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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 Participant's anticipated market exposure (Credit Limit) to be provided prior to competing in the WEM;
- Monitoring by the IMO of whether a Market Participant's 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 proposed 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 proposed to remove any prescriptive details in the Market Procedure for Prudential Requirements consistent with its broader move 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 will not be exceeded over a 70 day period (*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 Participants 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 during the first round of consultation**

While generally supportive of the intention of the majority of the IMO's proposed amendments, Alinta did 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*).

Specific details of Alinta's views are outlined in its 25 September 2013 submission available on the IMO's public website.

#### **Draft Rule Change Report**

In its Draft Rule Change Report the IMO made changes to clauses 2.37.5 and 2.37.8 to reflect the comments provided during the first round of consultation.

Those changes to clause 2.37.8 address the concerns raised by Alinta with respect to Issue 2. In particular the IMO has further amended the proposed Amending Rules to ensure inappropriate civil penalties would not be potentially accrued by participants where they failed to inform the IMO of a change in circumstances that would decrease its Credit Limit.

### **Alinta's views during second round of consultation**

Alinta remains generally supportive of the intention of the majority of the IMO's proposed amendments, including the IMO's recent decision to not amend the timing for providing updated Credit Support where a Margin Call is issued to 24 hours (*Issue 5*). However Alinta continues to not support the amendments to use the highest value of transactions owed to determine a Market Participant's Credit Limit (*Issue 1*).

Alinta also notes its concern that the IMO has re-numbered a significant number of clauses as part of this rule change, including a number of civil penalty provisions. This makes it difficult to maintain a clear historical record of the changes that have occurred to a specific clause. In other regulatory contexts renumbering clauses also makes it difficult and costly to identify relevant clauses to enable a robust audit process. Alinta's preference is for the IMO to retain the existing numbering of clauses. Any new obligations should be inserted and contain a letter suffix. Alinta does however acknowledge that during complete re-writes of the Market Rules, as occurred with the introduction of the competitive Balancing market, it may be appropriate to re-number the clauses more broadly.

Further details of Alinta's views on each of the specific issues being addressed by the IMO are outlined below. A table containing minor drafting issues between the proposed Amending Rules and proposed redrafted Market Procedure for the IMO's consideration is provided as an Appendix.

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

Alinta maintains the concerns expressed in its first round submission relating to the IMO's proposed revisions to clause 2.37.4<sup>1</sup> given they will fundamentally change the principles underlying the amount of prudential risk that the market is prepared to bear. The proposed approach is highly conservative and ultimately increases the prudential standards in the WEM<sup>2</sup>.

The IMO has failed to provide sufficient rationale as to why such a conservative approach should be adopted for the purposes of prudentials in the WEM. Alinta does not support the IMO simply enshrining its existing approach to prudentials into the Market Rules. We request that a detailed consideration of the relevant costs and benefits (with reference to the Market Objectives) of the proposed amendment to use the "highest value" is undertaken by the IMO and presented for consultation with industry.

Further details of Alinta's specific concerns with respect to Issue 1 are outlined below:

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<sup>1</sup> Please refer to Alinta's first round submission for further details of Alinta's concerns with respect to the change to the calculation of a participant's Credit Limits from being based on a value that would not be exceeded more than once to never being exceeded

<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.

Trade-off between protecting market and holding excessive monies

Alinta remains particularly concerned that there has been no 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. Alinta reiterates 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.

The IMO's position that the settlements regime is designed on the fundamental principle that all Market Participants will always be fully paid on time appears at odds with the views of CRA International, the expert engaged at market start by the IMO to develop the methodology for setting Prudential Credit Limits<sup>3</sup>. CRA International specifically noted that in setting the initial credit limits they required:

*“a balance between the cost of maintaining the credit support required for the credit limit and the number of margin calls which might be required. If the credit limits are too low, there will be an excessive number of margin calls which are costly; if the credit limits are too high, then the cost of maintaining the support is excessive.”*

This important trade-off between the amount of risk the market takes on and the amount of credit support to be provided has been at the heart of the recent consideration of the prudentials regime in the National Electricity Market (NEM). Given that the prudentials regime adopted in the WEM essentially mimicked that originally implemented in the NEM it's unclear why a similar consideration of the trade-off would not be relevant in the WEM.

As requested above, we consider a cost-benefit assessment of the proposed changes should be prepared by the IMO and presented to industry to enable consideration of whether an appropriate trade-off between protecting the market and unnecessarily holding monies is achieved by the IMO's proposed revisions.

Market Objective assessment

The IMO has not adequately demonstrated how the proposed calculation of Credit Limits will better the Market Objectives nor why the market should be required to pay the level of Credit Support that will be required under the proposed highly conservative approach. In fact the experience of the NEM would suggest that even the current less conservative approach (as is embedded in the WEM Market Rules) is inefficient, capital intensive and ultimately increases prices to end consumers (inconsistent with market objectives (a) and (d))<sup>4</sup>.

To date the justification provided for the changes is overly operational in nature and does not appropriately consider the broader market implications of the prudentials regime. Evidence to substantiate the claims made that the current process has “proven to be robust, predictable and repeatable” has not been presented by the IMO to industry. Simply because the IMO has been unable to implement the current approach prescribed in the rules is not sufficient rationale for the changes to be made.

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<sup>3</sup> CRA International (June 2006): Methodology for setting Prudential Credit Limits.

<sup>4</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.”

The market objective assessment presented in the Draft Report relies on the fact that the IMO will be providing transparency of its current operational practice for determining Credit Limits rather than actually considering how the proposed approach will better the Market Objectives. To apply the rule making test in such a manner undermines the integrity of the rule change process. The IMO should be specifically considering why the use of the “highest value” better the market objectives (or at least is consistent with the objectives) and not simply focussing on the fact that it is implementing its current practice into the rules.

There has also been inadequate consideration of the risk to the market of the default of a participant with and without the proposed changes. There has been 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>5</sup>. The IMO’s Draft Report fails to adequately consider this issue.

As they currently stand Alinta considers that the IMO’s proposed amendments to further increase the prudential standards in the WEM will:

- result in an inefficient use of capital (contrary to Market Objective (a));
- create a potential barrier to entry for new entrants by requiring the provision of the highest possible amount of credit support (contrary to Market Objective (b)); and
- increase prices for end customers (contrary to Market Objective (d)),

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

Alinta maintains its position that the ability for a Market Participant to request a review of its Credit Limit should be included into the Market Rules. The IMO’s requirement for participants to provide a notification where there has been a change in circumstances that may justify a revision to a Credit Limit (new clause 2.37.8) does not address Alinta’s core concern. This is because following such a notification the IMO is provided with discretion as to whether to reconsider a participant’s Credit Limit. This includes under the proposed amended Market Procedure where there is no express provision for the IMO to actually undertake a reassessment outlined in section 2.8<sup>6</sup>. The approach being adopted by the IMO provides no regulatory certainty that a re-assessment will occur within a reasonable timeframe.

There are potentially significant financial implications to Market Participants associated with revised Credit Limits and it is therefore appropriate that the associated processes are clearly outlined in higher order legislation. Alinta requests that the Market Rules make provision for:

- a Market Participant to request a change to its Credit Limit; and
- the IMO to undertake a reassessment within an appropriate period of time.

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<sup>5</sup> Alinta acknowledges that this is current practice and so there will be no “real” financial impact as a result of this proposed amendment.

<sup>6</sup> Under version 26 of the Market Procedure for Prudentials it is only implicit that the IMO will undertake a re-assessment in steps 2.8.3 and 2.8.4.

### Time period for historical data

Alinta maintains its position that the Amending Rules should be updated to clarify what time period for historical data will be used in determining a facility's Credit Limit to avoid confusion, particularly given the drafting still states it could be any 70 day period which could potentially include the period impacted on by the Varanus island explosion. While clarity that the 70 day period is from within the last 24 months is provided in the Market Procedure this is an important consideration that should be reflected in the rules.

More generally it's unclear how a "maximum exposure over any 70 day period" is a principle for the purposes of determining a facility's Credit Limit but defining a "maximum exposure over any 70 day period occurring during the last 24 months" would not be considered to be a principle. Alinta suggests more consideration is required as to what should be considered "principles" for the purposes of the Market Rules.

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

As referred to above, following the first round of consultation the IMO amended the proposed Amending Rules to ensure inappropriate civil penalties would not be potentially incurred by participants where they failed to inform the IMO of a change in circumstances that would decrease its Credit Limit. On this basis Alinta is generally supportive of the proposed amendments.

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

Alinta continues to support 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 continues to support the IMO in better defining the current processes for accounting for voluntary prepayments from Market Participants who may be reaching their Trading Limit.

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

Alinta continues to support the IMO's proposed amendments to remove the concept of Typical Accrual.

Alinta strongly supports the IMO in removing the proposed new obligation to provide additional credit support within 24 hours as has been signalled in the Procedure Change Proposal: Changes to Market Procedure for Prudential Requirements (PC\_2013\_04).

Alinta notes that the IMO's proposed requirement for additional credit to be provided within 24 hours where a Margin Call had been issued would have been impossible to ensure compliance with. 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 circumstance where a Margin Call is issued at 3pm on a Friday it is simply not possible to require additional monies by 3pm on the Saturday. Alinta notes that the response time for Call Notices in the NEM refers to Business Days not 24 hour periods. This is likely due to the

fact that financial institutions are unable to provide necessary funds outside of business hours.

Alinta requests that, based on the NEM regime for responding to Call Notices (Rule 3.3.13<sup>7</sup>), the IMO:

- considers whether similar flexibility to that contained within the NEM Rules with respect to late calls (clause 3.3.13(b)) could be reflected in the WEM Rules; and
- considers whether there should be an express ability for the IMO to extend the timeframes for providing additional credit support where a margin call is issued to avoid a participant unnecessarily going into default.

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

Alinta disagrees with the IMO's views that clause 2.38.1 is currently ambiguous – the drafting makes it clear that if at any time a Market Participant doesn't meet the Acceptable Credit Criteria it must provide a Credit Support<sup>8</sup>.

The current requirement appears to have been developed taking into account the important trade-off between protecting the market and holding excessive amount of participant's capital in the form of Credit Support. The rationale for moving away from this approach is unclear. In particular it remains uncertain what risk a company that in its own right meets the Acceptable Credit Criteria (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 acknowledges that another important consideration in this case may be the implications of not having a level playing field for all Market Participants, i.e. by only requiring Credit Support from participants with a lower credit rating. Alinta assumes that the IMO's proposal seeks to ensure that it is clear under the rules that all participants will be required to

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#### <sup>7</sup> 3.3.13 Response to Call Notices

- (a) Subject to clause 3.3.13(b), where AEMO has given a *call notice* to a *Market Participant*, the *Market Participant* must before 11.00 am (*Sydney time*) on the next *business day* following the issue of the *call notice* either:
- (1) agree with AEMO to an increase in the *Market Participant's* maximum credit limit by an amount not less than the *call amount*, and provide to AEMO additional *credit support* where, by virtue of the increase in the maximum credit limit, the *Market Participant* no longer complies with its obligations under clause 3.3.5;
  - (2) (where clause 3.3.13(a)(1) is not satisfied) pay to AEMO in cleared funds a security deposit of an amount not less than the *call amount*;
  - (3) lodge a *reallocation request* of an amount which is not less than the *call amount* and which is accepted by AEMO; or
  - (4) provide to AEMO any combination of clauses 3.3.13(a)(1), (2) and (3) such that the aggregate of the amount which can be drawn under the additional *credit support* provided and the amount of the security deposit paid and the amount of the *reallocation request* accepted by AEMO is not less than the *call amount*.
- (b) If AEMO gives a *call notice* to a *Market Participant* after noon (*Sydney time*), then AEMO is deemed to have given that *call notice* on the next *business day* for the purposes of this clause.

<sup>8</sup> Clause 2.37.1 of the Market Rules states "Where at any time a Market Participant does not meet the Acceptable Credit Criteria set out in clause 2.38.6, then the Market Participant must ensure that the IMO holds the benefits of a Credit Support in an amount not less than its Credit Limit."

provide Credit Support to ensure an even playing field exists. Rationale for this approach should be further explored and presented to industry.

Additionally, Alinta continues to consider that 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 and appears inconsistent with the IMO's "principles based" approach to drafting.

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

The original intention of the rules was to enable financial institutes etc. to directly engage with the IMO to be included onto the list of entities (as implemented by RC\_2010\_36). This created efficiencies whereby credit providers could potentially provide the relevant evidence of their own initiative. While the IMO is amending the rules to only refer to Market Participants being able to provide the relevant evidence that an entity meets the acceptable credit criteria, Alinta notes the IMO's comments that an entity would not be precluded from providing the relevant evidence to the IMO.

However it is unclear what potential "enforcement" issue the IMO is referring to in its Draft Report as necessitating the change. If an entity doesn't meet the criteria it simply doesn't go on the list of acceptable providers. If it does meet the criteria then it is included on the list and subject to the IMO's monitoring processes. Alinta acknowledges that the IMO's monitoring activities only assess whether an entity continues to have an acceptable credit rating – not if it meets all the acceptable credit criteria. It is however unclear how expressly enabling a financial entity to provide evidence to enable it to be included onto the list would change the responsibility of a participant for making sure its credit is from a provider who meets the acceptable credit criteria.

***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 reiterates 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.

**Appendix 1: Drafting issues between proposed Amending Rules and proposed redrafted Market Procedure**

Procedure Step	Issue	Suggestion
1.2.1(c)	The procedure refers to “how the IMO will assess <u>entities</u> against the Acceptable Credit Criteria” however clause 2.43.1 refers to “assessing <u>persons</u> against the Acceptable Credit Criteria”.	While Alinta acknowledges that clause 1.4.1 of the Market Rules clarifies that a person includes an individual, a firm a body corporate etc. it would improve the integrity of the rules and procedure if the same language was used.
2.2.3(b) and 2.3.2(b)(ii)	Clause 2.37.6 provides the IMO discretion, to the extent it considers relevant, to take into account a minimum amount that the IMO considers would adequately protect the WEM. Steps 2.2.3(b) and 2.3.2(b)(ii) paraphrase the requirements of clause 2.37.6 but appear to incorporate a different test to that contained within the rules, i.e. rather than the IMO applying its discretion “to the extent it considers <u>relevant</u> ” the procedure refers to a “minimum amount it <u>reasonably</u> considers...” Alinta considers it would be better regulatory practice to ensure that the same test was referred to in both the rules and procedure.	Alinta recommends that the IMO considers what test is appropriate (either a relevance test or reasonableness test) for the purposes of applying clause 2.37.6 and reflects the test in both regulatory instruments.