
Wholesale Electricity Market Rule Change Proposal Submission Form

RC_2012_23 Prudential Requirements

Submitted by

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Submission

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

Background

The Independent Market Operator (IMO) operates the Wholesale Electricity Market (WEM) and facilitates bilateral transactions between Market Participants both in the energy and the capacity parts of the market. The IMO also facilitates the financial settlements in the market by collecting and distributing revenue to Market Participants based on their activities in the markets.

Clauses 2.37 – 2.43 of the Market Rules prescribes the prudential requirements for the WEM. Further detail and guidance is also contained in a Market Procedure called “Prudential Requirements”.

There are no substantial funds that the IMO can draw on to pay Market Participants that are owed money. Instead, the settlement of the WEM relies on an arrangement where payments to the IMO by Market Participants owing money (net debtors) and payments by the IMO to Market Participants owed money (net creditors) taking place on the same day with only a few hours gap between payments to the IMO and by the IMO. In effect, the IMO is relying on all

net debtors making their payments in full and on time to have sufficient funds to make payments to all net creditors.

To protect all Market Participants from flow on effects from a financial default by another Market Participant the prudential requirements in the Market Rules allow for amongst other things:

- setting credit limits for each individual Market Participant,
- continually reassessing and potentially amending those credit limits,
- collecting and holding financial security to support individual credit limits,
- monitoring and enforcing trading limits, and
- issuing margin calls when trading limits are exceeded.

Issues

The IMO has identified a number of issues in relation to the operation of the current prudential requirements in the WEM as follows:

1. **Credit Limits:** The Market Rules currently require the IMO to set credit limits such that those limits are not expected to be breached more than once in any 48 month period. In determining the credit limit the IMO must take into account a number of factors including past credit defaults. In practice, the IMO has set credit limits based on available and observable data wherever possible and it has based its calculations based on historic data for the last 48 months, using a calculation to determine the maximum potential exposure for a 70 day period, covering the highest 15 day Short Term Energy Market (STEM) and 70 day Non-STEM exposure. The practice that has been adopted is not reflected in the current wording of the Market Rules.
2. **Change in circumstances affecting credit limits:** The Market Rules (clause 2.37.5) currently require Market Participants to notify the IMO when it considers there is likely to be a significant increase in its customer load or a significant decrease in bilateral purchases of energy. These are both events that would normally lead to an increase in the credit limit requirement. There is not a similar requirement on Market Participants to notify the IMO of events that may lead to a decrease in the credit limit requirement.
3. **Guidelines for determining expected values:** Clause 2.37.9 of the Market Rules requires the IMO to develop guidelines, in a Market Procedure, for determining the expected value of a transaction. These guidelines are to be consistent with those used to determine credit limits for Market Participants. The concept of expected value of a transaction is used to determine whether a transaction that a Market Participant is considering entering into will lead to a breach of its credit limit. The IMO has been unable to develop any such guidelines and is of the view that it will be more appropriate to develop more succinct factors to guide the determination of expected values.

4. **Voluntary prepayments and the Outstanding Amount:** The Outstanding Amount is a Market Participant's current liabilities to the IMO at any point in time and includes amounts yet to be invoiced. The Trading Margin for a Market Participant is the difference between the Trading Limit and the Outstanding Amount at any point in time. Market Participants must maintain a sufficiently high Trading Margin to continue to participate in the WEM. It is possible to improve an eroding Trading Margin by making a prepayment to the IMO. The process for receiving and applying these prepayments against the Trading Margin is not currently well defined, which may lead to at least a perception of increased risk around this aspect of the prudential requirements in the WEM.
5. **Typical accrual and margin calls:** Clause 2.42.3 requires the IMO to calculate the amount of a Margin Call as the difference between the Outstanding Amount (see above) and the Typical Accrual. The Typical Accrual is the amount that would have been the Outstanding Amount if average prices and quantities as used in determining the Market Participant's Credit Limit had applied. In practice, the IMO has found this concept complex and difficult to apply without there being any perceived benefit to the quality of the estimate.
6. **Credit support arrangements:** The IMO has identified a number of detailed and prescriptive instructions related to the credit support arrangements that may be moved to the associated Market Procedure. The IMO has also identified potential ambiguity in the wording of some of the clauses relating to credit support arrangements and proposed amendments to clarify these clauses.
7. **List of entities meeting Acceptable Credit Criteria:** Clause 2.38.7 requires the IMO to keep a list on its website of entities which meet the Acceptable Credit Criteria. The list would typically include well-known and respected financial institutions such as Commonwealth Bank and Westpac. The current wording of the clause is unclear as to who is responsible for providing evidence to the IMO about the eligibility of entities that are candidates for the list.
8. **Changes to Reserve Capacity Security:** The IMO has identified similar ambiguities in the section of the Market Rules that relate to Reserve Capacity Security as those described under the heading "credit support arrangements" above.

Change Proposal

The IMO submitted Rule Change Proposal 2012 23 "Prudential Requirements" on 14 August 2013.

The IMO proposed the following amendments in relation to the six high level issues identified above:

1. **Credit Limits:** The IMO has proposed to amend the Market Rules to reflect its current practice (as described above) in determining Credit Limits for Market Participants. Furthermore, the IMO has proposed to remove reference to certain concepts which it finds complex and / or of little practical value in assessing the Credit Limits, such as taking into account past breaches of the Market Rules.

2. **Change in circumstances affecting credit limits:** The IMO has proposed to amend clause 2.37.5 (and renumber it as 2.37.8) to specify that Market Participants must notify the IMO of any changes (actual and expected) in circumstances that may lead to both increases and decreases in the Credit Limit.
3. **Guidelines for determining expected values:** The IMO has proposed to remove the requirement for it to develop guidelines for determining the expected value of a transaction and instead have a requirement to develop specific factors, in the associated Market Procedure.
4. **Voluntary prepayments and the Outstanding Amount:** The IMO has proposed to amend clause 2.40.1 to make specific mention of any prepayments that have been made to the IMO for the purpose of reducing the Outstanding Amount. A new limb will be added to the clause to specify that such prepaid amounts should be deducted from the Market Participant's current liabilities when calculating the Outstanding Amount.
5. **Typical accrual and margin calls:** The IMO has proposed to remove the concept of Typical Accrual and codify that the amount of a Margin Call must be the amount that will bring the Market Participant's Trading Margin back to zero. The IMO has also proposed to amend clause 2.42.4 so that a Market Participant that has been issued with a Margin Call Notice must respond within 24 hours rather than the current "one Business Day" period.
6. **Credit support arrangements:** The IMO has proposed to move prescriptive detail to the associated Market Procedure. The IMO has also proposed to clarify in clause 2.38.1 that Market Participants must at all times ensure that the IMO holds the benefit of Credit Support for them without any reference to whether the Market Participant does or does not meet the Acceptable Credit Criteria.
7. **List of entities meeting Acceptable Credit Criteria:** The IMO has proposed to amend clause 2.38.7 to clarify that it is Market Participants that must provide the IMO with evidence as to the eligibility of entities to be included on the list of entities meeting the Acceptable Credit Criteria.
8. **Changes to Reserve Capacity Security:** The IMO has proposed to move prescriptive detail into the associated Market Procedure and make necessary clarifying amendments in a similar manner to those described above under the heading "credit support arrangements". Furthermore, the IMO has also proposed to amend clause 4.13.4 so that Market Participants must provide replacement Reserve Capacity Security within 24 hours rather than the current one Business Day period when required to do so by the events described in the associated Market Procedure.

Perth Energy's Views

In general, Perth Energy supports initiatives that improve the transparency and predictability of decisions made by the IMO that impact on Market Participants in the WEM. Perth Energy therefore welcomes and supports the proposed amendments by the IMO to clarify the methodology that will be used and the factors that will be considered when calculating Credit Limits, Outstanding Amounts and the size of Margin Calls. Perth Energy also supports the use of actual, observable values in these calculations in preference to using theoretical and

more abstract concepts such as the current concept of “Typical Accrual”. Using actual, observable values provides clarity and allows Market Participants to more easily estimate these values themselves and verify the values presented by the IMO.

Improving transparency and predictability is in Perth Energy’s view in general beneficial for further development of the WEM and encouraging competition in electricity generation and retail activities. It is particularly important for encouraging entry of smaller entities (that may not have the resources to fully assess and adapt their strategies to respond to complicated and abstract concepts in the Market Rules) in the WEM to promote transparency, predictability and simplicity wherever possible.

New clauses 2.37.5(f),(g) and (h) require the IMO to take into account historical levels of ancillary services payments, outage compensation payments and settlement reconciliation payments when determining a Market Participant’s Credit Limit. Perth Energy considers that there may be merit in considering reflecting average values for these parameters rather than the actual values appearing in the 70 day period that is the basis for the calculation of the Credit Limit. This is because these parameters are largely outside the control of individual Market Participants and it would be unreasonable to inflate the credit requirement due to for example a one-off significant settlement reconciliation amount caused by metering errors.

Perth Energy queries whether new clause 2.37.5(j) is necessary. The clause requires the IMO to consider the length of the settlement cycle when determining the Credit Limit of a Market Participant. Perth Energy queries how the length of the settlement cycle could have any impact on the maximum exposure over a 70 day period, which is the guiding principle for determining the Credit Limit. Perth Energy would also welcome a review of whether the 70 day period concept still represents a reasonable balance between risk mitigation and cost minimisation for the Wholesale Electricity Market (WEM).

Perth Energy welcomes the proposed change to allow Market Participants to also notify the IMO of changed circumstances that may lead to a reduction in credit limits. To support increased competition, and in particular retail competition, it is important that the rules for prudential requirements are sufficiently flexible to quickly and accurately reflect both positive and negative changes in individual circumstances. It would for example be inefficient for a retailer that has lost significant market share to continue to be lumbered with an onerous credit support requirement for up to 48 months until the new market share is reflected in the data used for calculating the Credit Limit. This would also be inefficient to the overall market and could lead to higher prices to end consumers if left unchanged.

In relation to new clause 2.37.8 which Perth Energy understands will attract civil penalties for breaches, we propose slightly amended wording as follows:

2.37.8. A Market Participant must notify the IMO as soon as practicable after becoming aware ~~where it considers~~ that:

- (a) its metered consumption quantities in a Trading Month ~~will~~ is likely to significantly exceed the amount assumed in the last calculation of its Credit Limit; or
- (b) its quantity of electricity purchased bilaterally in a Trading Month ~~will~~ is likely to be significantly lower than assumed in the last calculation of its Credit Limit.

Perth Energy also supports the proposed removal of the concept of “Typical Accrual” and basing Margin Calls on the principle of bringing the Trading Margin back to zero.

Perth Energy queries the practicality of applying a 24 hour rule rather than the current one Business Day rule to the amount of time that is afforded Market Participants to rectify certain credit related issues, such as providing replacement security where necessary. During week-ends and holidays it may not be possible for Market Participants to engage their credit provider within the 24 hour period. The result may be that the Market Participant may need to cease trading until the issue can be resolved on the first available Business Day. If the proposed move to a 24 hour period is retained in the final drafting, Perth Energy proposes that the IMO puts in place internal procedures to enable it to provide Market Participants that may be approaching a Margin Call during the upcoming non Business Days with advance warning so the Market Participant can make necessary arrangements with its credit provider ahead of week-ends and other non-Business Day periods.

A significant part of the rule change proposal is to move some of the details relating to prudential requirements to the associated Market Procedure. Perth Energy is aware that a draft of the proposed amendments to the Market Procedure was released as part of the papers for the 63rd Market Advisory Committee (MAC) meeting. It is in our view important to have access to the complete set of proposed changes, including those that will affect the Market Procedures, to be able to properly assess the impact of and make comment on these proposed changes to the prudential requirements. Perth Energy would welcome the release of the finalised proposed amendments to the Market Procedures for official consultation prior to the deadline for submissions on the second round of consultation on RC 2012 23.

2. Please provide an assessment whether the change will better facilitate the achievement of the Market Objectives.

Perth Energy considers that the proposed amendments to the Market Rules would positively impact on the ability to achieve Market Objective¹ (a) relating to economic efficiency. This is primarily due to the improved transparency and predictability that the proposed changes are likely to bring to the calculation of Credit Limits and Margin Calls.

Improving the transparency and predictability in the WEM is also likely to encourage new entrants and investment in both the generation and retail parts of the market with a positive impact on the ability to achieve Market Objective (b) relating to competition.

Perth Energy has not identified any impacts on the other Market Objectives.

¹ The objectives of the market are:

- (a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system;
- (b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors;
- (c) to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions;
- (d) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system; and
- (e) to encourage the taking of measures to manage the amount of electricity used and when it is used.

- 3. Please indicate if the proposed change will have any implications for your organisation (for example changes to your IT or business systems) and any costs involved in implementing these changes.**

Perth Energy has not identified any impacts on our IT or other business systems.

- 4. Please indicate the time required for your organisation to implement the change, should it be accepted as proposed.**

Perth Energy will not require any lead time to implement the proposed changes.