

Wholesale Electricity Market Rule Change Proposal Submission Form

RC_2011_09 Prudential Requirements

Submitted by

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Submission

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

Background

Under the Market Rules, the Independent Market Operator (IMO) must calculate credit limits for all participants, monitor compliance with these credit limits and take action such as drawing on credit support or issuing margin calls (requests to increase credit support). These requirements are collectively referred to as “Prudential Requirements”.

Prudential Requirements are in place in the Wholesale Electricity Market (WEM) to protect the IMO and other Market Participants from significant non-payment exposure becoming a market wide issue in the case of financial difficulties occurring with one of the Market Participants. This is standard practice in energy and other types of markets across the world.

The IMO has identified three issues with the current operation of the Prudential Requirements section of the Market Rules:

1. The methodology for calculating the Credit Limit is not sufficiently prescriptive and is therefore not sufficiently predictable and transparent,

2. The methodology for calculating the Outstanding Amount, which is effectively used for monitoring Prudential Requirements and guiding the IMO in making Margin Calls contains references to data points that do not exist, and
3. There is a lack of clarity around the use of the term “expected value”.

Clause 2.37.4 of the Market Rules sets out a detailed list of factors that the IMO must consider when calculating each Market Participant’s Credit Limit. These factors include past levels of generation, bilateral and STEM purchases as well as expected future activity, consideration of past breaches of the Market Rules and the degree of confidence that exists as to whether the Credit Limit will be large enough to meet large defaults.

Firstly, the IMO has identified that detailed information on each of the steps and factors to consider in calculating Credit Limits should be contained in a Market Procedure rather than in the Market Rules itself.

Secondly, the IMO considers that the current version of the Market Rules are not descriptive enough which means the IMO must also make qualitative decisions which may have significant impacts on the outcome of the Credit Limit calculation. An example of this is contained in clause 2.37.4(j) which compels the IMO to take into consideration past breaches of the Market Rules when calculating the Credit Limit. Clause 2.37.4(j) does not provide any guidance as to how to adjust the Credit Limit to reflect past breaches other than to take these into account.

In relation to calculating the Outstanding Amount the IMO has identified that the current process relies on data points that in practice cannot be obtained. For example, clause 2.42.2 makes reference to “average prices and quantities as applied in the most recent determination of the Market Participant’s Credit Limit”. Such average prices and quantities do not exist and are not made use of when calculating the Credit Limit.

Finally, the IMO considers that notion of an “expected value” of a transaction in clause 2.37.9 to be confusing and unnecessary.

Change Proposal

The IMO submitted Rule Change Proposal RC_2011_09 “Prudential Requirements” on 15 May 2012. The IMO proposed to amend the Market Rules to address each of the three issues outlined above.

In relation to issue 1 the IMO has proposed to remove most of the prescriptive detail from the Market Rules and include such detail in the Market Procedures instead.

On 19 June 2012 the IMO published a notice extending the first consultation period for RC_2011_09 until 24 August 2012 to allow parties to assess related proposed Market Procedure changes in conjunction with RC_2011_09. At the time of writing no proposals for new Market Procedures have been made and Perth Energy has therefore been unable to evaluate the entirety of the proposals in detail. Perth Energy would welcome details of any new Market Procedures well ahead of the close of the second submission period for RC_2011_09. As detailed below, Perth Energy’s strong preference would be for the details



of the prudential calculations to continue to reside in the Market Rules rather than in a Market Procedure.

The IMO has also proposed to remove altogether items that are impossible to apply in practice. In particular, the IMO has proposed to strike out sub clauses (a) – (j) of clause 2.37.4 and replacing them with a requirement to use historical actual data for current Market Participants to provide guidance on the level of credit required for each participant. Such historical data would relate to actual exposure that each Market Participant has had in the STEM (highest 15 consecutive days) and Non-STEM markets (highest 70 consecutive days) over the preceding 24 month period. For new Market Participants a subjective IMO estimate of its “reasonable expectation” is still required.

In relation to issue 2, the IMO has proposed to move away from the notion of using a “Typical Accrual” based around data points on average prices and volumes used when calculating the Outstanding Amount. Instead, the Outstanding Amount will be calculated as the sum of any actual outstanding invoices, the net current liability (non invoiced liabilities) and any forecast liabilities up until the next STEM Settlement Statement Date.

The individual results of these calculations will be provided to Market Participants daily. The size of any Margin Calls will be calculated to cover any shortfall that may exist between the Outstanding Amount and the current level of Credit Support that exists for the Market Participant.

Finally, in relation to issue 3 the proposed changes by the IMO remove the references to “expected value”. Instead, Market Participants and the IMO must use (proposed clauses 2.41.2 and 2.41.3) “reasonable assumptions about the Market Participant’s Net Current Liability and Net Forecast Liability” when contemplating transactions to avoid a Trading Margin value of zero or less.

Perth Energy’s Views

Perth Energy supports the majority of the IMO’s Rule Change Proposal subject to the comments made below.

The proposed amendments would in Perth Energy’s view make the process for calculating necessary credit limits and monitoring prudential requirements both 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 Participant’s with an established trading history and only relying on reasonable estimates when dealing with new entrants until they have established their own history.

Removing references to data points that are not available will in Perth Energy’s view improve transparency as well as the credibility of the prudential requirements process. Perth Energy agrees with this proposal subject to the proposal using the average (not highest) 15 consecutive days for STEM and average (not highest) 70 consecutive days for Non-STEM exposure. The highest values should be used only to provide an absolute cap on the calculation of a participant’s exposure. Our view is the probability of a participant’s true exposure relates to the average values, not highest values.

But 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. Our view is firmly based on the recent experience of change of the MRCP Market Procedure, which lacked rigorous analysis and genuine consultation with market and industry participants and customers. Retaining Prudential Requirements in the Market Rules provides some protection of rigour for all stakeholders.

Perth Energy supports the IMO's proposal to issue the Outstanding Amount calculation to Market Participant's on a daily basis. This is a simple measure to increase Market Participants' awareness of how their exposures are tracking against their available Credit Support. Perth Energy believes it may help Market Participants to become aware of credit related issues earlier than would otherwise be the case and therefore be able to make amendments to trading strategies or make arrangements for an increase in Credit Support in an orderly fashion if necessary. The need for issuing Margin Calls may therefore decrease.

The increased frequency in reporting the Outstanding Amount is becoming even more relevant with the recent introduction of changes to the Balancing and Ancillary Services markets. As independent power producers have more trading options available the issue of setting credit limits and monitoring them takes on a new level of importance as the potential values involved increase.

Perth Energy believes the proposed changes, subject to our comments about retaining the detail in the Market Rules rather than in a Market Procedure, will benefit all WEM participants as they provide improved clarity around the methodology for Prudential Requirements and also make the resultant Credit Limits and Outstanding Amounts more relevant as the proposed changes to a higher degree rely on actual data points.

Perth Energy looks forward to reviewing the further changes that the IMO has foreshadowed will be contained in a Market Procedure. As discussed above, Perth Energy firmly believes these should be incorporated in the Market Rules and not be relegated to a Market Procedure.

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

Perth Energy considers that the proposed changes to the Market Rules, subject to our comments above, would improve transparency and accuracy of the methodology for calculating Prudential Requirements. Perth Energy believes this would result in the proposed changes better facilitating achievement of Market Objective¹ (d) relating to minimising the long-term cost of electricity.

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;

Any improved accuracy that may flow from using actual data points should minimise the risk of having inadequate levels or unnecessarily high levels of Credit Support in place in future. Avoiding the first problem will reduce the potential cost to all participants in the market if a single participant were to fail. Avoiding the second problem will reduce the direct cost to all participants of having to provide unnecessarily high levels of Credit Support, damaging the prospect of stronger competition in the future.

Perth Energy has not identified any impacts on the other 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.

Perth Energy will not be impacted by the proposed changes.

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.

(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.