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Mr John Pierce
Mr Neville Henderson
Dr Brian Spalding
Australian Energy Market Commission

Dear Commissioners

Lodged electronically: www.aemc.gov.au (EMO0024)

## NEM financial market resilience second interim report

EnergyAustralia welcomes the opportunity to make a submission on the 'NEM financial market resilience' second interim report (*the report*).

EnergyAustralia is one of the country's leading retailers, providing gas and electricity to more than 2.7 million customers. We own and operate a range of generation and storage facilities, including coal, gas and wind assets, in NSW, Victoria and South Australia.

The second interim report builds on two years of intensive review. Consistent with our previous submissions on the various options and issues papers, we welcome two key findings in the report that confirm:

1. The 'retailer of last resort' (RoLR) scheme needs reform. RoLR is a poorly designed regulatory intervention that acts to exacerbate the risk of financial contagion. We support the incremental improvements recommended.

2. There is no case for new regulatory interventions in NEM financial markets. The cost of new regulatory interventions will exceed potential benefits and, in particular, there is no case to extend the proposed G20 derivative reforms to electricity participants.

The costs of RoLR are imposed on retailers that bear no responsibility for the failure of the initial retailer. Mitigation of the risk of financial contagion in the NEM should focus on reform of the RoLR arrangements, complemented by broader reforms to facilitate the long term economic sustainability of the electricity market, such as fully deregulating retail prices.

We welcome the Commission's key recommendations to reduce the costs and risks of RoLR.

- Improved cost recovery. To increase certainty the RoLR can quickly recover costs.

- Reduce the scale of RoLR coverage. Excluding very large customers will significantly reduce the magnitude of RoLR costs and more efficiently allocate risk.

- Delay additional network credit support. Avoids a potential step change in prudential costs (up to $700 million) and more efficiently allocates risk.

- Improving RoLR administration processes. In particular ensuring provision of timely and accurate data to help the RoLR understand, price and cover their new load.

There is scope to extend and improve these recommendations by delaying payment for all network costs in a RoLR event, and progressively decreasing the threshold for coverage.

We do not support the recommendation that the Government review Australia's corporate insolvency regime with a view to creating special administration arrangements for electricity retailers defined as 'too big to fail' or 'systemically important market participants' (SIMPs).

The rational proposed is for special administration is weak:

1. Inability to conclude there is no risk to financial stability in any future circumstance. This is an unreasonable test. There will always be some residual risk and seeking to achieve zero residual risk would impose excessive costs on consumers and tax payers.

2. An administrator cannot be relied on to act consistently with the National Electricity Objective (NEO). The administrator would face the same commercial incentives as all electricity retailers to deliver electricity services to customers efficiently and reliably.

Special administration for electricity retailers is disproportionate to any identified problem. The investigation and design phase would create uncertainty, and implementation would be complex, risky and expensive. The stated intention is to reduce the rights of creditors and make them subordinate to the needs of customers and market stability. Logically this would increase funding costs for electricity retailers, and potentially their owners.

It would be preferable to explore reforms to NEM rules that would facilitate ordinary administration without compromising prudential quality.

**Conclusion**

We strongly support the report's findings that the case has not been made for further regulatory interventions in NEM financial markets and the recommendations to improve RoLR arrangements.

We do not support the recommendation to create a new class of 'systemically important market participants' and apply special administration arrangements to them.

A response to the specific issues raised in the consultation paper is attached. For any questions regarding this submission, please contact me on (03) 86281034.

Regards

Ralph Griffiths

**Ralph Griffiths**
Wholesale Regulation Manager

**NEM financial market resilience, 2nd interim report, detailed response**

Note, please see our responses to the earlier stages of the review for more detail.

1. Issues paper July 2011 (TRUenergy)
2. Options paper December 2012
3. First interim report July 2013
4. Stage two options paper December 2013

*Chapter 1: Assessment framework*

We continue to support the assessment framework used for the review.

Reforms should be consistent with the criteria:

- Contribute to a reduction of the risk of financial contagion in the NEM
- Consistent with efficient allocation of risk in the market
- Effective, and unlikely to lead to perverse behaviour or moral hazard
- Transparent and accountable
- Proportionate to the impact on the market of the risk being addressed.

The findings, recommendations and reforms proposed by the AEMC are generally consistent with these criteria. The apparent exception is the proposal for new special administration arrangements. This is not proportionate or effective and may lead to perverse outcomes.

*Chapter 2: Risk to financial system stability through financial interdependencies*

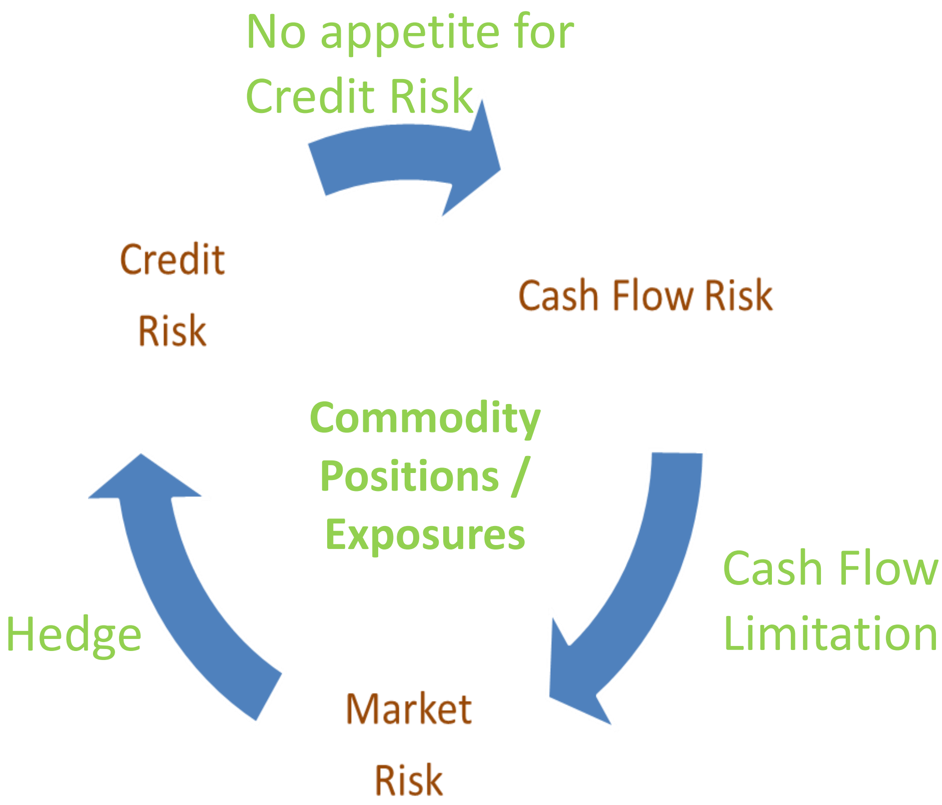
The second interim report provides a good description of the financial interdependencies in the NEM.

We are disappointed that the report continues to imply that OTC derivatives are inherently riskier than Futures contracts. All submissions by market participants to the stage 2 options paper noted that this implication is misleading.

The report suggests that contract counter-party default creates the most likely potential risk to financial stability in the NEM. This leads to the conclusion that OTC derivatives give rise to a more significant risk of financial contagion than the spot market or the futures market. The rational for this is that the prudential regime in the spot market, and margining in the futures market, manage counter party credit risk.

This reflects a narrow focus on credit risk that is inconsistent with the reports recognition that participants need to manage market, credit and cash flow risk concurrently.

The inherent risk for electricity retailers and generators is the market risk that is created by their decision to generate or retail electricity. Contracting via futures and OTC derivatives are controls that help transfer and manage risk. Hedging with OTC derivatives can reduce market risk, but with increased exposure to counter-party credit risk. Moving to Futures contracts can reduce credit risk but with increased exposure to cash flow risk.




Futures are not inherently superior to OTC derivatives. Collateralisation does not inherently reduce the cash flow risk arising from exposure to the physical market. There is no single optimal answer to the trade off between market, credit and cashflow risk. It depends on the business, the options available and the relative prices.

The 'worst cast' analysis by SEED and Frontier Economics demonstrates that the majority of costs facing a RoLR arise from 'secondary effects' driven by assumed changes in the physical market post default (ie high spot prices). Margining, collateralisation and use of futures does not reduce these costs or the risks they create. This supports the conclusion in the report that the cost of new financial market regulations would exceed the benefits.

*Chapter 3: Risks fo financial stability in the NEM – retailer of last resort*

We agree with the conclusion that the RoLR scheme creates a risk of financial contagion by imposing 'upfront' costs on the RoLR. The key challenge for the RoLR is to fund an immediate increase in working capital and credit support to meet settlement and prudential requirements for energy and network costs.

We welcome the Commission's recognition of the potential step change in increased network credit support, up to $700 million for a very large retailer failure.

Regulated monopoly network businesses are well placed to manage this credit risk for the extended period post RoLR transfer. They have a large regulated asset base and well established processes to recover any RoLR costs from all consumers in their service area.

We welcome the AEMC's new recommendation that the need for the RoLR to post network credit support should be delayed. To minimise the risk of financial contagion networks should temporarily bear the credit and cash flow risk associated with transition after RoLR for the failed retailer's customers.

This delay should  be extended to 3- 6 months to reflect the intensity of activities that need to be implemented following a RoLR event.  The first priority is ensuring continuity of supply and customer service.  A retailer will take some time to source and gain approval for additional credit support and this should not come at the expense of customer service.

*Chapter 4 Assessment of current arrangements to identify and mitigate risks to financial stability in advance*

There are strong governance and regulatory frameworks in place for the physical and financial markets in the NEM. All financial market participants must hold an Australian Financial Service Licence and are regulated by ASIC. As noted in the report, ASIC has recently examined risk management of electricity participants and concluded that:

> *'Generally, we consider that market participants' risk management policies and 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'.*

This finding is consistent with the representations made by all participants throughout the NEM financial market resilience review. It should not be surprising, as the commercial incentives for participants to identify and manage financial risk are extremely strong in the NEM. The robustness of participant risk management is frequently tested given the highly volatile nature of the electricity spot market.

No market failure has been identified to justify additional regulatory intervention.

*Chapter 5 Assessment of the current arrangements to respond to events that threatened financial system security*

The report concludes that the current arrangements to respond to events that threaten financial system stability in the NEM are not adequate for responding to a large participant failure.

This case has not been made and the finding is not consistent with the analysis of the risks.

A case has been made that RoLR is a flawed intervention that should be reformed and the automatic suspension of a market participant who is placed in external administration should be reviewed.  However, these issues are amenable to well-targeted reforms and it is not apparent that fundamental governance changes are necessary.

The AER, AEMO, ASIC and state regulators do have differing roles related to RoLR. It is difficult to imagine the circumstance when one of the relevant regulatory bodies would revoke a major retailer's licence to operate without considering the implications and communicating with relevant Governments and agencies. If needed, formal agreements to ensure appropriate communication between the agencies should be straight forward to implement.

We note that the AER and ASIC are both federal Government agencies, and AEMO is in regular contact with the Commonwealth. The National Electricity Retail Law requires the retailer to inform the AER and AEMO if it becomes aware of any circumstance which may at some time give rise to a RoLR event[1].

The best way to reduce coordination issues is to reduce the number of agencies and levels of Government involved. Complete implementation of the National Electricity Retail Law and elimination of state retail licences could have the additional benefit of allowing States to

[1] NERL, section 150

remove themselves fully from RoLR processes. This would be appropriate given the increasingly national electricity retail market.

The existence of the RoLR scheme provides a strong incentive for owners and creditors of a large retailer to address potential solvency issues and engage with Government well in advance of considering administration.

*Chapter 6 Responding to a large participant failure*

The report recommends the establishment of a separate framework to respond to the failure of 'systemically important market participants' (SIMPs). Essentially a separate process for retailers defined as 'too big to fail'.

Such a framework would gather to a single decision making point all the decisions that would make up the response, which could include:

- Allowing the SIMP time to rectify its financial condition (subject to conditions), allowing viable market arrangements to be explored prior to applying regulatory arrangements.
- Where the SIMP must be suspended from the market, a choice between applying the RoLR or an alternative arrangement.

The review suggests that the Chair of the CoAG energy Council should be the ultimate decision maker. Furthermore the review recommends the establishment of a 'NEM Resilience Council', including the AER, AEMC, AEMO and ASIC to define who is a SIMP and advise the Minister in the event a retailer fails.

The case for the establishment of a new council has not been made.

While there may be coordination issues under the current regime, the uncertain and complex governance proposed would increase coordination issues and uncertainty. At least until the arrangements are fully defined, in say 5 to 10 years, and then tested (which could be decades).

If Government did decide to intervene to support an electricity retailer, the decision would almost certainly need to be taken by the Commonwealth Treasurer. The Commonwealth Energy Minister, ASIC, AER and AEMO would certainly make themselves available to advise the Treasurer. A memorandum of understanding between the relevant agencies may be useful, but it is not evident that there would be benefit in more complex formal governance architecture.

We note that the Commonwealth recently abolished a very similar body, the 'energy security council'[2], as it determined the council was unnecessary. We also note that the AEMC has no operational role or relevant powers in relation to responding to a retailer failure. Again there would seem to be no practical impediment to the Government calling on their advice and no need for additional governance arrangements.

Introducing different arrangements and obligations for different classes of retailers (SIMPs and others) would create new distortions in the retail market and complex boundary issues as market shares evolve.

*Chapter 7: Stability arrangements*

We do not support the recommendation to create exceptional administration arrangements for electricity retailers. This approach is not well targeted or proportionate to the problem.

[2] http://www.treasury.gov.au/Policy-Topics/PeopleAndSociety/completed-programs-initiatives

Implementation would have far reaching consequences well beyond the operation of the RoLR and would necessarily be complex, costly and risky to implement.

In the first interim report the AEMC asked stakeholders two key questions:

1. Is there a need or justification for an alternative to the current arrangements to effectively manage the failure of a large retailer?

2. If additional arrangements are justified, is the specific design of the special administration regime (SAR) appropriate?

The resounding answer to both questions from all market participants was 'no'. In relation to question one it is well recognised that RoLR arrangements need reform and there is scope to reduce coverage of RoLR (or remove it altogether).

There was no support from affected participants for special administration.

The core element of the proposed administration is to change the objective of the administrator from maximising returns to creditors, to maintaining financial system stability and minimising the impact of the failure of a SIMP on consumers.

The change seeks to ensure creditor interests are subservient to market and consumer interests. Rationally, this must affect the credit worthiness and funding costs electricity retailers (and potentially any business owning an electricity retailer).

A key rationale for special administration is that an administrator acting in the interests of creditors may not supply customers consistent with the National Electricity Objective (NEO).

The case that an administrator's actions would not be consistent with the NEO is weak.

In the NEM, electricity retailers seeking to maximise their profit in response to market incentives deliver electricity services efficiently, reliably and safely, consistent with the National Electricity Objective (NEO). An administrator guided by the same market incentives would be likely to appropriately service and/or endeavour to sell their customers list. Both profits and returns to creditors are maximised by selling customers all the electricity they wish to consume at a price above the cost of supply.

The report suggests that in the absence of a plan to manage and respond to a SIMP failure, there is likely to be pressure on the stability of the system and a potential expectation for government to intervene. The creation of the SIMP designation and a plan to respond will confirm an expectation that the Government must and will intervene.

The report identifies that the RoLR process is not an ideal way of liquidating a large number of customers, and that supporting the failing company and/or facilitating a trade sale with an ordered transfer of customers is likely to be a preferred SIMP plan. This may be true, however this only supports the conclusion that the RoLR is a poorly designed regulatory intervention that needs reform.

Nothing in the analysis identifies a fundamental market failure to warrant special administration arrangements to apply exclusively to the retail supply of electricity.

*Chapter 8 Changes to existing arrangements – the RoLR scheme*

We generally support the proposed changes to the RoLR scheme. The most important changes proposed are:

1. Revised RoLR cost recovery to increase certainty the RoLR can quickly recover costs.
2. Limiting the extent to which RoLR arrangements apply to very large customers
3. Delaying additional credit support requirements for DNSPs
4. Improving RoLR administration processes, particularly ensuring provision of timely and accurate data

These changes directly target key flaws in the design of the RoLR scheme and would significantly reduce the risks. The RoLR scheme imposes significant costs on the RoLR and a step change increase in the need for working capital:

- Increased certainty of cost recovery will help RoLRs source short term funding.
- Excluding very large customers will reduce the magnitude of RoLR costs. The cost imposed on a RoLR is directly proportional to the customer load. Excluding sites whose annual consumption exceeds 10 GWhs will reduce load by 15-20% while affecting fewer than 1000 sites (and even fewer customers).
- The Frontier analysis identifies that delaying credit support to DNSPs could reduce immediate prudential costs for the RoLR by upto $700 million. It is also a more efficient allocation of risk.
- Timely accurate data about RoLR customers, including historical use, is essential to help the RoLR understand, price and cover their new load.

There is scope to extend and improve these recommendations.

Delaying payment for all DNSP costs in a RoLR event would reduce the risk of financial contagion and represents a more efficient allocation of risk. A delay of 12 weeks would better match the current billing cycle for most mass market customers. The RoLR should not be required to post prudentials to DNSP's or pay network costs in relation to RoLR customers before they bill those customers. The DNSP is well placed to bear the credit risk that RoLR customers do not pay their network component of their bills. Network regulatory arrangements could ensure cost recovery, and the customer cannot easily change network service provider to frustrate debt collection.

Consumption of 10 GWhs per year at a single site is a reasonable initial threshold. Single sites with electricity bills over $1 million dollars are well placed to consider and manage their own supply chain risks.

There are very strong advantages to financial stability and efficient response to large retailer failure associated with the exclusion of very large customers, particularly if the event coincides with high spot prices:

- Remove a large volume of load while affecting a very small number of customers
- Efficient allocation of risk. The customer is best placed to determine how to respond, including potentially reducing consumption.
- Some very large consumers, including multinational corporations and Government agencies, will have stronger credit ratings than their retailer and the financial strength to back their own RoLR arrangements.
- Some very large consumers may not be viable with high electricity prices. Default by a few very large customers may be the trigger for the default of the RoLR.

The Commission proposes to exclude sensitive loads (major health and transport services), so they remain within the current RoLR arrangements. While this is understandable on one level, it would be deeply concerning to think that very large sensitive electricity users did not actively identify and manage all contingencies that may impact their supply. Many of these consumers are Government owned, or implicitly backed by Governments for the provision of essential services. They should be best placed to manage their own arrangements. The complexity involved with identifying and excluding these loads may outweigh the benefit.

Over time the threshold for exclusion from RoLR could be progressively reduced as arrangements developed for very large customers are fully developed and standardised.

On balance we accept the recommendation to provide a brief delay in the AER appointing RoLRs and for RoLRs to provide credit support to AEMO. It is important in designing these changes to ensure that the credit quality of NEM settlements is not materially reduced, as this could transfer financial contagion risks to generators:

- Delay in credit support of one week and then ramping up over the following four weeks provides a reasonable balance between the objective of smoothing the impact on the RoLR and maintaining the prudential quality in the NEM.
- Providing the AER with an additional 24 hours to nominate RoLRs is not unreasonable, and may provide time for additional RoLR's to be 'encouraged' to nominate.

We support the Commission in not supporting the introduction of a temporary reduction in the Market Price Cap (MPC) or deferral of settlements related to RoLR customers during high price events.

Chapter 9 Market suspension under the NET

We support the recommendation to clarify the NER to allow the possibility of not suspending a participant, or parts of its activities, from the market when it is under external administration.

Generators are natural creditors to the market and there is no obvious rationale for suspending a generators registration because they are in administration. Suspending a generator during a period of market instability and very high prices is counterproductive and not in the interests of consumers.

Further it is not evident that any participant should be automatically prohibited from trading while in administration. If the administrator guarantees to meet all their trading obligations and provides appropriate prudential cover, then an orderly administration (restructuring or liquidating customers) is likely to be less disruptive than triggering RoLR.

This appears to be the logic behind the Commission's recommendation to develop special administration arrangements exclusive to electricity retailers. A better targeted and proportionate response to the issues raised by the RoLR scheme would be to review how the National Electricity Law and Rules could be modified to accommodate normal company administration.

Any participant allowed to operate in the market while under external administration should be required to meet all of the obligations that apply to any other participant. In particular the administrator would need to guarantee to meet all future debts and other obligations that result.

*Chapter 10: Risk management and transparency measures*

We agree with the Commission's view that the case is not established for mandating any additional regulatory measures to NEM financial markets, and that:

- The costs would outweigh the benefits
- The nature and magnitude of risks to electricity participants differ from the financial sector
- The measures would not address the key risk to NEM financial stability, the RoLR scheme

*Chapter 11: Advice on the G20 measures for OTC reform*

We agree with the Commission's view that the costs of implementing the G20 reforms would outweigh any benefits:

- Trade reporting (transaction level reporting) would impose significant costs and regulatory burden. There are no evident benefits to system regulators.
- Mandating central clearing could inefficiently discourage the use of OTCs to mange market risk.
- Margining and capital requirements would increase the cost of hedging and reduce the options available to participants to manage market risk.
- Development of electronic trading platforms is more appropriately driven by market demand for the service. Mandating the use of what is effectively a monopoly service will increase costs.

The failure of an electricity market participant would not create a material risk to the broader financial system. It is therefore not appropriate nor proportionate to apply these measures to electricity derivatives to protect the overall financial system.

We believe the Commission's findings and analysis in respect to the merits of applying the OTC reforms to electricity derivatives also apply to their application to gas and other commodities. The Commission should recommend the existing exemption for electricity derivatives be permanent.

The AEMC's role includes development of gas markets under the National Gas Law and we encourage the Commission to consider making the observation that Government should extend existing exemptions for electricity derivatives to gas derivatives. .