



INDEPENDENT  
MARKET  
OPERATOR

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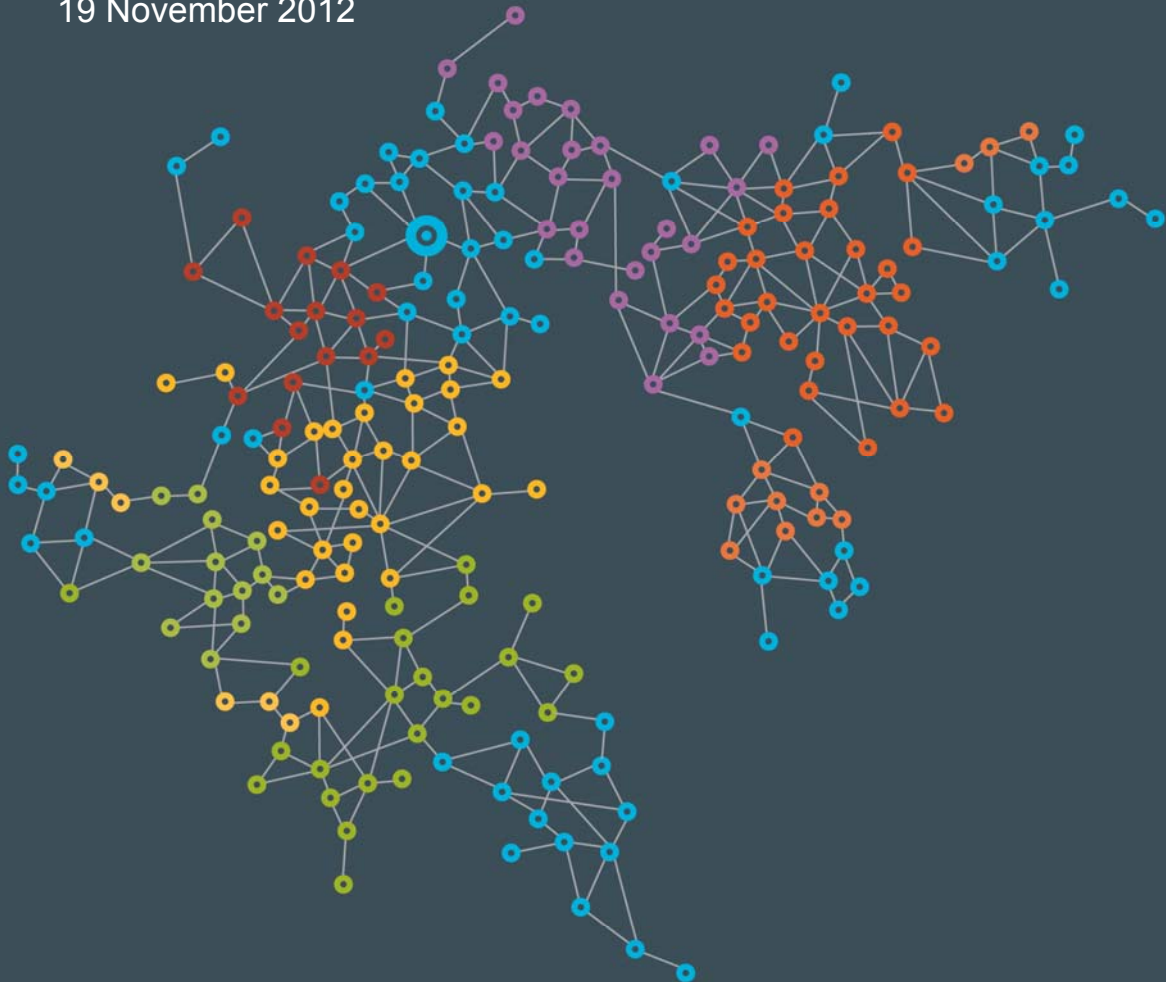
# Final Rule Change Report

## Title: Prudential Requirements

RC\_2011\_09  
Standard Rule Change Process

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19 November 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.

### ***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.
- The second submission period was held between 24 September 2012 and 22 October 2012. An out of session submission was received from Alinta.

### ***Assessment against Wholesale Market Objectives***

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

### ***Practicality and Cost of Implementation***

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

### ***The IMO's Decision***

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

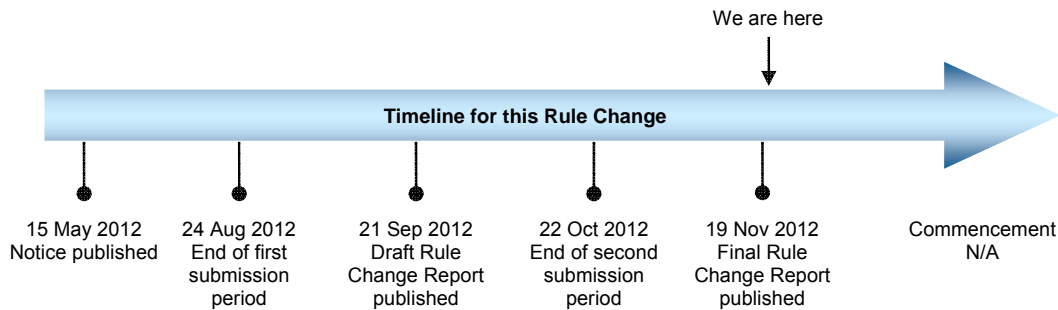
## 1. Rule Change Process and Timetable

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. Proposed Amendments

### 2.1. 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](http://www.imowa.com.au/rc_2011_09)

## 2.2. 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.

## 3. Consultation

### 3.1. 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>

### 3.2. 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. More detail on these issues is available in Section 5 of the Draft Rule Change Report which can be accessed on the Market Web Site: [http://www.imowa.com.au/rc\\_2011\\_09](http://www.imowa.com.au/rc_2011_09)

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 also 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 of the Draft Rule Change Report.

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 a number of concerns about the removal of prescriptive detail from the Market Rules to the Market Procedure.

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](http://www.imowa.com.au/rc_2011_09)

### **3.3. The IMO's response to submissions received during the first submission period**

The IMO's response to submissions received during the first submission period are detailed in Appendix 1 of the Draft Rule Change Report available on the Market Web Site: [http://www.imowa.com.au/rc\\_2011\\_09](http://www.imowa.com.au/rc_2011_09)

### **3.4. Submissions received during the second submission period**

Following publication of the Draft Rule Change Report, the second submission period was between 24 September 2012 and 22 October 2012. No submissions were received during the second submission period.

An out of session submission was received from Alinta on 23 October 2012. In its submission, Alinta supported the IMO's proposed decision in the Draft Rule Change Report to reject the proposed amendments. Alinta noted that the proposed amendments would reduce the IMO's ability to determine Credit Limits that reflect Market Participants' expected credit exposure to the WEM. Alinta provided a number of suggestions for consideration by the IMO when preparing its new Rule Change Proposal.

A copy of Alinta's submission in full is available on the Market Web Site [http://www.imowa.com.au/rc\\_2011\\_09](http://www.imowa.com.au/rc_2011_09)

### **3.5. The IMO's response to Alinta's submission**

The IMO's responses to each of the points raised in Alinta's submission are presented in Appendix 1 of this Final Rule Change Report.

### **3.6. Public Forums and Workshops**

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

## **4. The IMO's Draft Assessment**

The IMO's draft assessment, against clauses 2.4.2 and 2.4.3 of the Market Rules, and analysis of the Rule Change Proposal can be viewed in Section 5 of the Draft Rule Change Report available on the Market Web Site [http://www.imowa.com.au/rc\\_2011\\_09](http://www.imowa.com.au/rc_2011_09)

## **5. The IMO's Proposed Decision**

The IMO's proposed decision was to reject the Rule Change Proposal. The IMO made this decision based on the substantiveness of the issues identified during the first submission period.

## **6. The IMO's Final Assessment**

In preparing its Final 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 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 3 of this Final Rule Change 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 sections 6.1 and 6.2 below.

### **6.1. 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.

### **6.2. 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’<sup>1</sup>. 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.

### **6.3. Wholesale Market Objectives**

The IMO considers that the issues identified with the Rule Change Proposal and detailed in

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<sup>1</sup> 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.

Sections 6.1 and 6.2 above would render the proposed amendments inconsistent with the Wholesale Market Objectives.

#### **6.4. 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.

## **7. The IMO's Decision**

Based on the matters set out in this report, the IMO's decision is to reject the Rule Change Proposal.

### **7.1. Reasons for the decision**

In light of the considerations addressed in Section 6, the IMO has assessed that the Rule Change Proposal needs to be revised substantially to the extent that the IMO considers it necessary to 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 decided that this Rule Change Proposal be rejected.

## Appendix 1. Response to Alinta’s submission

	Submitter	Comment/Change requested	IMO Response
1	Alinta	Alinta considers that the variables currently outlined in clause 2.37.4 (a) – (j) are intended and necessary to describe the factors that the IMO must have in forming its expectation of the amount a Market Participant may owe the IMO over any 70 day period. That is, these variables recognise that historical data alone may not be adequate in determining Credit Limits in the future. For example, if a Market Participant’s level of Ancillary Service payments was expected to increase as a result of the implementation of new Amending Rules or due to facility aggregation, the IMO would be able to take this matter into account. Given the potential impacts on the prudential requirements on both new and existing Market Participants, Alinta Energy considers that it is most appropriate that clause 2.37.4 clearly prescribes the circumstances in which the IMO <u>may</u> rely on other information in setting the Credit Limit.	The IMO appreciates Alinta’s suggestion and will take it into consideration when developing the new Rule Change Proposal.
2	Alinta	Alinta also suggests the following amendments to the process for determining Credit Limits for the IMO’s consideration during the development of its new Rule Change Proposal:	The IMO appreciates Alinta’s suggestion and will take it into consideration when developing the new Rule Change Proposal.

	Submitter	Comment/Change requested	IMO Response
		<ol style="list-style-type: none"> <li>1. New Clause 2.37.2A: A new rule should be made so that in addition to the IMO being able to revise a Market Participant's Credit Limit at any time (as per clause 2.37.2), a Market Participant should also be able to apply to the IMO to review and if appropriate revise its Credit Limit outside of the situations contemplated by clause 2.37.5. This would be consistent with the discretion currently provided to the IMO in revising a Credit Limit following a request from a Market Participant outlined in step 2.1.2 of the Market Procedure for Prudential Requirements.</li> <li>2. Clause 2.37.5: It appears that this clause focuses on changes in a Market Customers position and doesn't directly consider that changes in a Market Generators position may occur. A Market Generator with increased bilateral contracts would be more likely to buy from the market and therefore it may be appropriate for the IMO to determine a revised Credit Limit. There may be value in considering whether clause 2.37.5 unnecessarily limits the situations under which a Market Participant must notify the IMO of a change in circumstances.</li> </ol>	

	Submitter	Comment/Change requested	IMO Response
3	Alinta	Alinta considers that if the IMO determines that the expected value of transaction guidelines can continue to be removed from the Market Rules, any forthcoming amendments to clauses 2.41.2 and 2.41.3 need to ensure that it is clear that the obligation on a Market Participant or the IMO relates to the expected affect of the transaction that is being contemplated/submitted on the Market Participant's Net Current Liability and Net Forecast Liability	The IMO appreciates Alinta's suggestion for reviewing clauses 2.41.2 and 2.41.3 in line with the changes to the expected value of transaction guidelines. The IMO will take this into consideration when developing the new Rule Change Proposal.