3 October 2014

John Pierce
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW NSW

(lodged online at www.aemc.gov.au)

Dear John,

NEM Financial Market Resilience – Second Interim Report

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the *NEM financial market resilience Second Interim Report (the Report)*. AFMA represents the interests of participants in Australia's wholesale banking, financial and energy markets. Our members include Australia's major energy companies and other users of over-the-counter electricity derivatives.

Whilst acknowledging the importance to NEM stability of the retailer of last resort (ROLR) process, AFMA's focus is on the efficiency and robustness of OTC financial markets. Accordingly, our comments are limited to those areas that relate to financial markets. Consequently, this submission does not respond to a number of areas covered in the Report, such as recommended changes to the Retailer of Last Resort (ROLR) Scheme, but other areas relating to financial system stability, stability arrangements and regulatory and G20 measures.

Financial system stability risks

Section 2 of the Report states that "while the possibility is uncertain, there is a risk of financial contagion occurring through OTC contracts". It explicitly highlights how the spot market and exchange traded derivatives market manage settlement shortfall and counterparty default risk (page 9). It neglects to mention in this same summary section the ways in which the OTC markets manage risk. The omission in this section (as well as in the Executive Summary), coupled with the detailed description of how financial contagion "could be transmitted" through OTC contracts, appears to have the intention of elevating a risk to a level greater than that which is observed by evidence.

OTC electricity derivatives market participants risk management policies was recently the subject of an ASIC review (REP 390). This is summarised by your report on page 37. The key conclusion from this review is their consideration that "risk management practices appear to be appropriate to the nature of their business, taking into account the size and complexity of the financial services business they conduct". The ASIC review provides an assessment of the OTC electricity derivatives market that relates to essentially the same risk that the AEMC is assessing. Given the comprehensive nature of that review, and the conclusions drawn, it would appear that ASIC does not share the level of concern that the AEMC appears to have.

As noted in our submission to the initial Issues Paper in July 2012, OTC electricity market participants have developed rigorous policies and procedures covering implementation, review and monitoring of counterparty credit limits, which, supplemented by extensive use of the ISDA Credit Support Annex, makes the likelihood of a default with systemic implications quite remote. The Report's statement that "it does not appear to be standard practice among participants in the NEM to exchange collateral" seems to be at odds with ASIC's review, in which the use of credit support annexes, as well as a significant number of risk management practices, are used by more than 50% of market participants.

As noted on page 20 of the Report, Seed Advisory concluded that "the failure of the largest counterparty of a vertically integrated retailer would be unlikely to cause financial contagion and threaten financial system stability in the NEM." As noted in our submission to the Option Paper in December 2013, AFMA supports this conclusion. This view is also supported by a number of stakeholders, as discussed on page 18 of your Report.

The conclusion in Chapter 2 is that "While the possibility is uncertain, there is a risk of financial contagion occurring through OTC contracts". As noted in our July 2012 submission, the combination of supervision of NEM participants and effective control process implemented by those entities active in OTC electricity derivative markets should give the AEMC considerable comfort that a financial contagion from a default by a NEM participant is unlikely in the extreme. Given the ASIC report and Seed Advisory conclusions subsequent, there appears to be little evidence otherwise. AFMA continues to hold this view.

Responding to a large participant failure

Section 6 recommends "the establishment of a separate framework to facilitate a timely, proportionate and suitable response to a SIMP experiencing some significant financial distress or failure", such framework to "gather to a single decision-making point all the decisions that would make up the response".

Given AFMA's view of the very low risk of financial contagion given current regulations and market practices, a number of our members question the need for such a framework. We have concerns as to how the decisions that a NEM Resilience Council might make could interfere with contractual rights of parties and the powers of any external administrator, and the potential regulatory burden associated with this suggestion. A number of our members have also expressed concerns of potential moral hazard in that the designation of SIMPs creates a notion of “too big to fail” for some entities and a treatment which is inequitable relative to other market participants.

Stability arrangements

Section 7 of the Report states that “there is merit in developing an alternative ….they would involve a form of special external administration or management”.

As noted in AFMA’s submission to the AEMC’s First Interim Report in August 2013, it is of crucial importance to our members to ensure that any resolution regime preserves safeguards to protect contractual termination and netting rights and collateralisation agreements. Any powers to stay such rights or override section 14 of the Payments System and Netting Act 1998 that may be granted by a resolution regime would be seen by our members as highly disruptive to the efficient functioning of the market. This is an area of particular importance on which AFMA, through its relevant committees, would be pleased to have ongoing engagement if you continue work on this concept.

Risk management, transparency and G20 measures

In Section 10 of the Report, the review has considered additional regulatory measures that seek to reduce probability of financial contagion through counterparty failures by identifying and mitigating risks in advance. The Report’s conclusion is that “the case is not established for mandating such additional measures”. Given AFMA’s opinion stated above of the low likelihood of financial contagion, AFMA supports this conclusion.

In Section 11 of the Report, the review considers that “the case for implementing the G20 reforms for electricity participants has not yet been established”. AFMA also supports this conclusion for reasons identified in previous submissions.

Conclusion

In summary, AFMA supports the AEMC’s objective of identifying risks to financial system stability, but has reason to question the likelihood of these risks occurring on the basis of evidence. AFMA’s view is that the risk of financial system instability is extremely low. AFMA also suggests that there are important contractual and other matters to take into account in considering separate frameworks and potential stability arrangements. Finally, AFMA supports the conclusions that additional regulatory measures and G20-like reforms are not necessary.

Please contact myself at mchadwick@afma.com.au if you have any queries regarding our comments.

Yours sincerely

M. Chadwick

Mike Chadwick
Director - Markets