



INDEPENDENT
MARKET
OPERATOR

Wholesale Electricity Market Procedure Change Proposal

Procedure Change ID: PC_2013_04

Change requested by

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Address:	Level 17, 197 St Georges Terrace, Perth
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Urgency:	2-medium
Procedure change title:	Changes to Market Procedure for Prudential Requirements
Market Procedure(s) affected:	Market Procedure: Prudential Requirements

Introduction

The IMO or System Management, as applicable, may initiate the Procedure Change Process by developing a Procedure Change Proposal. Rule Participants may notify the IMO or System Management, as applicable, where they consider an amendment or replacement of a Market Procedure would be appropriate.

If an Amending Rule requires the IMO or System Management to develop new Market Procedures or to amend or replace existing Market Procedures, then the IMO or System Management, as applicable, is responsible for the development, amendment, or replacement of Market Procedures so as to comply with the Amending Rule.

Market Procedures:

- (a) must:
- i. be developed, amended or replaced in accordance with the process in the Wholesale Electricity Market (WEM) Rules (Market Rules);
 - ii. be consistent with the Wholesale Market Objectives;
 - iii. be consistent with the Market Rules, the Electricity Industry Act and the Regulations; and



- (b) may be amended or replaced in accordance with clause 2.10 and must be amended or replaced in accordance with clause 2.10 where a change is required to maintain consistency with Amending Rules.

The Wholesale Market Objectives 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;
- (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.

Details of Procedure Change Requested

1. Provide a reason for the proposed new, amended or replacement Market Procedure:

Background

The IMO developed the Rule Change Proposal *RC_2012_23: Prudential Requirements*¹ to provide clarification on the obligations of Market Participants and the IMO with respect to prudential security and management of financial exposure in the market resulting from payment defaults. The Rule Change Proposal was submitted into the Standard Rule Change Process on 14 August 2013 and the Draft Rule Change Report was published on 24 October 2013. The Rule Change Proposal is currently in the second submission period which closes on 21 January 2014.

In response to the proposed Amending Rules in *RC_2012_23*, the IMO has proposed changes to the associated *Market Procedure: Prudential Requirements* (Market Procedure). The IMO is seeking to outline the principles in the proposed Amending Rules in *RC_2012_23* and retain the prescriptive detail in the Market Procedure.

The Market Procedure provides further detail on issues related to the:

- (a) determination of a Market Participant's Credit Limit;

¹ More details are available on the Market Web Site: http://www.imowa.com.au/rc_2012_23.

- (b) notification of changes in circumstances justifying an increase to a Market Participant's Credit Limit;
- (c) circumstances in which a Market Participant must provide replacement Credit Support;
- (d) management of the list of entities meeting Acceptable Credit Criteria;
- (e) application of a Market Participant's voluntary prepayments to its Outstanding Amount;
- (f) concept of a Market Participant's Trading Margin and the calculation and method of making a Margin Call; and
- (g) list of factors for assessing the expected value of transactions.

It should be noted that the Market Procedure has not been amended since 2008 necessitating substantial changes to implement the proposed Amending Rules from RC_2012_23 and reflect the IMO's new standards in style, language and formatting. As a result, the IMO has not provided a marked-up copy of the proposed amended Market Procedure.

Consultation

The IMO presented the proposed amended Market Procedure to the IMO Procedure Change and Development Working Group (IMOPWG) at the 20 September 2013 meeting. The following key comments and issues were raised:

- Mr John Rhodes noted that the time period for historical data used to determine Credit Limits should remain in the Market Rules rather than being moved to the Procedure. Mr Rhodes noted that this issue would be raised in Synergy's submission to the Rule Change Proposal.

The IMO responded to this issue in the Draft Rule Change Report for RC_2012_23 noting that clause 2.37.4(c) of the Market Rules had been drafted to directly link the definition of Credit Limit to the methodology defined in the Market Procedure thereby removing ambiguity related to the time period of historical data. Additionally, the proposed drafting of clause 2.37.4 of the Market Rules ensured that future amendments could not be made to this clause without simultaneously considering the Market Procedure.

- Mr William Street noted that the current Credit Limit determination process would set an unnecessarily high figure as it was unlikely for a Market Participant to reach the maximum STEM and Non-STEM Settlement amounts in the same period.

The IMO acknowledged the concern and reiterated that the proposed Amending Rules in RC_2012_23 were designed to reflect current practice, with a more substantial review of Prudential Obligations and the settlement process to be undertaken at a later date. The IMO noted that the current Rule Change Proposal is necessary to align the Market Rules to current practice and provide transparency around the current operation of prudential requirements.

- Mr Rhodes noted that the proposed drafting of clause 2.38.7 of the Market Rules placed the obligation for providing the information on the Market Participant and not the Credit Support provider (e.g. banks) as existed previously in the Market Rules.

The IMO noted that the Market Participant is the appropriate entity on which to place the obligation because the Credit Support provider itself falls outside the purview of the Market Rules.

- Dr Steve Gould and Mr Rhodes noted that the change from one Business Day to 24 hours to respond to a Margin Call Notice and provide replacement Credit Support was unlikely to be able to be met.

The IMO agreed that it could be difficult but noted that this requirement is common across financial markets².

- Mr Street questioned if more information would be provided on what the IMO considered as a 'reasonable estimate' of the forecast exposure.

The IMO noted that it was developing the optimal determination for this variable and added that more information would be provided in the prudential risk report which would be circulated to the IMOPWG members.

The minutes of the IMOPWG meeting no. 15 held on 20 September 2013 are available on the Market Web Site: <http://www.imowa.com.au/IMO-Procedures-Working-Group>.

Following the IMOPWG meeting, the IMO re-circulated the revised amended Market Procedure to IMOPWG members on 13 December 2013 soliciting feedback by 20 December 2013. Additionally, the IMO also provided a draft version of the prudential risk report to demonstrate the proposed calculation for estimating forecast exposure to give a Market Participant certainty of its prudential security in the market.

During this consultation period, feedback was received from Alinta Energy and Community Electricity. Alinta Energy was concerned that sufficient detail had not been provided on the calculation of the forecast exposure and its effect on the Outstanding Amount. Community Electricity was concerned that the processes related to providing Security Deposits as Credit Support seemed administratively inefficient and incongruous with the timelines for responding to Margin Calls. Community Electricity suggested that a more efficient system could be instituted by allowing for a "general" Security Deposit deed to be submitted to the IMO. Market Participants could then make payments (including voluntary prepayments and Margin Call amounts) by depositing funds as required, without the need for any additional documentation.

In response to Alinta Energy's concerns, the IMO has proposed further amendments to section 5 of the Market Procedure. Specifically, the IMO has provided greater clarity on the calculation of the Outstanding Amount.

In response to the concerns raised by Community Electricity, the IMO has considered the timeline for providing Credit Support and has concluded that the IMO should determine the

² The IMO received further feedback and information on the response time of 24 hours and has subsequently decided to revert to one Business Day. This issue is discussed in more detail in Issue 5 of this Procedure Change Proposal.

timeline based on a Market Participant's specific circumstances. This will provide flexibility such that where a new Market Participant is required to provide Credit Support for the first time, the IMO can determine a longer timeframe as opposed to situations where additional Credit Support may need to be deposited within a short timeframe.

The IMO is also considering improvements to the documentation associated with Credit Support provision. Based on its assessment, the IMO will update the various prudential forms currently available on the Market Web Site.

Proposed Amendments

The key areas that the IMO has proposed to amend substantively in the Market Procedure are discussed below.

1. Credit Limit determinations

Clause 2.37 of the Market Rules requires the IMO to determine, review and revise a Credit Limit for each Market Participant. RC_2012_23 proposes to make amendments to strengthen the linkages between obligations and move the prescriptive detail for determining a Market Participant's Credit Limit to the Market Procedure.

Specifically, RC_2012_23 seeks to amend clause 2.37.4 of the Market Rules so that the Credit Limit is:

- (a) determined as the maximum amount owed by a Market Participant over a 70-day period, making the Credit Limit calculation predictable, repeatable and robust;
- (b) calculated by taking into account various factors as laid out in proposed amendments to clause 2.37.5 of the Market Rules; and
- (c) supported by an obligation on the IMO to provide the Market Participant with details of the factors used in making the determination as proposed in clause 2.37.7 of the Market Rules.

Consequently, the IMO has revised the Market Procedure with respect to Credit Limit determinations to:

- (a) provide greater transparency around the application of various factors in determining Credit Limits under section 2 of the proposed amended Market Procedure;
- (b) provide further detail on the calculation of the Credit Limit for each type of Market Participant under section 2.2 and 2.3 of the proposed amended Market Procedure; and
- (c) improve the IMO's process of notifying a Market Participant of its Credit Limit under section 2.7 of the proposed amended Market Procedure.

The IMO has also included the amendments to the Market Procedure to reflect the Amending Rules made in *RC_2010_11: Removal of Network Control Services Expression of Interest and Tender Process* by removing the references to Credit Limits for Network Operators which are required to fund Network Control Service Contracts.

2. Time period of historical settlement data used in Credit Limit determination

In determining Credit Limits, the IMO uses historical data to predict future behaviour. The IMO currently uses settlement data from the previous 48 months to form the basis of a Market Participant's Credit Limit. The IMO has received suggestions from Market Participants that this time period is too long and therefore does not adequately represent current circumstances and behaviours.

To assess the impact of the proposed reduction in the time period, the IMO has examined the results of the last two annual Credit Limit reviews performed in 2010 and 2011. Using the current 48-month time span, the analysis shows that approximately 50% of Credit Limits were set based on settlement data within the later 24 months. The remaining 50% were set based on settlement data in the first 24 months of the 48-month time span. The analysis indicated that half of the Market Participants would have had their Credit Limits set at a lower level under the proposed shorter time span. This is likely to have resulted in reduced prudential financing costs to those Market Participants.

While the proposed amendments may result in the IMO holding a lower level of prudential security for some Market Participants, the regular monitoring of Market Participants' Trading Margins and the increased ability for the IMO to make Margin Calls will reduce the financial risk of default to the market overall.

Based on considerations as discussed above, the IMO proposes that the time period of historical data to be used in Credit Limit determination should be reduced to 24 months. A time period of 24 months captures two peak periods (by including two summer seasons). A shorter time period would not offer enough peak periods and would reduce further if exceptional events occurred (for example price spikes due to Varanus Island) and had to be factored out.

The IMO proposes to amend section 2.2 of the Market Procedure which details the process to be followed to determine a Market Participant's Credit Limit. More specifically, the amendments to step 2.2.3 reflect the proposed change in time span from 48 to 24 months.

3. Notification of any change in circumstances affecting a Market Participant's Credit Limit

Currently, clause 2.37.5 of the Market Rules only contemplates situations where a Market Customer's prudential risk may be affected resulting in an increase in its Credit Limit. The clause currently does not take into account situations where Market Generators may need to vary their position in the Balancing Market based on changes in their Bilateral Contract position. The exclusion of circumstances affecting Market Generators in clause 2.37.5 of the Market Rules does not provide the IMO with an opportunity to revise their Credit Limit accordingly. Furthermore, this clause does not contemplate situations where a decrease in a Market Participant's Credit Limit may be considered.

In the Draft Rule Change Report for RC_2012_23, the IMO proposed to amend clause 2.37.5 of the Market Rules (renumbered to 2.37.8) to require a Market Participant to notify the IMO of information that may result in an increase to the Market Participant's Credit Limit. In circumstances where a potential decrease to the Credit Limit is expected, the Market Participant may (but is not required to) notify the IMO. The details regarding the circumstances under which a Market Participant must notify the IMO are proposed to be

moved from the Market Rules to the Market Procedure.

The IMO proposes to include in step 2.8.1 of the proposed amended Market Procedure a non-exhaustive list of circumstances that a Market Participant must notify the IMO of as they may justify an increase to its Credit Limit.

4. Accounting for voluntary prepayments in the calculation of the Outstanding Amount

RC_2012_23 clarifies that Market Participants are allowed to make voluntary prepayments to reduce their Outstanding Amount and consequently increase their Trading Margin to securely transact in the market. The current processes around handling these monies are not well-defined and therefore present a financial risk to the market, particularly as they relate to Suspension Events such as a Payment Default or insolvency of a Market Participant.

The current Market Procedure does not specifically address prepaid amounts. The IMO proposes to amend section 5.2 of the Market Procedure to detail the obligations on Market Participants and the IMO with respect to the processes to be followed for handling voluntary prepayments.

The IMO proposes amendments to the Market Procedure to require a Market Participant electing to make a prepayment to complete a proforma deed (which will be available on the Market Web Site) stating that the amount is to be applied to reduce a Market Participant's Outstanding Amount and thereby increase its Trading Margin. The proposed amendments also require the IMO to adjust this amount in the next Invoice and appropriately reduce the Outstanding Amount in the prudential risk report available through the Market Participant Interface on the WEM System.

5. Credit Support arrangements and timelines

In RC_2012_23, the IMO proposes to amend clauses 2.38.1, 2.38.2 and 2.38.3 of the Market Rules to:

- (a) provide greater clarity to Market Participants with respect to their obligations to provide and maintain an appropriate level of Credit Support; and
- (b) retain the principles in the Market Rules and move the prescriptive detail with respect to timelines for providing Credit Support and circumstances which may necessitate replacement Credit Support to the Market Procedure.

As a result, the IMO proposes amendments to section 3 of the Market Procedure to provide further detail around the processes to be followed by Market Participants and the IMO, to ensure that adequate Credit Support is maintained at all times.

The IMO notes that the proposed Amending Rules (clauses 2.38.3 which relates to the provision of replacement Credit Support and clause 2.42.4 of the Market Rules which relates to provision of Credit Support in response to a Margin Call Notice) in RC_2012_23 had been amended to replace the timeline of one Business Day to 24 hours. This timeline had been introduced to ensure that the financial risk in the market arising from a time lag in responding to a Margin Call or providing replacement Credit Support was minimised.

During the first submission period for RC_2012_23 and consultation with IMOPWG members, concerns were raised on the practicality of implementing this timeline. The IMO has conducted further research on this issue and has formed the view that 24 hours is not practicable for several large banks to respond and has therefore decided to revert to one Business Day. The IMO has reflected these changes in steps 3.4.2 and 5.4.2 of the proposed amended Market Procedure. The IMO will include these further amendments to the proposed Amending Rules (clauses 2.38.3 and 2.42.4 of the Market Rules) accordingly in the Final Rule Change Report for RC_2012_23.

6. List of factors to assess the expected value of transactions

In RC_2012_23, the IMO proposes to develop a list of factors to be taken into account when determining the expected value of a transaction. The IMO proposes to include this list in Appendix 1 of the Market Procedure.

Call for Submissions

The IMO is seeking submissions regarding this proposal. The submission period is 20 Business Days from the publication of this Procedure Change Proposal. Submissions must be delivered to the IMO **by 5:00 PM on Tuesday, 11 February 2014**.

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

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

Independent Market Operator
Attn: Group Manager, Development & Capacity
PO Box 7096
Cloisters Square, Perth WA 6850
Fax: (08) 9254 4399

2. Provide the wording of the amended Procedure

The proposed amended Market Procedure is provided as an attachment to this proposal.

3. Describe how the proposed changes to the Market Procedure would be consistent with the Market Rules, the Electricity Industry Act and Regulations

The proposed amended Market Procedure has been reviewed as a whole by the IMO to ensure compliance of the Market Procedure with the relevant provisions in the:

- Electricity Industry Act;
- Regulations; and
- Market Rules.

4. Describe how the proposed changes to the Market Procedure would be consistent with the Wholesale Market Objectives

The steps described in the proposed amended Market Procedure will facilitate the prudential obligations to be met by Market Participants and the IMO as described in clauses 2.37 to 2.42 of the Market Rules. Specifically, the IMO considers that the proposed amendments to the Market Procedure:

- (a) support the Amending Rules proposed in RC_2012_23, which better achieve Wholesale Market Objectives (a) and (b);
- (b) provide additional clarity on the obligations of Market Participants and the IMO with respect to maintaining prudential security in the market;
- (c) document the current process and obligations thereby improving transparency; and
- (d) provide a basis for future consideration of reforms to the prudential regime.

For these reasons, the IMO considers that the amended Market Procedure, as a whole, is consistent with the Wholesale Market Objectives.

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