
Wholesale Electricity Market Rule Change Proposal Submission Form

RC_2012_23 Prudential Requirements

Submitted by

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Submission

1. Please provide your views on the draft report, including any objections or suggested revisions.

Background

Efficient and clearly defined prudential requirements are an essential element to a well functioning centralised trading market. Setting the level of prudential requirements participants must meet resolves to balancing the risk and consequence of default with the financial cost incurred by participants in funding the level of prudential requirements set. In effect, the prudential requirements constitute an insurance against a default impacting all participants.

Typically, insurance products allow users to determine the level of risk they wish to bear with premiums adjusted accordingly. Extending this to a cleared trading market sees its governing body making that decision on behalf of member participants. In the WEM, the level of prudential requirements participants must make available is set out in the market rules, in particular, in clauses 2.37 to 2.43 and is supported by the Market Procedure: Prudential Requirements.

In particular, clause 2.37.4, which sets out what the IMO must take into account when determining a participant's credit limit, results in an estimate of the maximum net amount the participant is expected to owe the IMO over any 70 day period. In determining this limit the IMO must take into account certain price volatilities, correlations between energy quantities and market prices and statistical distributions of accrued outstanding amounts. Translating these somewhat arcane requirements into practical and useful determinations of credit limits has been challenging for the IMO and it is questionable as to whether such requirements represent best practice in this area which suggests that a review and re-evaluation of the determinant criteria is appropriate.

Synergy also notes that clause 2.37.4 caps the credit limit at an amount not expected to be exceeded more than once in a 48 month period. Putting aside the merits or otherwise of a

look back period of 48 months, the important point is that the credit limit as currently determined, being an amount not expected to be exceeded more than once in a 48 month period, implies that the market as a whole bears a degree of credit risk in return for reduced funding costs from the associated lower credit limit. That is, the rules currently do not embrace the concept of 100% cover of the maximum amount owed, but a somewhat lesser amount which has been determined to represent a prudent level of exposure, also noting that that decision was taken in the context of establishing a new market and without the benefit of participant trading histories.

RC_2012_23 – Proposed Rule Change

A number of changes are proposed to deal with the shortcomings and uncertainty of the credit limit calculations and increase their transparency which should be beneficial to participants. In particular, it is proposed to replace clause 2.37.4 requirements, to be embodied in revised clause 2.37.5, with the calculation regime currently employed by the IMO in determining participant credit limits. In undertaking these calculations, the IMO will seek to determine the amount owed to it by the participant over any 70 day period based on observable historical transactions.

Synergy notes two new elements have been included in the list of requirements that the IMO must take into account when determining a participant's credit limit:

- (i) A participant's historical level of *payments* based on its bilateral contract sale and purchase quantities (*italics emphasis added*); and
- (ii) Any other factor that the IMO considers relevant.

Other key proposed amendments are:

- (i) Imposition of an obligation on participants to inform the IMO of any of the circumstances specified in the relevant market procedure that may result in a change to the participant's credit limit;
- (ii) Promulgating a list of factors participants must take into account prior to making a market submission that could result in the participant's outstanding amount inclusive of that submission exceeding its trading limit; and
- (iii) Accounting for voluntary prepayments in calculating the outstanding amount.

Synergy's assessment

Synergy supports the overall thrust of the amendments which is to retain the principles of credit limit determination within the rules and remove the prescriptive calculation regime to the regulations. Adopting the current calculation process undertaken by the IMO on the basis of it being robust, transparent and repeatable and removing the current requirements of clause 2.37.4 which have proved to be difficult to interpret and apply in practice is a sensible move – the implications of this are further considered below.

IMO discretion in setting credit limits

Synergy also supports the proposal for the IMO to have discretion to take into consideration any other factors that it considers relevant in determining a participant's credit limit and believes that that discretion should operate to both increase and decrease the final determined amount. It should be increased where the IMO forms the view, after considering the available data, credit history and financial standing of the participant that default risk is not adequately covered by the amount determined through revised clause 2.37.5. Similarly, where the results from clause 2.37.5 calculations when viewed in the context of the available

data, credit history and financial standing suggest that the default risk is very low or negligible, then the IMO should exercise its discretion to reduce the credit limit to a level below that determined from the application of clause 2.37.5 calculations.

Bilateral payment values removed

In regard to the new requirement for the IMO to take account of the participant's historical level of payments based on bilateral sale and purchases (viz. clause 2.37.5(b)), Synergy notes the absence of discussion in the rule change proposal as to the merit of its inclusion. While Synergy fully appreciates that bilaterally traded sale and purchase **quantities** are a legitimate inclusion in a credit limit determination, it fails to understand the inclusion of the obligation on the IMO to take account of the level of **payments** when such information is confidential, therefore requiring an estimate – this adds an unnecessary element of uncertainty to the calculations and is contrary to the IMO's intention to make credit limit determination transparent. Synergy recommends that references to bilateral payments be removed.

Valuing market submissions

Synergy acknowledges that it is undesirable for a trading margin to be extinguished by a participant's incremental submission. While there is merit in requiring a participant to have a view of its trading margin and how it may potentially change following a submission to the market, Synergy believes that there are difficulties with the IMO's proposal which effectively requires participants to value a proposed submission according to the list of factors referred to in clause 2.41.5. Compliance with the obligation in clause 2.41.2 suggests that the participant must first value the proposed transaction before submitting it to the market to ensure that it will not expunge its trading margin. In practice this means that the list of factors must be converted to a codified algorithm that can be built into participant trading systems. Synergy notes that clause 2.41.3 empowers the IMO to reject any submission from a participant where the transaction contemplated by the submission if when valued by the IMO according to the clause 2.41.5 list of factors could result in the participant's trading margin being exceeded.

Of particular concern is the requirement to take account of Non-STEM trading activities and invoiced amounts which include balancing amounts owed to and payable by the IMO. Synergy submits that it is problematic to know or even reasonably estimate the balancing position of the Notional Wholesale Meter given that it forms part of the Non-STEM invoice which is not known until six weeks after the end of the trading month. Other participants may also find it difficult to estimate their balancing positions on a daily basis.

Synergy is concerned about the implications of clause 2.41.2 when in regard to the Notional Wholesale Meter there is a paucity of immediately available and reliable data to form a basis for the required submission valuation. Accordingly, to overcome these practical difficulties Synergy recommends that the IMO share its proposed approach for codifying the list of factors (to give effect to clause 2.41.3) so that participants are in the best position possible to test potential market submissions in their trading systems against their trading margins prior to making such submissions.

Evidence satisfying Acceptable Credit Criteria

Synergy notes proposed amendments to clause 2.38.7(a) would disallow entities providing credit support from providing evidence to the IMO, of their own volition as is currently the case, that they continue to meet the Acceptable Credit Criteria. The amendments propose that the obligation to provide the evidence that an entity continues to meet the Acceptable

Credit Criteria be placed on and restricted to participants – the rationale of the benefit to the market from the IMO proposing this change is difficult to understand. In Synergy's view, there are efficiencies if credit providers can of their own initiative provide this evidence: this reduces costs to participants and potentially introduces an element of competition among credit providers where they have sought to provide the necessary evidence. In Synergy's view there is scope to retain the option for entities to self-provide the necessary evidence as well as allowing participants to also procure the evidence; to remove the scope for the entities to provide such evidence introduces and inefficiency where none existed.

Overall market credit risk

While Synergy supports the thrust of the proposed changes and in particular that the credit limit is the maximum net amount owed to the IMO not expected to be exceeded over any 70 day period Synergy notes amended clause 2.37.4:

- (i) Makes no reference to the look back period over which the 70 day amount will be assessed; and
- (ii) Defines the credit limit to be that amount not expected to be exceeded over any 70 day period.

In regard to the first point, Synergy notes that the accompanying market procedure stipulates a look back period of 24 months. Synergy supports reducing the period from 48 to 24 months which is a sufficient period to identify any underlying episodic trends in participant exposure. The look back period is a critical element of the assessment process and therefore should be stipulated in the rules, as is currently the case. Retaining the period in the rules has the benefit that change proposals can be initiated by an interested party and are subject to the more rigorous rule change process which in particular allows participants to respond to the IMO's assessment of first round submissions – which is not the case in respect of the procedure change process. Further, it is consistent with the IMO's approach that the rules embody matters of principle while the procedures contain matters of prescriptive detail. In Synergy's view, the look back period over which the 70 day exposure will be assessed constitutes a matter of principle and hence should remain in the market rules.

In regard to the second point, Synergy notes that the proposal contrasts with the current requirement that the credit limit is an amount being the maximum net amount a participant is expected to owe the IMO over any 70 day period that is not expected to be exceeded more than once in a 48 month period. That is, it is proposed to change the credit limit to be that determined as the **maximum** net exposure to the IMO over any 70 day period whereas currently the rules contemplate a lesser limit in that it is amount expected to be exceeded no more than once. The proposal represents the worst possible circumstance for a participant which when scaled across all participants implies that the market takes virtually no credit risk also noting that the trading limit is set at 87% of the credit limit which provides a built in insurance margin. Synergy interprets this to mean that by definition the market will be required to hold the highest level of credit support which in turn translates to a significant premium which ultimately is passed to customers.

Synergy suggests that the level of credit risk borne by the market is an important design parameter and that any change in that parameter, especially one which affects all participants, should be examined in appropriate detail as a prerequisite to a consensus being achieved across the market as the mandate for change. Synergy recommends that the IMO initiate the debate by scoping credit limit policies in other relevant energy markets and

present options for the market's consideration, thus ensuring that the change process is transparent and the market fully informed of available options in regard to determining the risk the market as a whole is comfortable with.

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

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.

Synergy notes that the proposed changes will have significant impact on its business IT systems. In particular, in order to comply with 2.41.2 that a participant not make a submission, if valued according to the list of factors referred to in 2.41.5, that could result in the participant's trading margin being exceeded will require that the list of factors be codified in Synergy's trading system. This is likely to be a difficult exercise, especially given the material uncertainty related to the daily position of the Notional Wholesale Meter, and amount to a significant cost.

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

Codifying and including the list of factors referred to in 2.41.5 into Synergy's trading systems will take a number of months as such changes would require significant modelling assessment and benchmarking, peer review and extensive user testing.