



20 December 2013

Mr Eamonn Corrigan
Director
Australian Energy Market Commission
Sydney South NSW 1235

By email: aemc@aemc.gov.au

Dear Mr Corrigan

NEM Financial Resilience Stage 2 Options Paper

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the Stage Two Options Paper *NEM Financial Market Resilience* (the Options Paper). 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.

Our comments are set out in the attached paper to this letter. Overall we consider that a number of the options presented in the Options Paper may not achieve the desired outcome of managing risks to financial stability, and in fact may actually increase risk in the system, as additional cost and regulatory burden can result in undesired changes in market structure and hedging behaviour of participants.

We agree with the foundation conclusion in the Options Paper that a failure of a large electricity business would not cause major instability to the overall financial system given the extent of the exposures the financial system has towards the NEM.

More consideration needs to be given to whether the case for additional regulatory intervention based on demonstrated market failure can be made out before making recommendations for change to the Standing Council on Energy and Resources (SCER). AFMA believes that there is an important threshold policy question about the optimal regulatory oversight regime for dealing with NEM market resilience that should be explored before considering regulatory changes.

As the AEMC deliberates further on the issues raised in the Options Paper and possible recommendations to the SCER, AFMA through its Electricity Market Regulatory Group would be pleased to engage further with the AEMC.

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

Yours sincerely

A handwritten signature in black ink, appearing to read "M. Chadwick". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mike Chadwick
Director - Markets



NEM FINANCIAL MARKET RESILIENCE

OPTIONS PAPER TWO

December 2013

TABLE OF CONTENTS

1. Summary.....	2
2. Supervision regime – A threshold issue	2
3. Financial contagion and systemic risk.....	4
4. Risks and risk management in the NEM.....	4
5. Measuring the materiality of systemic risk.....	5
6. Assessment framework.....	5
7. Potential options to reduce systemic risk	7
8. Options commentary	10
8.1. Option 1: No new measures	10
8.2. Option 2: Trade Reporting	10
8.3. Option 3: Stress test reporting	11
8.4. Option 4: Code of best practice	11
8.5. Option 5: Trade reporting and additional margin requirements	11
8.6. Option 6: Stress test reporting and additional supervision and regulatory powers	11

1. Summary

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the Australian Energy Market Commission's (AEMC) Stage Two Options Paper on National Electricity Market (NEM) Financial Market Resilience (the Options Paper). 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 (OTC) electricity derivatives.

AFMA believes that there is an important threshold policy question about the optimal regulatory oversight regime for dealing with NEM market resilience. We suggest that more policy thought needs to be given to this question.

AFMA does not believe that G20 policy reforms for banking and the OTC derivatives market are applicable to the NEM. We agree with the foundation conclusion in the Options Paper that a failure of a large electricity business would not cause major instability to the overall financial system given the extent of the exposures the financial system has towards the NEM. Hence, the scope of consideration of systemic risk needs only to be the risk of cascading failure within the NEM and not the broader financial system in Australia.

It is important to clearly identify a material risk of market failure before making any recommendations for additional regulation in this area. We agree with the conclusions made in the Seed Advisory report in this regard.

With respect to the options presented in the Options Paper, it is important to note that a number of them may not achieve the desired outcome of managing risks to financial stability, and in fact may actually increase risk in the system, as additional cost and regulatory burden can result in undesired changes in market structure and hedging behaviour of participants.

Our detailed responses to the questions are set out below.

2. Supervision regime – A threshold issue

The analysis in the Options Paper raises an important threshold policy question around whether there is an optimal regulatory oversight regime for dealing with NEM market resilience. AFMA considers that policy thought needs to be given to this question before any consideration can be given to measures suggested in the Options Paper that would require prudential or systemic oversight skill sets.

One fundamental lesson that comes from the global financial crisis and its source in the repackaging of high risk US home loans is that misdirected policy interventions, along with

dispersed and uncoordinated financial sector regulation, fosters an environment where serious market failure can arise. A great source of strength for the Australian financial system during the crisis was that we had a well-designed financial system regulatory regime that was able to deal with the situation in a coordinated manner and where regulators had clear mandates and powers.

In examining the issues surrounding NEM market resilience, the Options Paper usefully illustrates that there is a complex regulatory mosaic with dispersed and unclear regulatory responsibilities. The Options Papers points out that in relation to external risk management obligations, multilayered requirements may apply to participants, such as:

- Australian Prudential Regulation Authority (APRA) prudential requirements;
- Australian Securities and Investments Commission (ASIC) financial services license capital requirements; and
- Australian Energy Market Operator (AEMO) NEM prudential requirements.

The NEM is the subject of a high level of regulatory intensity, placing a high compliance burden on participants. Therefore, it would be worthwhile to consider whether the current supervisory regime is an optimal arrangement. AFMA does not at present have a view on a better supervisory arrangement, but in order to obtain benefit from some of the suggested measures in the proposed options it would be necessary to have appropriately equipped supervisory arrangements in place. For example, in Option 2 the issue of derivatives trade reporting is raised. The prime purpose of such reporting is to provide data to a systemic regulator, in Australia's case the Reserve Bank, to monitor financial sector systemic risk. OTC electricity derivatives transaction data has no real significance in this wider context as it needs to be looked from the perspective of activity in the spot market to be meaningful.

In summary, AFMA considers that the Standing Council on Energy and Resources (SCER) should be advised that a threshold analysis needs to be carried out around the supervisory arrangements for the NEM as a financial market before determining whether additional regulatory measures are required in respect of market resilience.

The AEMC's careful approach in not putting forward recommendations at this stage is commended, however it is unclear why the paper defines a range of options before identifying a clear problem. AFMA's basic request is to clearly identify and demonstrate the potential for a material risk of market failure before making recommendations to intervene in the market with additional regulation. This is a fundamental basis for an effective regulatory impact assessment in accordance with the Office of Best Practice Regulation's guidance and the Council of Australian Governments (COAG) best practice. In relation to the existing well-functioning NEM, adherence to a proper assessment is of critical value to the well-being of the market.

3. Financial contagion and systemic risk

Are there other potential channels which have not been identified by this review, as discussed in chapter two?

We agree with the foundation conclusion in the Options Paper that a failure of a large electricity business would not cause major instability to the overall financial system given the extent of the exposures the financial system has towards the NEM and that the scope of consideration of systemic risk needs only to be the risk of cascading failure within the NEM and not the broader financial system in Australia.

AFMA does not consider the macroeconomic systemic risk governance and management developed for the financial system, and in particular G20 policy reforms for banking and the OTC derivatives market, are applicable to the NEM. The implementation of global systemic risk related banking and OTC derivatives reforms is proving very complex, costly and burdensome for affected financial institutions and impacts on the efficient functioning of the market. The appropriateness and benefits of such measures in effectively enhancing systemic risk management are matters which are open to continuing debate and will take a long time to assess. The underlying policy principle justifying regulatory intervention is the demonstration of, or the high likelihood of, market failure. The extension of generic systemic management measures to a self-contained, parochial market like the NEM lacks an underlying policy justification for intervention based on market failure.

4. Risks and risk management in the NEM

Please provide any additional comments you may have on the description of risks and risk management set out in chapter three.

AFMA members participating in the NEM have strong existing internal risk management frameworks approved by their boards of directors that determine overall risk management parameters. These include the business's 'risk appetite', trading limits and counterparty credit limits. Risk committees are operating under the supervision of participants' board of directors to handle day-to-day internal risk management oversight. These oversight functions are supported by internal reporting policies.

In accordance with best practice AFMA member participants segregate trading, middle office and back office functions within the company. Standard risk management practices also appear to include the testing of financial resilience under a number of stress scenarios, and measuring financial exposures through Value-at-Risk methodologies.

Do you consider there is merit in the Commission exploring the accounting standards for OTC contracts as part of this review?

AFMA considers that the AEMC should not explore accounting standards for OTC contracts. This matter sits properly within the expertise of the Australian Accounting Standards Board (AASB). The AASB has recently reviewed this area of reporting and replaced its earlier guidance on fair value measurement in AASB accounting literature with a single standard with effect on reporting periods from 1 January 2013. This standard is AASB 13 Fair Value Measurement and related AASB 2011-8 Amendments to Australian Accounting Standards arising from AASB 13.

In respect of prudentially regulated financial institutions, APRA has issued reporting instructions through Reporting Form SRF 534.0 Derivative Financial Instruments which states the expectation that reporting to it should be in accordance with AASB 13. On 16 December 2013, ASIC issued its findings on 30 June 2013 financial reports noting, amongst other things, that a number of entities should improve disclosures to enable participants to assess the significance of, and the nature and extent of, risks under financial instruments. Market participants in the NEM are expected to report in accordance with this regulatory guidance.

AASB 139 also requires listed companies and their auditors to take a view about those derivative positions that are hedge activities and those that are speculative, which enables transparency around the positions of listed companies in the sector.

5. Measuring the materiality of systemic risk

What are the appropriate methods for assessing the materiality of systemic risk in the NEM?

The report for the Private Generators Group, the National Generators Forum and the Energy Supply Association of Australia dated 14 August 2013 by Seed Advisory¹ on NEM Financial Resilience provides conclusions on this question that AFMA supports.

Is there a material risk of financial contagion in the NEM?

The conclusions in the Seed Advisory report on this question are also supported by AFMA.

6. Assessment framework

Do you agree with the assessment framework set out in chapter five? What (other) factors could be relevant when assessing the potential application of any measures in the context of the NEM?

¹ [Weblink to Seed Advisory Report](#)

On this point, AFMA refers to the analysis contained in the Seed Advisory report.

Do you think the concepts of 'systemic importance' and 'hedging' are relevant when considering the scope of applicability of any measure, and how could these concepts be best defined?

The fundamental question is whether 'systemic importance' in the way it is understood in terms of financial system oversight has any real applicability to a self-contained market like the NEM.

The main criteria for assessing systemic importance relates to the potential to have a large negative impact on the market and other participants and their customers taking into account direct and indirect impacts. Typically, the magnitude of the direct impact relates to size and the degree of substitutability, while the magnitude of the indirect impact depends on the strength of interconnectedness. Size and interconnectedness are the most frequently cited criteria in the responses to the survey, and the importance of these criteria is also illustrated by the experiences with the recent financial crisis.

- Size: The importance of a single component for the working of the financial system generally increases with the amount of financial services that the component provides.
- Lack of substitutability: The systemic importance of a single component increases in cases where it is difficult for other components of the system to provide the same or similar services in the event of a failure.
- Interconnectedness: Systemic risk can arise through direct and indirect interlinkages between the components of the NEM so that individual failure or malfunction has repercussions around the market, leading to a reduction in the aggregate amount of services.

The three criteria provide a useful analytical device to structure the assessment of systemic importance, but their relevance is often greatest when they are combined in different ways.

The link between the size of a participant and the systemic impact that its distress or failure will bring about is generally accepted as a key factor in the assessment of its systemic importance. The size of the balance sheet and off-balance sheet exposures of the organisation, the volume of transactions it engages in and processes, and the volume of assets it manages are all indicative of the extent to which its customers will be unable to carry on their own businesses, its business with other institutions will be disrupted and the magnitude of losses its counterparties may face. While size can be important in itself, it is much more significant when there are connections to other institutions.

Some participants could lack immediate substitutes for the key role they play in the market. They are systemically important not so much because other participants are financially exposed to them but because other market participants rely on them for the continued provision of key specialised services.

Interconnectedness captures situations when financial distress in one participant materially raises the likelihood of financial distress in other participants because of the network of contractual relations in which the institution operates. The larger the number of links (the larger the number of creditors and customers), the higher potential to cause spill overs onto either customers and/or creditors.

7. Potential options to reduce systemic risk

What is your view on the assumptions made regarding the limited merit of platform trading and central clearing for electricity derivatives?

The OTC electricity derivatives market has a substantial track record as a well-functioning market.

Non-standardised OTC electricity derivatives play a central role in risk management and in business decision-making that cannot be filled by standardised clearable instruments. OTC derivative transactions provide their participants with the ability to isolate, manage and efficiently match or offset a particular risk or set of risks. Participants know best how to manage their own risk and must be free to take or transfer risks appropriately. Participants that do not want risk must be able to shed or transfer it so they can focus on their fundamental business. This, ultimately, is what OTC derivatives are all about, regardless of whether they are cleared or non-cleared.

If participants are forced to shift away from using non-cleared derivatives and instead employ imperfect hedges, they will be faced with residual unwanted risk. This is the risk (commonly called basis risk) of market price changes between the underlying position and the hedging derivative instrument due to differences in underlying economic factors.

Derivatives trading in the electricity sector is dominated by asset-backed businesses that have a prevailing or 'natural' position. Generators hedge their production to secure revenue and reduce volatility in earnings while retailers hedge their load to offer contracts to customers on fixed terms. Internal risk limits dictate minimum hedging levels which are in place to limit exposure to market prices.

Non-asset backed participants in the OTC derivatives market (such as financial institutions) enhance overall liquidity and are themselves sophisticated trading entities. The complexity of trading in OTC electricity derivatives is a barrier to entry for participants without sufficient knowledge to participate, and hence the market is restricted to

sophisticated participants only. OTC derivative transactions are inherently valuable to businesses because of their non-standardised nature. They provide opportunities for bilateral transactions which are tailored to the individual needs of businesses and are often the best products for optimal hedging. The addition of constraints or removal of the current flexibilities of the OTC market would represent a loss of capability and would reduce participants' ability to manage their own risk.

Another advantage that OTC transactions offer to electricity businesses over centrally cleared ones is the reduced collateral requirements. The OTC market provides participants with flexibility on credit arrangements, which allows for tailored, and generally less onerous requirements than for exchange based contracts. Participants can take their own view on appropriate credit limits and collateral arrangements, to achieve an appropriate balance between credit and market risk exposure. This is important as the credit risk associated with participants who are hedging an underlying physical position can be lower than speculative participants.

Central clearing of all standardised OTC derivatives would be harmful to the electricity sector. Firstly, it would force standardisation of OTC contracts, with the adverse consequences articulated above; and secondly add significantly to the credit collateral requirements for market participants. This requirement would be an inefficient use of limited collateral, with no material benefit to market participants or consumers, particularly the former, who currently have sufficient regulatory and commercial incentives to manage financial risks.

The AEMC would be interested in receiving feedback on the options proposed in chapter eight. Participants are encouraged to discuss what they see as the main costs and benefits of each option, whether they see benefit in one (or more) of these options, or whether there are alternative options that should be considered.

We are particularly interested in hearing stakeholders' views on:

- Do you agree with the elements of a stress testing regime? What could be added or removed to make it more effective?

Stress testing requires equipping a regulator with prudential regulation type powers. We refer back to our comment in section 1 about examining in the first instance the appropriateness of supervisory arrangements.

- Do you currently use one or more electronic trading platforms (other than the exchange) to conduct OTC transactions? What are your views on the merit of such platforms?

Standardised centrally cleared/exchange traded products are complementary to the OTC market. They have advantages and disadvantages and participants should be allowed the flexibility to utilise both market arrangements to optimise their risk management activities. There would be a significant loss of market functionality and efficiency if participants were required to use a standardised and credit collateral intensive market environment when this is unsuited to their business needs.

- Given that a contract would need to be sufficiently standardised to be able to be centrally cleared, as discussed section 7.2.1, what percentage of your OTC contract book would in your opinion be suitable for a clearing obligation? What is the volume (in percentage of total and in MWhs) associated with these contracts?

A pre-requisite for central clearing would be forced standardisation of OTC contracts and a corresponding reduction in the ability for participants to enter into flexible arrangements to manage their risk exposures. OTC electricity derivatives meet specific needs of NEM counterparties that cannot be adequately addressed through standardised exchange traded and cleared products. For example, the timing of payments and receipts are commonly matched with the underlying revenue and expenses.

An undesirable consequence of this approach would be to discourage investment in the sector, particularly from new-entrants, as there will be fewer parties who are able to provide the necessary credit collateral required to operate in the electricity sector.

Greatly increasing collateral requirements across the industry would lead to practices where hedging strategies are driven by available collateral and not by sound risk management approaches. Ultimately it will lead to less contracting, greater spot market volatility and higher risks for the sector. Increasing the risk profile for the industry would feed through to cost increases to customers for no apparent benefit.

Due to the large volumes of credit involved in the electricity sector, there is likely to be an overall reduction in credit available to other parts of the economy which is not conducive to overall economic growth. To put the collateral requirements into context, for a contract position of 10TWh that was exchange traded, the initial margins required would be \$32M and a \$5/MWh adverse movement in price would require a further \$50M in variation margin.

This requirement would be an unproductive and wasteful use of cash or working capital headroom for a situation where a generator has not taken a position on price and simply hedged the output of its stations.

8. Options commentary

8.1. Option 1: No new measures

Option 1 canvasses a status quo approach. We note in section 1 that a threshold analysis needs to be carried out around the supervisory arrangements for the NEM as a financial market before determining whether additional regulatory measures are required in respect of market resilience. While AFMA is not advocating for change it is possible that such analysis could lead to a rationalising of regulatory oversight. For example, the role of ASIC might be deemed redundant and a recommendation made to exempt electricity derivatives from the definition of financial product could be made.

8.2. Option 2: Trade Reporting

There is no significant net benefit to the economy from increasing the coverage of reported electricity derivative transactions. End-user exemption is planned based around a threshold size or volume of trades which would mean that only partial reporting would apply which may mean that two or three market participants might be required to report. The limited number of participants would restrict the publication of the data, even at the aggregated level proposed for the Trade Repositories' reporting, because of the potential to identify commercially sensitive information about participants' positions and strategies.

AFMA considers that hedging activities by end-users should be exempt from reporting entirely. The Australian Accounting Standard AASB 139 already requires listed companies and their auditors to take a view about those derivative positions that are hedge activities and those that are speculative, providing a high degree of transparency into the positions of listed companies in the sector.

The analysis in the Options Paper also only discusses the purposes for which ASIC is seeking trade reporting data. It should be remembered that the primary purpose for the introduction of the trade reporting regime is to provide data to systemic regulators. In Australia's case this is the Reserve Bank. ASIC and APRA may also use the data in ways relevant to their respective objectives. For ASIC this means for market integrity purposes around the conduct of participants and by APRA when looking at the market and counterparty credit risk exposures of prudentially regulated institutions. There are strict controls around how trade repository data may be shared and it requires legislative permissioning to allow such data to be provided beyond the confines of the three financial sector regulators.

As noted in section 1 of these comments, it is unclear how effectual use could be made of OTC electricity derivatives data for systemic risk analysis under current supervisory arrangements.

8.3. Option 3: Stress test reporting

While stress testing sounds like it might have simple appeal, it could have a serious downside consequence as it is likely to impose significant distortions and costs. It would effectively act as a prudential standard and distort participant risk management decisions towards the stress test and specific risks when a portfolio approach would otherwise be appropriate. Further, it is unlikely that any one test would be applicable to all entities or capture information regarding their key risks.

8.4. Option 4: Code of best practice

AFMA notes without making any recommendation industry led initiatives in developing and maintaining codes of best practice which have proved successful in the financial sector. Industry bodies like AFMA can facilitate the development and support for codes of best practice.

8.5. Option 5: Trade reporting and additional margin requirements

Beyond our comments on trade reporting in respect of Option 3 we note the analysis by Seed Advisory indicates that the total cost of an OTC market default is dominated by the costs arising from spot and derivative market behaviour after the default. Assuming this is correct, then introducing mandated credit support for all OTC derivatives or requiring margining has the potential to increase the capital required of industry participants without necessarily reducing the risks to those participants.

8.6. Option 6: Stress test reporting and additional supervision and regulatory powers.

Again we refer to the need to look at current supervisory arrangements before considering additional supervision and regulation.
