale for the changes to clause 2.38.1 is not entirely clear. No case has been presented as to why a participant that meets the Acceptable Credit Criteria must necessarily provide a Credit Support. It is unclear what risk such a company (which in the WEM is likely to be backed by the state) would pose to the market to justify holding a potentially significant amount of capital as credit support. Alinta requests further details of the rationale for this change are presented to industry for its consideration.

Alinta also considers the IMO's proposed drafting of clauses 2.38.1, 2.38.2 and 2.38.3 adds unnecessary additional prescription to the rules by repeatedly clarifying that a Credit Support has to be in the form specified in clause 2.38.4. Given that any single clause needs to be read in the context of the Market Rules this proposed amendment is unnecessary.

***Issue 7: List of entities meeting Acceptable Credit Criteria***

While Alinta considers it is unclear why an entity could not provide evidence to the IMO that it meets the Acceptable Credit Criteria rather than the relevant Market Participant. The intention of introducing this amendment into the rules originally was to enable financial institutes etc. to directly engage with the IMO to be included onto the list of entities. While this might not have occurred to date it is unclear why removing this ability is necessary or required. Alinta requests further details of the IMO's rationale for this amendment.

Additionally Alinta notes that details of the obligations for monitoring the list of entities etc. are not currently provided in the Market Rules and requests clarity of what exactly the IMO intends to move from the rules into the Market Procedure for Prudentials. Alinta notes that the Market Procedure for Prudentials still requires updating following the original Rule Change Proposal that introduced the concept of a list of acceptable credit providers.

***Issue 8: Corresponding changes to relevant Market Rules for Reserve Capacity Security***

With respect to the proposed changes to the Reserve Capacity Security rules Alinta wishes to reiterate its concern (also noted above with respect to Issue 6) that the IMO is including unnecessary prescriptive detail into the Market Rules with respect to the requirement for a Reserve Capacity Security to be in the form outlined in clause 4.13.5.

Alinta has no objections to the other proposed amendments around Reserve Capacity Security.

If you require any further clarification of the matters raised in this submission please directly contact Fiona Edmonds, Wholesale Regulation Manager.