INFORMATION

NEM financial market resilience

Publication of AEMC issues paper

The AEMC has published an issues paper commencing consultation on advice it has been asked to provide to the Standing Council on Energy and Resources (SCER). This advice will assess the resilience of the financial relationships and markets that underpin the operation of the National Electricity Market (NEM).

Advice requested by SCER

At its December 2011 meeting, SCER requested that the Australian Energy Market Commission (AEMC), with input from market participants, provide advice on any risks to the efficient functioning of the NEM arising from financial interdependencies between market participants as a result of their exposure to a common spot price and their hedging arrangements.

SCER has requested AEMC advice on:

- the nature of any risks to financial stability in the NEM arising from financial interdependencies between market participants;
- whether the existing mechanisms to mitigate these risks are adequate; and
- if necessary, options to strengthen those existing mechanisms and minimise the identified risks and their consequences.

Financial relationships in the NEM

Generators, retailers and other businesses in the NEM have complex financial relationships with each other. These relationships primarily arise from the financial contracts that participants use to hedge their exposure to the spot price for electricity.

Electricity retailers and generators that participate in the NEM buy and sell almost all of their electricity through the wholesale spot market. Retailers and generators pay and receive the spot price for this electricity. The spot price is calculated every 30 minutes and can be highly volatile – it can vary between $12,500 and -$1,000 per megawatt hour.

This spot price volatility creates significant risks for retailers and generators. They manage these risks by entering into a range of financial relationships with each other and with other financial market participants, including a variety of types of hedge contracts.

These financial relationships can create a high level of financial interdependency between market participants. As a result, there is a risk that if one participant encounters significant financial difficulties, other participants could also be affected. These interdependencies could mean that an unexpected or unusual event or series of events could lead to financial contagion that affects several businesses and the overall efficiency of the market.

Generators and retailers currently adopt a range of strategies to manage these risks. They are also subject to the requirements of financial regulators and external parties such as brokers and exchange operators, which may mitigate some of these risks.

Our initial view is that the financial relationships and markets that underpin the efficient operation of the NEM are generally robust. However, energy and financial markets around the world have been subject to periods of significant stress in recent years, for example during the global financial crisis.

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Our advice will assess whether the financial relationships and markets underpinning the NEM are sufficiently resilient to manage an unexpected event or series of events that could result in one participant's financial distress being transmitted to other participants and causing financial contagion that could hinder achievement of the National Electricity Objective.

The issues paper commences public input into the development of the AEMC's advice on risks to financial stability in the NEM arising from financial interdependencies between market participants

Submissions are due by 20 July 2012

Issues paper

We have commenced this advice by producing an issues paper for public consultation.

The issues paper:

- explains the nature of the financial relationships between NEM participants;
- explores the concept of financial interdependency in the NEM and the potential risks to the achievement of the National Electricity Objective as a result of financial interdependencies between market participants;
- provides some examples of unusual or unexpected events that might give rise to the risk of financial contagion – ie the risk that one participant's financial difficulties will be transmitted to other participants as a result of financial interdependencies between participants;
- describes the existing risk mitigation strategies adopted by market participants to manage these risks; and
- sets out our reasons for focusing as a first priority on the potential risks to market stability following the failure of a large retailer and the resilience of the NEM's retailer of last resort arrangements in the event of such a failure.

The issues paper was developed with assistance from an industry working group.

Next steps

The AEMC invites comments on the issues paper, which contains specific questions relating to the nature of financial interdependencies in the NEM.

Submissions are due by 20 July 2012.

Following receipt of responses, we intend to develop an options paper and an interim report by the end of 2012 that address potential options for mitigating the risks and consequences of the failure of a large retailer.

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