



INDEPENDENT
MARKET
OPERATOR

Draft Rule Change Report

Title: Prudential Requirements

RC_2011_09

Standard Rule Change Process

21 September 2012

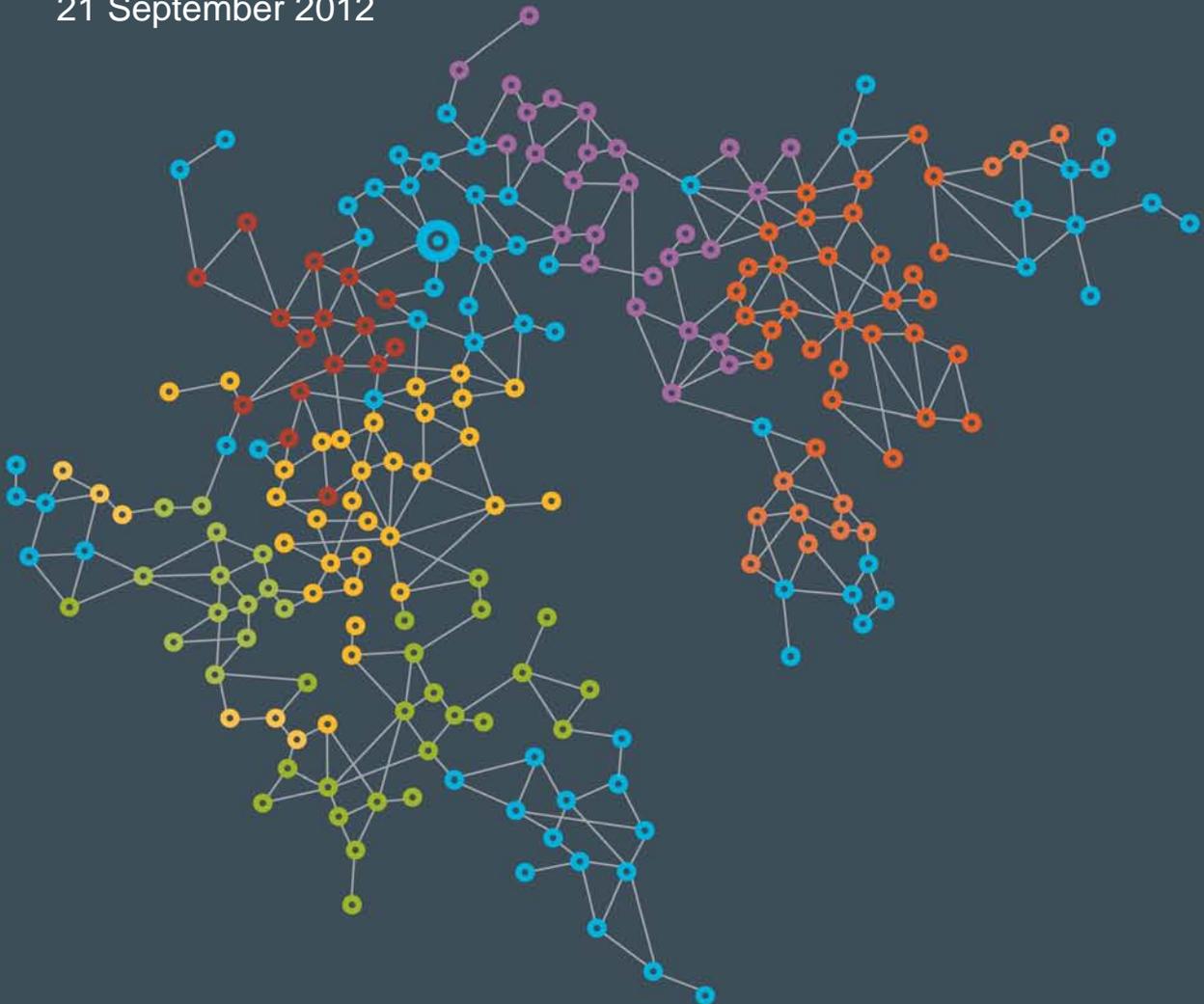


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Executive Summary

Proposed Amendments

The IMO developed this Rule Change Proposal to amend several clauses relating to Prudential Requirements for Market Participants. The Rule Change Proposal listed three main issues and proposed amendments as follows:

1. **Issue 1: Credit Limit:** The IMO considered that clause 2.37.4 did not provide enough clarity regarding the determination of Credit Limits. The Rule Change Proposal proposed amendments to calculate Credit Limits using forecast liability based on reasonable expectation for a new Market Participant and forecast liability based on historical data for an existing Market Participant.
2. **Issue 2: Outstanding Amount, Typical Accrual and Margin Call:** The IMO considered that the current methodology used to calculate a Market Participant's Outstanding Amount relies too heavily on historical data and potentially results in Margin Calls being too high or too low to cover the risk. The Rule Change Proposal proposed amendments to clause 2.40.1 to introduce Net Current Liability and Net Forecast Liability into the calculation of Outstanding Amount. The proposed new clause 2.40.1A stipulated that the Outstanding Amount would be calculated and provided to the Market Participant daily. This provision would preclude the need for expected value of transaction guidelines.
3. **Issue 3: Expected Value of Transaction Guidelines:** The IMO considered that the concept of an expected value of transaction would be rendered unnecessary if daily calculation and provision of Outstanding Amount was implemented. The Rule Change Proposal suggested removing this concept from the Market Rules.

The IMO published an extension notice during the first submission period noting that the IMO would prepare and circulate the associated Market Procedure: Prudential Requirements. This would allow Market Participants to consult with the IMO in a holistic manner on both the proposed Amending Rules as well as the revised Market Procedure.

Consultation

- An issues paper on Prudential Requirements (IP_2011_01) was presented to the Market Advisory Committee (MAC) at its 8 June 2011 meeting. No issues were raised by MAC members in relation to the paper. Subsequently, the Pre Rule Change Proposal was presented to the MAC on 14 December 2011. At this meeting, MAC members agreed to the progression of the Rule Change Proposal and the associated changes to the Market Procedure.
- The IMO submitted the Rule Change Proposal and called for submissions on 15 May 2012. On 19 June 2012 the IMO extended the first submission period to 24 August 2012, to allow the IMO to prepare and circulate the associated Market Procedure: Prudential Requirements to the IMO Procedure Change and Development Working Group (IMOPWG).
- During the process of drafting changes to the associated Market Procedure: Prudential Requirements to align with the Rule Change Proposal, the IMO identified significant issues with the Rule Change Proposal. The issues pertained to the determination of Credit Limits, the calculation of Outstanding Amount and the development of expected value of

transaction guidelines. On 21 August 2012, the IMO issued a notification to subscribers of RulesWatch advising that it intended to recommend to the IMO Board that the current Rule Change Proposal be rejected. The IMO also advised of its intention to develop a modified Rule Change Proposal and revised Market Procedure that would address the issues identified during the first submission period.

- One submission was received from Community Electricity during the first submission period. An out-of-session submission was also received from Perth Energy.

Assessment against Wholesale Market Objectives

The IMO considered that the issues identified in the Rule Change Proposal would render the proposed amendments inconsistent with the Wholesale Market Objectives.

The IMO's Proposed Decision

The IMO's proposed decision is to reject the Rule Change Proposal. The IMO has proposed this decision based on the assessment of the issues identified with the Rule Change Proposal. The IMO considered that the implementation of a workable solution would involve substantial changes to the proposed amendments, to the extent that the IMO considered it necessary to progress a new Rule Change Proposal that would correct the identified issues and allow full consultation by industry.

Under the Market Rules the IMO cannot withdraw a Rule Change Proposal after it has been formally submitted. Therefore, the IMO has proposed to reject the Rule Change Proposal.

Next steps

The IMO now invites interested stakeholders to make submissions on this Draft Rule Change Report by **5.00pm on Monday, 22 October 2012**.

1. Rule Change Process and Timetable

On 15 May 2012 the IMO submitted a Rule Change Proposal regarding amendments to clauses 2.37.4, 2.37.9, 2.40.1, 2.40.2, 2.41.2, 2.41.3, 2.42.1, 2.42.2, 2.42.3, 2.42.7, 2.43.1, 10.7.1, the Glossary and new clause 2.40.1A of the Wholesale Electricity Market Rules (Market Rules).

This proposal is being processed using the Standard Rule Change Process, described in section 2.7 of the Market Rules.

In accordance with clause 2.5.10 of the Market Rules, on 19 June 2012 the IMO decided to extend the first submission period until 24 August 2012. This was to give the IMO time to prepare and circulate the associated Market Procedure: Prudential Requirements to the IMO Procedure Change and Development Working Group (IMOPWG) for review and consideration at the same time as the Rule Change Proposal. Further details of the extension are available on the Market Web Site.

The key dates in processing this Rule Change Proposal, as amended in the extension notice, are:



2. Call for Second Round Submissions

The IMO invites interested stakeholders to make submissions on this Draft Rule Change Report. The submission period is 20 Business Days from the publication date of this report. Submissions must be delivered to the IMO by **5.00pm on Monday, 22 October 2012**.

The IMO prefers to receive submissions by email (using the submission form available on the IMO website: <http://www.imowa.com.au/rule-changes>) to: market.development@imowa.com.au

Submissions may also be sent to the IMO by fax or post, addressed to:

Independent Market Operator

Attn: Group Manager, Market Development
PO Box 7096
Cloisters Square, PERTH, WA 6850
Fax: (08) 9254 4399

3. Proposed Amendments

3.1. The Rule Change Proposal

The IMO developed this Rule Change Proposal to amend several clauses relating to Prudential Requirements for Market Participants. Prudential security for Market Participants is intended to provide secure trading within the Wholesale Electricity Market (WEM) and remove credit risk from the trading energy price.

The IMO proposed changes to the current methodology of determining prudential requirements to increase the efficiency of monitoring and managing credit risk for Market Participants. The IMO sought to amend the Market Rules to be principles-based rather than prescriptive, moving prescriptive detail to the Market Procedure for Prudential Requirements. Accordingly, the IMO intended to progress a Procedure Change Proposal for the Market Procedure in conjunction with this Rule Change Proposal.

The Rule Change Proposal listed three main issues and proposed amendments as follows:

- 1. Issue 1: Credit Limit:** The IMO considered that clause 2.37.4 did not provide enough clarity to Market Participants regarding Credit Limit requirements. The clause lists different factors that the IMO is required to take into account but does not prescribe how these are to be carried out. The IMO considered that this resulted in the IMO having to make qualitative decisions on the required levels of prudential security. The Rule Change Proposal proposed amendments to calculate Credit Limit using forecast liability based on reasonable expectation for a new Market Participant and forecast liability based on historical data for an existing Market Participant.
- 2. Issue 2: Outstanding Amount, Typical Accrual and Margin Call:** The IMO considered that the current methodology used to calculate a Market Participant's Outstanding Amount relies too heavily on historical data and potentially results in Margin Calls being too high or too low to cover the risk. The Rule Change Proposal suggested amendments to clause 2.40.1 that would introduce Net Current Liability and Net Forecast Liability into the calculation of Outstanding Amount. The Rule Change Proposal also proposed the addition of a new clause 2.40.1A stipulating that the IMO must calculate and publish a Market Participant's Outstanding Amount daily.
- 3. Issue 3: Expected Value of Transaction Guidelines:** The IMO considered that the concept of an expected value of a transaction was rendered unnecessary because of the proposed new clause 2.40.1A. The Rule Change Proposal suggested removing the concept from the Market Rules and instead linking a Market Participant's submission or the IMO's rejection of the submission to whether it would result in the Trading Margin reaching zero based on reasonable assumptions held by the Market Participant or the IMO at the time.

For full details of the Rule Change Proposal please refer to the Market Web Site: http://www.imowa.com.au/rc_2011_09

3.2. The IMO's Initial Assessment of the Proposal

The IMO decided to progress the Rule Change Proposal on the basis that Rule Participants should be given an opportunity to provide submissions as part of the rule change process.

4. Consultation

4.1. The Market Advisory Committee

An issues paper on Prudential Requirements (IP_2011_01) was presented to the Market Advisory Committee (MAC) at its 8 June 2011 meeting. No issues were raised by MAC members in relation to the paper. Subsequently, the Pre Rule Change Proposal was presented to the MAC on 14 December 2011. At this meeting, MAC members agreed to the progression of the Rule Change Proposal and the associated changes to the Market Procedure.

Further details are available in the MAC meeting minutes available on the Market Web Site: <http://www.imowa.com.au/MAC>

4.2. Submissions received during the first submission period

The first submission period for this Rule Change Proposal was between 16 May 2012 and 24 August 2012. A notice extending the first submission period was published on 19 June 2012.

During the first submission period, the IMO identified significant issues with the Rule Change Proposal. The issues pertained to the determination of Credit Limits, the calculation of Outstanding Amount and the development of expected value of transaction guidelines. Section 5 of this Draft Rule Change Report provides more detail regarding these issues.

On 21 August 2012, the IMO issued a notification to subscribers of RulesWatch advising that it intended to recommend to the IMO Board that the current Rule Change Proposal be rejected. The IMO also advised of its intention to develop a modified Rule Change Proposal and revised Market Procedure that would address the issues identified during the first submission period.

A submission was received from Community Electricity. An out of session submission was received from Perth Energy.

Community Electricity supported the Rule Change Proposal on the grounds that it clarified and improved existing processes. In particular, Community Electricity supported:

- a) that the applicable Market Rules should describe principles rather than be prescriptive and the detailed processes should be contained in the supporting procedure;
- b) that the concept of “expected value of transactions” and its supporting guidelines is unnecessary;
- c) that new participants should be treated differently from existing ones when calculating Credit Limit; and
- d) that the Outstanding Amount should be calculated daily.

Community Electricity also made suggestions to improving certain concepts. These suggestions and the IMO’s responses are detailed in Appendix 1.

In its submission, Perth Energy supported the daily calculation and provision of an Outstanding

Amount to Market Participants. Perth Energy considered that Market Participants should be made aware of credit related issues earlier than would otherwise be the case and would therefore be able to make amendments to trading strategies or make arrangements for an increase in Credit Support appropriately. The need for issuing Margin Calls may therefore not be necessary.

Perth Energy also noted that the increased frequency in reporting the Outstanding Amount is becoming more relevant with the recent introduction of changes to the Balancing and Load Following Ancillary Services markets.

In addition, Perth Energy suggested an alternative methodology for the determination of Credit Limits and raised concerns about the removal of prescriptive detail from the Market Rules to the Market Procedure. Perth Energy's issues and the IMO's responses are detailed in Appendix 1.

A copy of all submissions in full received during the first submission period is available on the Market Web Site: http://www.imowa.com.au/rc_2011_09

4.3. The IMO's response to submissions received during the first submission period

The IMO's response to each of the issues identified during the first submission period is presented in the Appendix 1.

4.4. Public Forums and Workshops

No public forums or workshops were held with regard to this Rule Change Proposal.

5. The IMO's Assessment

In preparing its Draft Rule Change Report, the IMO must assess the Rule Change Proposal in light of clauses 2.4.2 and 2.4.3 of the Market Rules.

Clause 2.4.2 outlines that the IMO *"must not make Amending Rules unless it is satisfied that the Market Rules, as proposed to be amended or replaced, are consistent with the Wholesale Market Objectives"*.

Additionally, clause 2.4.3 states, when deciding whether to make Amending Rules, the IMO must have regard to the following:

- any applicable policy direction from the Minister regarding the development of the market;
- the practicality and cost of implementing the proposal;
- the views expressed in submissions and by the MAC; and
- any technical studies that the IMO considers necessary to assist in assessing the Rule Change Proposal.

The IMO notes that there has there has not been any applicable policy direction from the Minister or any technical studies commissioned in respect of this Rule Change Proposal. A summary of the views expressed in submissions and by the MAC is available in section 4 of this report.

While preparing the proposed amendments to the Market Procedure, the IMO identified two areas in the proposed Market Procedure that were not aligned with the proposed amendments as presented in the Rule Change Proposal.

The IMO's assessment of these issues is outlined in the following sub-sections.

5.1. Determination of Credit Limits

The IMO considered that the proposed amendments to clause 2.37.4 as presented in the Rule Change Proposal were too prescriptive as they did not allow the IMO to exercise any discretion. The IMO considered that situations may arise (for e.g., price spikes due to Varanus Island incident) where the IMO may assess the historical data in respect of that Market Participant were no longer an appropriate representation of that Market Participant's forecast liabilities. In such situations, the IMO should have the ability to exercise discretion to revise the Credit Limit appropriately.

5.2. Calculating Outstanding Amount:

When initially developing the Amending Rules the IMO had assumed the availability of certain data items following the implementation of the Rule Change Proposal: Competitive Balancing and Load Following Markets (RC_2011_10). These data items were specifically 'net value of trades in the balancing market' and 'sum of past balancing transactions'¹. The calculation of these data items depends on the availability of metering data, dispatch information and final Theoretical Energy Schedule (TES) calculations. As the process currently stands, these data items are not available early enough in the Settlements cycle for the IMO to reliably and accurately estimate the Outstanding Amount. This implies that the proposed amendments to the calculation of Outstanding Amount and the removal of expected value of transactions guidelines must be reviewed.

5.3. Wholesale Market Objectives

The IMO considers that the issues identified in the Rule Change Proposal and detailed in Section 5.1 and 5.2 would render the proposed amendments inconsistent with the Wholesale Market Objectives.

5.4. Practicality and cost of implementation

The IMO considers that the implementation of the proposed amendments was not practical. The IMO decided not to assess the costs associated with the implementation.

6. The IMO's Proposed Decision

The IMO's proposed decision is to reject the Rule Change Proposal.

6.1. Reasons for the decision

In light of the considerations mentioned in Section 5, the IMO has assessed that the Rule Change Proposal needs to be revised substantially to the extent that the IMO considers it necessary to

¹ These values are identified as BS and $\sum DP_BS$ respectively in Appendix 1 of the Rule Change Proposal, accessible on the Market Web Site.

progress a new Rule Change Proposal which corrects the identified issues and will allow full consultation by industry.

Under the Market Rules the IMO cannot withdraw a Rule Change Proposal after it has been formally submitted. Therefore, the IMO has proposed that this Rule Change Proposal be rejected.

Appendix 1. Responses to Submissions received during the first submission period

	Submitter	Comment/Change requested	IMO Response
1	Community Electricity	In clause 2.37.4, the IMO should have reasonable regard to Market Participant's current operational circumstances relative to the history.	The IMO agrees with Community Electricity's suggestion. However, the IMO notes that it proposes to reject the Rule Change Proposal. The IMO has logged the suggestions received in submissions and will take them into account when preparing the forthcoming Rule Change Proposal and Market Procedure.
2	Community Electricity	In clause 2.40.1, a clarification should be included that the IMO determines the Net Forecast Liability rather than only the next settlement date. It should also be clarified that the value for Net Current Liability is determined by the IMO.	The IMO notes that Community Electricity has raised the following two issues: <ul style="list-style-type: none"> a) The proposed wording in clause 2.40.1(b)(iii) seems to imply that the IMO determines the next Settlement Date rather than the Net Forecast Liability. b) The proposed wording does not clarify that Net Current Liability and Net Forecast Liability are to be determined by the IMO. The IMO notes that these issues will be addressed in the forthcoming Rule Change Proposal and Market Procedure.
3	Community Electricity	Clause 2.42.2 should have regard to the effect of price volatility in underscoring the Margin Call and, if so, the IMO should reasonably seek to issue a single Margin Call rather than,	See response to Issue 1.

	Submitter	Comment/Change requested	IMO Response
		for example, once a week as the situation unfolds.	
4	Community Electricity	Credit Support should be flexible in terms of provision and release. Ideally, a participant should be able to immediately lodge cash during an expensive period and then withdraw any excess during cheaper times.	See response to Issue 1.
5	Perth Energy	<p>Perth Energy noted that the associated Market Procedure was not made available for comment.</p> <p>Perth Energy also noted that the proposed amendments would, make the process for calculating Credit Limits and monitoring prudential requirements more transparent and more reflective of actual credit requirements. This is mainly because of the move towards using actual and relevant data points where possible for Market Participants with an established trading history and only relying on reasonable estimates when dealing with new entrants until they have established their own history.</p> <p>Perth Energy agreed with this proposal subject to it using the average (not highest) 15 consecutive days for STEM and average (not highest) 70 consecutive days for Non-STEM</p>	<p>The IMO notes Perth Energy's support for improving transparency in the calculation of Credit Limits.</p> <p>The IMO also notes Perth Energy's recommendation to reflect a Market Participant's true market exposure by using average, not highest values. However, the IMO considers that the use of average rather than maximum quantities would be inappropriate and would expose the market to unacceptable risk. Assuming that historical patterns were reflective of future activity, using average values would imply that a Market Participant would have insufficient Credit Support to cover its exposure half the time.</p>

	Submitter	Comment/Change requested	IMO Response
		<p>exposure. The highest values should be used only to provide an absolute cap on the calculation of a Participant's exposure. Perth Energy's view is that the probability of a Participant's true exposure relates to the average values, not highest values.</p>	
6	Perth Energy	<p>Perth Energy does not believe that moving all detailed steps of the prudential requirements to the Market Procedures will improve the clarity or transparency of the Market Rules. Perth Energy has formed this view based on the recent experience of change of the Market Procedure: Maximum Reserve Capacity Price, which in their opinion, lacked rigorous analysis and genuine consultation with market, industry participants and customers. In Perth Energy's opinion, retaining Prudential Requirements in the Market Rules provides some protection of rigour for all stakeholders.</p>	<p>The IMO notes Perth Energy's concern. However the IMO considers that the current Market Rules already require the detail of the methodology to be covered in the Market Procedure.</p> <p>The IMO also notes that the Procedure Change process is subject to robust governance as the Rule Change process (for e.g., IMOPWG reviews amendments before formal submission, formal consultation process, subject to assessment against Wholesale Market Objectives and decisions being subject to procedural review). The IMO also notes that it is currently developing a Rule Change Proposal to further strengthen the governance around Procedure Changes. This would allow for Market Participants to request review of the decisions made by the IMO or System Management in their Procedure Change reports.</p>