



John Pearce - Chairman
The Australian Energy Market Commission
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EMO0011 – Strategic Priorities for Energy Market Development

Dear John

In the AEMC's discussion paper for the Strategic Priorities for Energy Market Development market review, the AEMC points out on page 36, that "increasing vertical integration of retail and generation activities to create gentailers may reflect efficient risk management decisions by [...] retailers, but it also has the potential to undermine liquidity in the contract market."

This submission will point out that vertical integration (VI) does not only have the potential to undermine liquidity but has already resulted in a lack of liquidity in certain regions. Far from being an efficient risk management tool, VI exposes the VI entity and the NEM to serious systemic risk and inefficiency.

1. Vertical Integration in the NEM and other markets

VI results in reduced liquidity in the contracts markets as is evidenced by the lack of liquidity in the d-cyphaTrade ASX24 electricity futures market for South Australia, the most vertically integrated region in the NEM (apart from Tasmania for which there is no liquid hedge market due to Tasmania being nearly 100% vertically integrated). The effect of the NSW privatisation and resulting VI of NSW generation capacity and retail demand into Origin and TruEnergy remains to be seen, however, the first figures for the month of April seem to indicate that VI may have already had a detrimental effect on market liquidity¹. Similarly, the vertically integrated NZ electricity market dominated by 5 gentailers traded only 1.6 TWh of futures during the 12 months to 9th May 2011 despite the NZ physical market consuming approx 39 TWh p.a.

2. Risks of VI

- a. VI is not in itself a particularly effective hedge. This was evidenced during February this year by the effects of Cyclone Yasi on VI generation, and more significantly during the catastrophic generation outages during January 2007, triggered by inter-connector outages and later by generator water shortages during Q1 and Q2 2007. A hedging strategy which relies on VI can have a serious impact on the financial results of a gentailer when such generation outages occur². As these examples and many others illustrate, the unavoidable non-firmness of generation availability undermines the reliability and effectiveness of VI as a hedge.

¹ In April 2011, one month after the partial NSW privatisation, trading activity dropped significantly and the d-cyphaTrade ASX Electricity Futures and Options market recorded its lowest monthly volumes within the past two years.

² http://www.agl.com.au/Downloads/942430_ASX_070211.pdf

- b. VI is, however, very effective in thwarting regional retail competition.
- c. When VI is used as a hedging strategy it impairs price transparency within regional financial markets and undermines investment signals. Without investment signals, the market fails to attract new market entrants and the incumbent gentailers effectively control new investment into the market as they have a significant information advantage. If a sufficiently liquid hedge market does not exist, new entrants faced with the risk of \$12,500/MWh pool costs in the absence of a hedge are unlikely to commit to retailing in the region in significant scale.
- d. VI leads to a withdrawal of hedge contract availability as previously separated generators and retailers withdraw their hedging volumes from the market. This in turn has a multiplier effect as financial intermediaries (providers of significant liquidity in financial markets) also reduce their traded volumes because lower financial market liquidity increases their trading risks. e.g. many financial intermediaries deliberately avoid trading financial contracts in South Australia.
- e. Where a VI retailer relies on its generator availability as a hedge:
 - i. Generation outages (which are likely to coincide with extreme spot prices dramatically increasing retailer costs) of the entity are more likely to trigger a domino-style default event, bringing down other NEM Participants via the NER's Retailer of Last Resort (ROLR) mechanism;
 - ii. In the event of a VI generation outage, financial risks to the VI entity may be extreme because it is less capable of attaining replacement hedges at an efficient price via a contract market which has poor liquidity (due to the proliferation of VI in that region). When its generation asset fails, the VI retailer immediately becomes a distressed buyer seeking to purchase hedges to cover its short retailer position as contract prices spike because its own plant failure has triggered a costly spot price spike;
 - iii. a VI hedge strategy fails at precisely the time that the VI participant can least afford it e.g. when electricity prices reach \$12,500/MWh *because* the VI entity has lost its generator hedge.
- f. In the longer term, VI undermines traded volumes in independent and prudentially safer financial markets such as futures. This leaves all participants with less ability to manage their physical market risks during extreme price events and exposes the entire market to much increased risk. In this way VI also creates an immense barrier to entry (and delay) for new retailers because building their own generator becomes a prerequisite to compete as a retailer in the region.
- g. VI also creates perverse incentives for a gentailer to use its generator to set artificially high pool price (and thereby contract prices) merely to drive pure retail competitors out of the market or to deter new retailers from entering the region.

- h. VI contradicts a key underpinning design objective of the NEM. i.e. the NEM was designed to be a gross pool market, as opposed to a net pool, in order to give all participants access to physical power supply.

3. Recent changes to NER have encouraged a pro-VI market structure whilst creating or retaining barriers to independent retailers and generators

- a. The AEMC's Review into the role of hedging contracts in the existing NEM prudential framework revealed that the NER provides lucrative AEMO credit support offsets (up to 67%) for VI utilities, even across regions³. The only financial markets based alternative allowed under the NER for independent retailers seeking AEMO credit support offsets is via AEMO ex ante reallocation derivatives, which are inefficient due to their reliance on generator availability, OTC credit default risks and limited supply. In this way the NER encourages VI as a form of hedging by financially rewarding VI retailers via AEMO credit support reductions which are not practically available to independent retailers via financial markets.
- b. In the same Review, the AEMC finally recommended that Future Offset Arrangements (FOAs) be implemented by AEMO to deliver AEMO credit support efficiency gains, particularly for independent retailers. FOAs would enable independent retailers to use their ASX 24 futures hedges (which would also concurrently support transparency and credit risk reduction benefits across the NEM) to partially offset their AEMO credit support requirements. FOAs would create efficiency gains for independent retailers via AEMO credit support offsets without the need to build a generator or to purchase AEMO reallocation offset derivatives from (and under terms set by) incumbent generators or competing VI retailers.

However the FOA implementation process has being delayed substantially and AEMO, the operator of the competing (reallocation) offset market, has been empowered by the AEMC to ultimately decide if FOAs should be implemented. Despite numerous submissions to the AEMC requesting the implementation of FOAs dating back to 2006⁴, via Rule Change Request, submissions to other Rule Change Requests and an AEMC Market Review into FOAs and AEMO Credit Support, the AEMC has not given AEMO a firm FOA implementation deadline.

³ <http://www.aemc.gov.au/Media/docs/Final%20Report%20-%20Review%20into%20the%20role%20of%20hedging%20contracts%20in%20the%20existing%20NEM%20prudential%20framework-6f7eaaa9-e9f2-40ac-a815-65a8dfd526f3-0.PDF>, point 4.3

⁴ The first submission to the AEMC requesting FOAs was made in August 2006 on behalf of 20 industry participants, requesting that FOAs be incorporated in the rule change process which ironically approved AEMO reallocation offset arrangements but chose not to implement FOAs.

- c. In the absence of supporting FOAs, the NEM's reallocation rules and automatic AEMO credit support cost reductions given exclusively to VI retailers represent regulatory encouragement of VI which risks turning a gross pool market into a net pool market whilst promoting non-transparent and inefficient OTC trading (i.e. OTC reallocation derivatives) as the only available alternative to VI. i.e. the NER financially discourages NEM retailers from utilising futures markets as a hedge alternative to VI.
- d. In stark contrast, the US Frank Dodd Legislation due to take effect in July 2011 will force OTC trading (with few exceptions) onto daily margined futures clearing houses. The US legislation is a regulatory solution to the now obvious inability of OTC markets (such as reallocation derivatives) to prudently manage price risk, as policy makers seek to avoid a repeat of tax-payer-funded bailouts of defaulting OTC participants. Unlike OTC markets, futures markets reduce (not merely transfer) credit risk in financial systems via daily mark-to-market margining and central clearing. Financial hedge strategies that rely precariously on physical generation reliability and/or delivery such as VI and AEMO reallocation OTC derivatives further increase the likelihood and magnitude of a cascading credit default crisis engulfing multiple NEM Participants, triggered by a single generation outage. US regulators are seeking co-operation from international regulators (via IOSCO) in implementing the mandatory use of clearing houses for financial derivatives across other jurisdictions.⁵

In summary, one of the strategic priorities for energy market development should be to reduce the regulatory encouragement of VI and instead encourage more efficient and systemically safer methods of hedging energy risk.

We would welcome the opportunity to discuss this submission with you in more detail.

Yours Sincerely,

Dean Price
General Manager

⁵ ASIC's Tony D'Aloisio was co-Chairman of the IOSCO Task Force on Unregulated Markets and Products.