

18 December 2013

Rachel Houston  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Ms Houston

**RE: STAGE TWO OPTIONS PAPER: NEM FINANCIAL MARKET RESILIENCE**

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (the Commission) *Stage two options paper: NEM financial market resilience* (your reference: EMO0024).

The GFC and subsequent G20 derivative reform agenda have driven a number of recent consultations, including those by ASIC, the Commonwealth Treasury, and the Council of Financial Regulators (ASIC, APRA, RBA). Given this, the Commission's work on NEM financial market resilience is being closely observed by a range of parties and will inform how these bodies interpret the issues and choose to move forward. We note in particular that the Treasury is looking to the outcome of this consultation process to provide direction on the application of G20 requirements on the electricity sector.

We support the Commission's release of a special Options Paper to address the issues and we discuss the options presented in some detail in this submission. In summary, we do not believe there is a case for new policy measures to address systemic financial risk in the NEM resulting from OTC electricity derivative counterparty failure. We do not believe that material systemic OTC counterparty credit risk actually exists (at least not in a way that might be predicted and managed), and we note that this is a position supported by an independent consultant that addressed the various risks and exposures for different counterparties in the NEM.<sup>1</sup>

In ERM Power's view, spot price volatility in the NEM is so extreme that the most resistant market will be one where generators and retailers are fully hedged with bespoke agreements such as OTC electricity derivatives. Policymakers should *want* parties to use OTC derivative contracts: they are efficient and low cost.

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<sup>1</sup> Seed Advisory, in work carried out for the Private Generators' Group, National Generators' Forum and Energy Supply Association, found that the immediate loss as the result of a failure of a large derivative counterparty would not be enough to result in further contagion and systemic risk to the NEM. See Seed Advisory (2013) *NEM Financial Resilience*, 14 August 2013, at <http://www.aemc.gov.au/Media/docs/Consultancy-report-by-Seed-Advisory-61a83f79-d4d6-4444-81c2-2cd990bd6e58-0.PDF>



In fact, regulating OTC markets only introduces more risk and cost. This can be in the form of the market risk from unhedged positions when OTC electricity derivative contracts are made sufficiently unattractive to market participants, cash flow risk from potential margining requirements, or the increased costs from inefficient hedges if OTC contracts are forced into standardised forms. Reduced use of the OTC market also will reduce its liquidity, which will only cost participants more (and eventually consumers).

To be clear, risk is an inherent aspect of the NEM and the total risk cannot be reduced; it can only be transformed. Of the risk trade-offs, that is, between market risk (spot price), credit risk (counterparty failure) and cash flow risk (increased margining), credit risk is the most manageable, and is already managed through a range of sophisticated complementary measures by risk experts.<sup>2</sup>

### **About ERM Power**

ERM Power is an energy company listed on the ASX that operates electricity sales, generation, and gas exploration and production businesses across Australia.

We have led the development of six power stations, representing approximately 5 per cent of Australia's total power generation capacity. All six power stations have been gas-fired. We have divested our interest in four of these power stations.

Our energy sales business, ERM Power Retail, is licensed to sell electricity in all Australian states, the Australian Capital Territory and the Northern Territory, and has grown organically to become the fourth largest seller of electricity in the National Electricity Market by load.

ERM Power Retail (branded as ERM Business Energy) specialises in providing electricity to business and government customers. We have accrued over 13 per cent of the large Commercial and Industrial (C&I) customer market, and this year we started to offer electricity to the Small to Medium Enterprise (SME) segment of the market.

### **Overview of ERM Power's position on NEM financial resilience**

Before addressing the Commission's questions to stakeholders we thought it useful to articulate ERM Power's perspectives on the consultative process and issues raised.

#### *We need to be realistic about objectives*

An issue with several of the NEM financial resilience debates to date (across policymakers) is that they conflate a number of issues and different perceptions of risk. The concerns that many people have about financial contagion based on experience in the financial services industry have translated into potential policy assumptions for the OTC market (and the NEM), such as:

- (a) the OTC electricity derivative market is not sufficiently transparent, which means there is unnecessary and unmanaged risk of financial market contagion from counterparty failure;

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<sup>2</sup> Note that we have not included settlement risk given this is managed by the AEMO prudential regime.

- (b) if there was greater transparency about OTC electricity derivatives, the market and its regulators could somehow do things differently to avoid potential crisis; and
- (c) policy measures to support further regulatory intervention (potentially including margining requirements) or oversight of OTC electricity derivatives will reduce the risk of financial contagion in the NEM.

In our view the assumptions above, the links between them, and most of the policy measures proposed to date under (c), are not valid. There is no evidence of market failure, and the likelihood of NEM-wide financial distress from OTC derivative credit risk has not been examined with any rigour<sup>3</sup> (although we note the Commission's Option Paper commences this process). Further, the assumption that an as yet undefined financial crisis can be averted through greater external intervention and cost to the system seems optimistic. We don't actually know what a NEM financial crisis would look like, how it would come about, or what anyone could do to identify or prevent it.

ERM Power believes that the debate needs to refocus on a pragmatic assessment of material systemic credit risk in OTC electricity derivatives, specifically to discover if it exists, where it comes from (if indeed it does exist) and what realistic and appropriate means of avoiding or managing risk might be proposed. We need to unpack the assumption that catastrophic risk, or 'black swan'<sup>4</sup> type events can be avoided if only we tweaked certain aspects of what is a complex and sophisticated market.

If we do not take a more evidence-based approach to this issue, the cost of unnecessary interventions will be high, potentially even leading to the market participant failures that we are concerned to avoid. To be clear, while not precisely a self-fulfilling prophecy (because catastrophic NEM financial contagion is unlikely under any circumstance) jumping at shadows could bring about a costly RoLR event.

We are pleased that the Commission's Options Paper appears to follow this path of pragmatic analysis, and we are largely supportive of the Commission's approach to date. We particularly support the Commission's statement on page 44 of the Options Paper that it will:

...only recommend the implementation of any of the measures and options discussed in this paper if we consider that:

- the existing market and regulatory risk management mechanisms are inadequate or could be enhanced, strengthened or supplemented;
- a deficiency has been identified that results in material risk of contagion; and
- implementation of the measure would be likely to promote efficient investment in, and efficient operation of electricity services for the long term interests of consumers of electricity.

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<sup>3</sup> With the exception of the Seed Advisory work referred to previously.

<sup>4</sup> That is, an event that is extremely difficult to predict; it is random and beyond usual expectations.

However, we do have some concern that other aspects of the Commission's analysis may be unrealistic, depending on how they are addressed in further consultation. For example, the Commission states on page 10 of the Options Paper:

To assess the risk that the failure of one market participant will lead to the subsequent failure of other participants due to the nature of hedging arrangements between participants, an evaluation of the following four issues is particularly important:

- (a) whether market participants are able to correctly identify their level of interconnectedness with other market participants and are able to quantify their potential liabilities of a counterparty default;
- (b) whether participants are determining their trading credit limits with other market participants to appropriately mitigate the risk of contagion occurring;
- (c) whether participants are assessing credible stress scenarios to understand how unexpected variations in market outcomes (eg, spot prices, generation capacity) could compound the liabilities incurred with counterparty risk. This checks whether risk management strategies are robust enough to manage the risk of a number of coinciding events (coincidence risk); and
- (d) whether the level of reserves and available cash flow margins are set accordingly, taking (b) and (c) into account to confirm that the business can survive the impact of another market participant failing.

These are good questions but we cannot see how an external party such as the Commission, or a regulator, is going to know the 'correct' answers, particularly to (a) and (b).

First, there is no evidence to date that there could ever be 'correct' answers to these questions that could be applied in an objective and ex ante sense. Each market participant will run its risk approach differently, based on business investments, diversification into other areas, past experience and risk appetite. The correctness or otherwise of any approach will be context-specific to the organisation, as well as being specific to future multiple contexts (and how businesses view these) that may or may not come to fruition and that no party can naturally predict more than another.

Second, regardless of whether there can ever be risk approaches that can be judged more or less 'correct' ex ante, ERM Power believes that we cannot expect any of the proposed policy measures to put a regulator in the position of recognising whether market participants are correctly identifying their level of interconnectedness as per (a), whether participants are determining their trading credit limits to 'appropriately mitigate the risk of contagion occurring' as per (b), or whether anyone is in the position of predicting multiple variables across the NEM and the economy to 'confirm that the business can survive the impact of another market participant failing' as per (d). Item (c) runs into some of the same issues, with an inherent expectation that 'coincidence risk' can be fleshed out and turned into credible stress scenarios with some degree of agreement across industry and policymakers.



Market participants' traders and risk managers are trained specialists who are operating within their specific technical and investment environment, and already adhering to existing regulations, including accountability to their own Boards. Government regulators are by definition not able to manage an individual business's risk better than the business's own professional risk managers. This may not be palatable to those who are concerned about risk in the NEM but it does not make it less true.

ERM Power believes that the Commission and any participants in this consultation process should go through a process of real reflection on what is possible rather than what might be 'nice to have' in a perfectly rational future world. We have seen a number of consultations in recent years across the energy industry where there is a belief that a complex environment can be rendered clear and manageable to external parties (such as regulators and policymakers) if only there was more data. The further assumptions underpinning this are that: the new data will be fundamentally useful and meaningful in ways that current data is not; and regulators and policymakers will have capacity to monitor the new data and transform it into useful information (that they can confidently act on) in ways they have not done in the past.

These assumptions are generally wrong: data is just data and the process of turning it into genuinely useful 'information' will be no more easy in the future than the past. The chances are it will just be more noise in a policy environment that will continue to search for ways to be more comfortable about the very real and unavoidable risk in the NEM.

*There is no evidence to support new policy measures*

We note that Option 1 is for the Commission to make a recommendation to SCER that existing arrangements provide sufficient mitigation of systemic risk and so there is insufficient justification to introduce any new measures. We support Option 1 for two primary reasons:

- 1) For natural market participants (generators and retailers), OTC and on-exchange contracts such as through the ASX are used to manage exposure to volatile spot price risk, and are based on physical positions in the market. This is hedging, not speculation, and does not carry with it the same risks as the financial services industry. Therefore exemptions from G20 conditions are warranted and the concerns that some have about financial contagion in the NEM should be tempered by a recognition of this fundamental point of difference from the financial services industry.
- 2) Retailer and generator trading and risk management are already highly regulated, both externally via AFSL requirements, accounting standards and Corporations Law, and internally via businesses' credit management policies to manage both commercial risk and compliance requirements. Traders and risk managers run sophisticated systems under rigorous risk management policies. External intervention or assessment of market participants' risk management via reporting or other such measures is unlikely to identify better ways of managing risk at least cost.

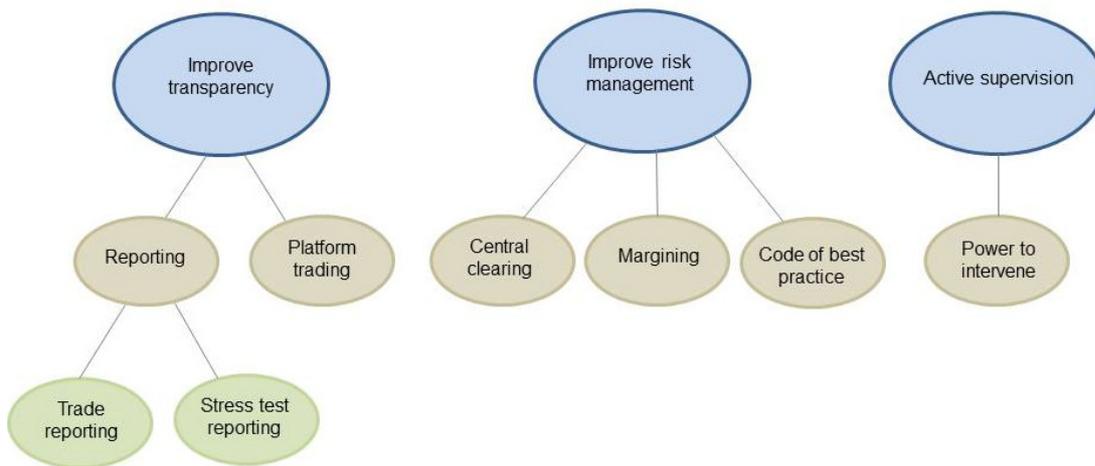
Financial contagion is always possible under very specific circumstances, but we suggest that these circumstances are highly unlikely and the costs of trying to avoid these circumstances through new policy measures will outweigh the benefits. Such actions will not support the NEO.

*However a measure to promote transparency may be a palatable alternative*

Despite our belief that Option 1 is the only valid approach, we recognise that this may not be acceptable to stakeholders who are concerned about what they do not know about how market participants manage risk, and how OTC electricity derivatives contracts are managed in particular. The range of concerned stakeholders is large and there may be a political need to ‘do something’, even if the issue has not been sufficiently proven to exist.

Therefore we have considered the alternatives proposed by the Commission. We have reproduced the Commission’s proposed range of potential policy measures from page 43 in Figure 1 below to assist in the discussion.

**Figure 1: The Commission’s range of potential measures (Figure 5.1 in Stage two options paper: NEM financial market resilience)**



Taking the options at the highest level of *improving transparency*, *improving risk management* and *active supervision*, the most we can support is a policy measure to improve transparency. As noted above, risk management is already extensive and requires no further policy support, and the law and regulation already in place means that further supervision and potential intervention is likely to be duplicative at best and costly and harmful at worst.

The question then remains about what transparency means and what objective is to be met. Is the objective to test/demonstrate the resilience of the NEM to OTC electricity derivative counterparty failure? We are assuming this is the case.

The only policy option we can support is a refined version of the existing annual OTC Derivatives Survey, jointly conducted by APRA, ASIC and the RBA (‘the agencies’). The survey already covers a number of the issues around business process, mark to market exposure and counterparty credit



risk. Several of the existing questions in the survey could be refined for the electricity industry, which we expect is a matter for the agencies to directly address with the industry. We discuss this option further in the submission.

If further action is to be taken, this is the only way to support the NEO: the survey as suggested does not bring with it the high costs of trade reporting as currently contemplated, or the risks of reducing use of OTC electricity derivatives through margining requirements or standardisation. It also does not put the industry and the regulator in danger from misunderstanding or misconceptions about the nature of risk in the NEM, which would arise from stress test reporting.

The rest of this submission addresses most of the Commission's questions, which are shown in the shaded boxes. We have structured the responses under the following headings:

- A) Risks and risk management in the NEM
- B) Measuring the materiality of systemic risk
- C) The Commission's assessment framework
- D) Potential options to reduce systemic risk

If you have any queries about this submission please feel free to call me on the number below.

Yours sincerely,

[signed]

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**ERM Power’s response to the questions in *Stage two options paper: NEM financial market resilience***

**A) Risks and risk management in the NEM**

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

*Managing OTC counterparty credit risk*

The Commission has stated that “the majority of OTC transactions in the NEM tend to be uncollateralised...Instead, credit risk is managed through restricting maturity limits and transaction sizes with entities depending on their creditworthiness, in order to manage exposure” (page 16).

We want to emphasise that these means of managing risk are relevant and valid, and that this is the result of expert risk managers in professional risk management environments. Managing financial risk is what traders, credit managers/officers and risk managers do, and it is not in their interest to enter into poorly managed counterparty agreements. Once a counterparty has been established, a business’s risk department attributes a credit limit to that counterparty via a private report, credit reporting or desktop analysis. This is within a set of business rules that address a range of risks to counterparties and balancing market risk and credit risk.

We also note the Commission’s discussion of why the physical assets behind generator and retailer trading positions mean that any perceived lack of collateralisation should be approached with caution (see page 38), and we agree with this perspective.

*OTC contracts versus on-exchange contracts*

The Commission has noted that in its discussions with market participants they have explained that they do not see OTC contracts and on-exchange contracts as substitutes:

The choice is more complicated, and often these two types of hedges can be complementary. For example, a participant could manage the risk associated with an OTC contract through participating in a trade in the opposite position on the exchange. (page 19)

The Commission also states that the ASX has recently expanded its range of electricity products, with monthly futures (available since July 2013) and quarterly average rate options. The Commission considers that this expansion of products “could assist market participants in better managing their hedging needs using on-exchange products” (page 20).

ERM Power agrees that these new instruments add liquidity but this is not enough. Generators and retailers will always need bespoke agreements to efficiently manage the half hour exposure of the physical market. ASX products cannot fill this need given they are standardised. Even increasing the range of ASX choices does not meet the need to tailor contractual arrangements between generators and retailers.

*Credit risk, market risk and 'natural' participants*

On page 46 of the Options Paper the Commission states that the G20 obligations are intended to apply primarily to banks and other financial institutions which typically engage in speculative trade and arbitrage activities. The Commission goes on to note that electricity businesses primarily trade in commodity derivatives where, contrary to speculative trades, there is a link with an underlying position in a physical commodity market.

ERM Power agrees with this characterisation, and further, we believe that these aspects of the NEM financial resilience debate should define the approach to managing risk. Leading from the Commission's statements above and its comprehensive discussion of the issues, we believe that the discussion can be reduced to three fundamental and related concepts:

1. **Market risk is real and must be managed:** As noted by the Commission, market risk is present in the electricity market; this is unavoidable given spot price volatility. Therefore market participants enter into OTC derivatives and on-exchange contracts (such as through the ASX) to manage this risk. Derivatives reflect the diversification of risk, which is a good thing. OTC contracts introduce a degree of counterparty credit risk (although traders implement measures to manage credit risk) but this is more manageable than the original market risk.
2. **OTC derivatives are the most efficient tool to manage market risk:** Of the derivatives available, and as discussed above, OTC electricity derivatives are more efficient than ASX derivatives. ASX derivatives do not have the flexibility to manage the half hour exposure of the physical market. Generators and retailers that depend on ASX derivatives only will be regularly under- or over-hedged, which is in itself expensive and risky.

It must be recognised that measures that inhibit the use of OTC electricity derivatives (through imposing onerous external reporting, margining or intervention measures) may reduce credit risk but will shift risk back to the original market risk. In the event of reduced use of OTC contracts between generators and retailers, market risk management can then take two paths:

- There will be increased trading through exchanges like the ASX, which means less efficient hedges against market risk because contracts will be less tailored to specific risk profiles. Reduced efficiency means higher cost, which will be eventually passed through to consumers. Further, and as noted by the Commission the daily margin calls associated with on-exchange contracts can create cash flow risk (see page 18).
- The market will concentrate to reflect vertical integration as the best risk management approach, which will dampen competition across the market. While vertical integration is not in itself a bad thing, the market should not be entirely comprised of vertically integrated parties if competition is to be at its most vigorous.

3. **Natural participants have physical NEM positions underpinning derivatives, which reduce the risk of valueless OTC electricity derivatives:** There are broadly two types of market participants: natural participants (that is, retailers and generators) which are the ones hedging market risk due to their exposure arising from customer sales or through the ownership of physical assets, and proprietary participants, such as banks and funds who trade OTC and on-exchange contracts to speculate. While there is market risk associated with the physical positions given the volatility of the spot price, the point is still that the derivatives for natural participants are associated with real, physical assets that have inherent value, and derivatives for proprietary participants are not.

As noted by the Commission, the physical component - whether that is a generation asset or a portfolio of customers – “reduce the risk that an OTC contract could become valueless” (page 46). The effect of this is that financial distress is more difficult to transmit between natural participants. Further, the Commission notes that:

Following an OTC contract default with a counterparty, either a generator or a retailer could be able to enter into similar contracts with other counterparties. Hence the cost of replacing those original contracts could be spread over the duration of the initial contract. (page 38)

We believe that the difference between natural and proprietary participants needs to be brought out in the policy debate. Our own observation of the current OTC market is that it comprises:

- all generators and retailers; that is, natural participants;
- a handful of banks: Westpac, Macquarie Bank, Deutsche Bank and ANZ; and
- three to four purely fund-type trading entities.

Viewing the market through this lens helps to determine the real risk faced by the NEM as a whole. For example, if the majority of OTC electricity derivative contracts are (a) underpinned by physical positions, or (b) involve large, diversified banks, then risk of OTC derivative counterparty default leading to catastrophic NEM financial contagion is extremely remote.

## **B) Measuring the materiality of systemic risk**

### **4. What are the appropriate methods for assessing the materiality of systemic risk in the NEM?**

#### *Degree of concentration in the market*

We note that the Commission raises the degree of concentration in the market as a possible means of assessing risk, and it specifically asks the question about the AFMA data that show the top three respondents have an almost 60 per cent share, and the top eight participants 92 per cent share (page 37).

The AFMA data as shown in Figure 4.1 do not name the parties, which raises questions about their relevance to NEM resilience. For example, if the key parties are large and diversified banks, trading in the NEM would not present a risk of them failing; therefore there would be no risk of contagion.

#### *The value of open OTC positions*

The Commission also notes that the value of open OTC positions held by each participant could be used to reach a view on the level of systemic risk, where large negative open positions, occurring on a consistent basis, may trigger concern.

The problem with this approach is that it does not take into account what other measures the participant has; for example, an open OTC position may be offset with a contract on the ASX and so mean no net risk for the participant.

#### *Degree of collateralisation*

As discussed above, we agree with the Commission's views on why the presence of physical positions (from generating units or a portfolio of customers) makes the degree of collateralisation less relevant for electricity derivatives than other derivatives.

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

We do not believe there is a material risk of financial contagion in the NEM. There has been no definition provided for 'material' risk, let alone a case made that this risk exists. Financial contagion is always possible under very specific circumstances, but we suggest that these circumstances are highly unlikely and the costs of trying to avoid these circumstances through new policy measures will outweigh the benefits.

#### *Seed Advisory analysis*

As noted previously, consultant Seed Advisory found that the immediate loss as the result of a failure of a large derivative counterparty would not be enough to result in further contagion and systemic risk to the NEM.<sup>5</sup>

Based on high level estimates Seed found that the immediate loss as the result of the failure of a large derivative counterparty would be \$140 million for a vertically integrated participant (\$10 million for a stand-alone generator). This would represent between a quarter and a third of company-wide annual profits for the two largest vertically integrated retailers whose results are published (based on mid-year results for 2012/13). Seed advises this would:

...present no funding issues. The costs are also relatively small when compared to their annual cash flows and year end cash positions. We believe the risk of further failures in these circumstances appears low. (Seed Advisory, 2013: 5)

<sup>5</sup> See Seed Advisory (2013) *NEM Financial Resilience*, 14 August 2013, at <http://www.aemc.gov.au/Media/docs/Consultancy-report-by-Seed-Advisory-61a83f79-d4d6-4444-81c2-2cd990bd6e58-0.PDF>

Seed acknowledges that the defaulting counterparty is unlikely to have had only one OTC counterparty. Given the 2011/12 turnover in the NEM of around \$6 billion, the likely short term funding requirement of \$200-\$560 million (spread over a number of counterparties) would at its maximum represent just under 10 per cent of total annual turnover. Seed advises that while this is significant, “it is unlikely in our judgement to represent an immediate systemic risk” (ibid: 6).

Seed states that there could still be a loss of enterprise value resulting from replacing the ineffective positions with newer, more expensive positions. This could be a loss of between \$200 and \$490 million for a participant over a period of two plus years, which, while potentially affecting shareholder valuations (depending on the participant’s financial strength, customer contracts and the regulatory environment) is unlikely to result in immediate failures (ibid: 6).

#### *The Commission’s findings in the Options Paper*

While it does not assess financial outcomes in the same manner as Seed, the Commission’s own analysis seems implicitly supportive of the position that there no material risk of financial contagion in the NEM; at least none which can be identified and prevented without unnecessary cost.

For example, we note that the statements made in the Options Paper indicate that the primary risk of counterparty failure for a NEM participant is reduced by a physical position, and that the cost of a replacement hedge can be spread over the contract rather than reflecting an immediate cost.

Importantly, we also note that the Commission’s analysis in the Options Paper suggests that there is no clear definition of systemic risk or how to assess the materiality of what might be considered systemic risk. This is telling, and we suggest the Commission’s criteria to take action as described on page 44 of the Options Paper have not been met (and perhaps cannot be).

### **C) The Commission’s assessment framework**

6. 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?

We support the Commission’s assessment framework. Our overview of our position (pages 2- 5 of this submission) sets out the issues as we see them and our suggestions for assessing the financial resilience of the NEM.

7. 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 Commission notes that the concept of 'systemic importance' for the NEM is different from the application of the concept to the overall financial system or the wider economy (page 29). The Commission thus refers to systemic importance as “those participants whose failure could potentially lead to financial contagion in the NEM”. We agree with this assessment.

Regarding hedging, the Commission notes that regulators in the EU and the US have implemented exemptions to some of the G20 requirements for OTC contracts entered into for the purpose of hedging; that is, “circumstances where the participant has an underlying physical exposure to a price event and it entering into a contract to reduce the risk of that exposure” (page 47). We agree with this point and support a similar application in Australia.

The Commission goes on to say that market participants have indicated that the distinction between 'hedging' and 'speculation' may not always be easy to make. This is valid, however perhaps the issue is less about defining hedging but about the concept underpinning it, which is the existence of a physical market position. This is why we have characterised the market as being comprised of natural market participants (that is, generators and retailers) and proprietary participants (such as banks and funds). Businesses can be profiled to determine whether they are primarily hedging a physical position or not; technical nuancing through accounting standards is probably unnecessary.

We request that the Commission take the opportunity to examine how the US and EU regulators define hedging for the purpose of the exemptions; perhaps there is something we can learn from overseas on this issue.

#### **D) Potential options to reduce systemic risk**

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

ERM Power supports the Commission’s view that there is limited merit in platform trading and central clearing for electricity derivatives. In fact, we believe there is no merit at all in these approaches being mandated for electricity derivatives, for the reasons outlined by the Commission.

By definition, platform trading and central clearing are problematic given the degree of OTC standardisation required. As we have noted earlier in this response, OTC contracts need to be bespoke to be efficient, and if they are not efficient competition will be dampened through market participants using vertical integration as a hedge or they will create less efficient (and so more expensive) hedges against spot market risk.

9. 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?

As discussed above, we do not believe that the case has been made for policy intervention in the NEM to support financial market resilience. There is no evidence of material systemic risk, and the counterparties are highly sophisticated. Therefore, we support Option 1 as proposed by the

Commission. As suggested by the Commission under this option, any improvements that could be considered to the existing arrangements would be outweighed by the costs of the measure(s).

We note that the Commission’s criteria for recommending policy measures from page 44 of the Options Paper have (so far) not been met.

**Table 1: How the options meet the Commission’s criteria for action**

Criteria from page 44 of the Options Paper	Criterion met?
The existing market and regulatory risk management mechanisms are inadequate or could be enhanced, strengthened or supplemented.	There has been no evidence presented to date that the existing market and regulatory risk management mechanisms are inadequate or could be enhanced, strengthened or supplemented without increasing risk and/or cost.
A deficiency has been identified that results in material risk of contagion.	No deficiency has been identified that results in material risk of contagion. In fact, no definition of material risk of contagion has been provided or agreed.
Implementation of the measure would be likely to promote efficient investment in, and efficient operation of electricity services for the long term interests of consumers of electricity.	Most of the measures proposed to date are more likely to increase risk (and cost) in the NEM and so are not likely to promote efficient investment in, and efficient operation of electricity services for the long term interests of consumers of electricity.

In the event that Option 1 is not politically or practically possible, the only policy option we can support is a refined version of the existing annual OTC Derivatives Survey, jointly conducted by APRA, ASIC and the RBA (‘the agencies’). The survey already covers a number of the issues around business process, mark to market exposure and counterparty credit risk. Refining the survey would be a matter of modifying/clarifying some of the existing questions for the electricity industry and is something that the agencies would directly address with the industry.

Using the survey in this way would provide a check across relevant participants to help reinforce the existing requirements and provide to the agencies a picture of counterparty exposure. Results would remain confidential with no publication of outcomes: the point is to assist the agencies in their understanding of risk, not to send messages to the market in general. Of the agencies, the powers of ASIC in particular are sufficient to pursue any further enquiries about market participants’ risk exposure.

We believe this approach is the only way to continue to support the NEO: it does not bring with it the high costs of trade reporting as currently contemplated, or the risks of reducing use of OTC electricity derivatives through margining requirements or standardisation. It also does not put the industry and the regulator in danger from misunderstanding or misconceptions about the nature of risk in the NEM, which would arise from stress test reporting.

Our detailed comments on Options 2 – 6 as proposed by the Commission are on the following pages.



### *Option 2: Trade reporting*

This option would require all parties to OTC electricity derivative transactions to report information across 55 data fields about every OTC contract they enter into. As noted by the Commission, ASIC trade reporting rules currently do not apply to electricity derivatives.

The argument for trade reporting is that it could provide greater transparency about OTC electricity derivative market activity and assist market participants to assess the impact of the failure of a large participant.

It is a truism that more information should improve transparency, but the problem is that it is not this easy. The notion that trade reporting addresses NEM resilience through increased transparency involves rather optimistic (some might say heroic) assumptions of the capacity of market regulators (and other participants and observers) to observe, assimilate and act on this significant dynamic data set to prevent or otherwise mitigate systemic risk across the NEM.

When combined with the administrative burden on market participants, trade reporting as proposed is clearly an inadequate and costly measure.

### *Option 3: Stress test reporting*

As described by the Commission, a stress test reporting regime would require market participants to periodically report information about their ability to deal with major shocks, with the purpose being to provide information for an assessment about whether participants can manage financial shocks without transmitting financial distress to other participants.

This is the only option that provides a NEM-wide view of risk management, and so we can see that it is worth considering. A challenge with this option – whoever it is applied to – is in its design, and how to overcome the problems of this only ever being a ‘snapshot’ rather than an ongoing tool (which it cannot be by definition). This has been noted by the Commission.

This being said, in our view the biggest problem is not that stress testing provides a snapshot but that it will put businesses and regulators in impossible positions. We understand that the Commission would expect stress testing to provide detail about each market participant’s financial outlook to attempt to answer the questions on page 10 of the Options Paper, and it is on this basis that we raise our concerns. It may sound reasonable in principle but actual practice along the lines of the Commission’s apparent expectations will show a stress testing regime to be dangerous and costly to all involved.

First, and as we have stated already, we are concerned that the Commission thinks that it, or any external party, might better know how participants should run their businesses and specifically manage risk. No regulator is in the position of knowing better than industry what constitutes a ‘correct’ level of interconnectedness as per (a) on page 10 of the Options Paper, or better judging trading credit limits to ‘appropriately mitigate the risk of contagion occurring’ as per (b). There is definitely no way for a regulator (or a business) to ‘confirm that the business can survive the impact of another market participant failing’ as per (d) given the range of factors involved.

On a related point, some risk *must* be acceptable. The NEM is not a risk-free market by definition – both from a philosophical view on competition and a practical view given the spot market. Expecting the market (or any market) to be risk-free is counter-productive. If a business was to carry out daily operations in anticipation of a one in fifty year or ‘black swan’ crisis event happening any day, the business would be inefficient and costly – it would be over hedged, over insured and unable to exist in any sensible way in a market where spot prices reach a market price cap of \$13,100/MWh.

So what does the concept that some risk is acceptable mean for policymakers and regulators? In forming views of ‘credible’ stress scenarios and ‘appropriateness’ of industry response, the regulator will have to say what is ‘enough’ risk; it will have to explicitly recognise that failure is acceptable under some circumstances. Surely this puts the regulator in a challenging political situation.

Given the above, we expect that the development of the scenarios will be a problem. There is a paradox in that the stress events tested will need to be extreme, and so will probably set the industry up to fail. As noted above, this is because some risk has to be accepted and ‘black swan’ events cannot be managed ahead of time. In fact, it is possible that there is no such thing as a ‘credible’ stress test for the Commission’s purposes that can:

- (a) test for extreme negative coincidental events; while
- (b) reflecting reasonable expectations of market risk approaches (that accept risk on some level), and also
- (c) providing confidence to policymakers that risk in the NEM is manageable and politically acceptable.

Even in the event that credible stress scenarios can be developed in theory, we are not sure that the industry is well enough understood by policymakers that there would be consensus on what constitutes a credible scenario, and specifically how to judge risk responses to very high consequence but low probability events.

Finally, the Commission has raised the possibility that disclosure of the information requested may also need to be provided to the market as a whole for listed businesses. If this turns out to (unintentionally) be the case it is extremely concerning. This constitutes an unfair advantage to businesses that are not listed, and a significant risk for those who are. If the scenarios are skewed toward failure (which, paradoxically they must be), the messages to investors may well spark the financial distress we are concerned to avoid.

#### *Option 4: Code of best practice for NEM participants*

This option involves the introduction of a code of best practice for risk management in the NEM, where the Board of each participant would be required on a regular basis to attest that they have complied with the Code.

We would support an industry-developed, voluntary Code if this is a viable alternative to Option 1, but this would seem an unlikely political solution. This type of Code would largely constitute a

reinforcement of existing risk management practices and requirements, including accounting standards.

If the Code is to go much beyond further embedding existing requirements it will be challenging to negotiate into existence across the various interested parties. Regardless of ultimate governance and enforcement, the development of such a Code will be harder in practice than in concept: inevitably these go from lofty ideals of high-level guidance along self-regulatory lines and then turn into prescriptive detail as various issues are debated and trade-offs are made.

Overall, while we acknowledge that a Code could provide benefits to the businesses through the sharing of information and knowledge about risk management practices in the sector, this seems to be secondary to the main objective of the NEM financial market resilience policy work.

#### *Option 5 - Trade reporting + additional margin requirements*

As described by the Commission, this option would apply the ASIC trade reporting rules to electricity derivatives, as mentioned under Option 2, and would impose additional credit support requirements on non-centrally cleared derivatives.

In our view this is the worst of the options. It has all the negative aspects of Option 2 (including a basic inability to meet the objective of providing a full picture of NEM resilience) plus a mechanism that will go further to bring about financial fragility and systemic risk in the NEM than anything else.

We fundamentally do not support margin requirements for non-centrally cleared derivatives. Adopting this option will undermine the efficiency of what is already an efficient and well managed risk framework. At its best it will merely lead to a more expensive market, where prices are passed through to customers. At its worst it will play a role in RoLR events by amplifying financial pressure on businesses already experiencing stress.

The Commission has noted these points in its Options Paper, also stating:

Some market participants may be unable or unwilling to bear the costs of margining for the totality of their OTC derivative contract book which may lead to similar effects as a central clearing obligation. This could include increased exposure of participants to the spot market, increased vertical integration and reduced overall contract liquidity. In turn, this could increase overall risk. (page 68)

We agree with this view.

#### *Option 6 - Stress test reporting + additional supervision and regulatory powers*

This option combines a stress test reporting regime as per Option 3 with additional supervision and regulatory powers. As the Commission states, this measure introduces macro-prudential regulation into the electricity market, where the intent is to safeguard the market as a whole.

It is difficult to argue against the concept of 'safeguarding the market as a whole', but again, we question what this means in practice and if additional regulatory powers are actually necessary.

We have already commented on stress testing and our views are the same for this option.

Regarding the additional element of supervision and regulatory powers, the Commission suggests that the regulatory powers might include:

- The power to direct market participants to limit or contain their derivative exposures.
- The power to require systemically important market participants to strengthen their balance sheets, by maintaining adequate access to liquidity (to meet any sudden cash flow obligations) and capital (to absorb losses) in periods of heightened systemic concern.
- The power to facilitate an orderly exit from the market when a systemically important market participant faces financial distress and its solvency is at risk. (page 69)

These powers are not something that we can support. As stated earlier, managing financial risk is what traders, credit managers and risk managers do, and they do this within a set of business rules that address a range of risks to counterparties and trading off market risk and credit risk. Given the problems with stress tests that we have already identified, we believe that providing further powers to regulators to take action just further reinforces the impossible decisions expected of the regulator and the danger faced by industry from the unintended consequences of the approach.

Expectations of a regulator to exercise these powers and make 'better' judgements than professional traders and risk managers are fundamentally unrealistic. We note again the Commission's statements of the key issues to be evaluated to assess the risk of contagion from counterparty failure from page 10 of the Options Paper (that is, the 'correct' level of interconnectedness, 'appropriate' mitigation of risk of contagion occurring', and evidence to 'confirm that the business can survive the impact of another market participant failing') and ask if a regulator has any capacity to know the answers better than industry.

Finally, the Commission states that the:

...introduction of such powers could potentially introduce a risk of moral hazard as it may create the impression with participants that a regulator would step in and prevent any participant from failing. Or alternatively, it leads to market participants not carrying out their own robust risk assessment of potential counterparties because it considers that the regulator is adequately doing this. (page 69)

We agree with these points.

#### *Other questions from the Commission*

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?

In our view, there is limited value from using electronic trading platforms (other than the exchange) to conduct OTC transactions. As we have noted above we value the bespoke nature of OTC contracts as they provide the necessary efficiency in hedging. We also do not see the value in developing electronic platforms in competition with the exchange.



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?

ERM Power has a high proportion of non-standard OTC contracts in our contract book. We do not support standardisation in any form, including to provide for central clearing obligations.