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Australian Energy Market Commission
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NEM financial market resilience – Issues Paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (the Commission) Issues Paper on NEM financial market resilience.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

esaa agrees with the Commission's assessment that the National Electricity Market (NEM) financial markets are generally robust. The electricity industry is made up of sophisticated businesses with substantial experience dealing with the inherent volatility of the wholesale spot market. As noted in the Issues paper, market participants have a range of internal risk management practices in addition to the regulatory risk management requirements.

Market participants use the over-the-counter (OTC) and exchange based markets to manage their exposure to the wholesale spot price. Both markets assist in limiting the risk of the spread of financial contagion. Since the beginning of the NEM, there have been no incidents in OTC markets where cash reserves have been needed.

esaa agrees that the key risk for the spread of financial contagion is the failure of a large retailer, triggering a retailer of last resort (ROLR) event. To date, the retailer failures of EnergyOne and Jackgreen in the energy markets have been handled smoothly, but these were both small retailers. esaa acknowledges that the ability of the market to absorb customers from a large retailer collapse, under existing ROLR provisions, is untested. However, as the Commission acknowledges, the likelihood of such an event occurring is quite remote.

Given the Commission finds the existing financial markets generally robust, particularly the existing risk management procedures, the key outstanding risk appears to be the ROLR arrangements. esaa therefore supports the Commission's recommendation to focus its assessment on the effectiveness of those arrangements and to identify proportionate responses supported by a robust cost-benefit analysis

Retailer of last resort

The Issues paper flagged that if a large retailer collapsed, the ROLR process could actually result in the spread of the financial contagion. In the short term, increased credit support requirements and increased exposure to the wholesale spot price due to lack of hedging for their new customer load, could result in a designated ROLR facing financial distress. However, the materiality of the second issue is dependent on the cause of the retailer collapse (if precipitated by a generator collapse it is likely to be an issue).

As noted in the Issues paper, the customers acquired by the designated ROLR could be profitable over the long term, but in the short term the costs associated with increased Australian Energy Market Operator (AEMO) credit limits and distribution network service provider credit support may create liquidity and cash flows issues the retailer is not able to meet. The Commission canvasses the possibility that a retailer may ultimately be suspended from the NEM by AEMO, due to the short term financial pressure created by becoming a designated ROLR. It would be a perverse outcome if a retailer ends up being punished for providing a safety net service, ensuring that customers continue to receive electricity and payments flow in the NEM.

The Issues paper does not propose to completely review the ROLR arrangements. However, it is important that the Commission identifies any weaknesses in the system that could result in a designated ROLR experiencing financial distress, and propose possible solutions where appropriate. For example, if the current credit support requirements are likely to place undue strain on a designated ROLR, consideration may need to be given to adopting slightly different rules for adjusting a retailer's maximum credit limit in the period immediately after a ROLR event. Alternatively, ways to ensure that the designated ROLR's revenue matches its increased costs in the short term could be examined[1]. However, any options would need to ensure that an attempt to provide relief to a designated ROLR does not simply shift the problem to another part of the market and does not unfairly punish affected customers.

Retail price regulation

In major collapses around the world, the inability to pass on high wholesale energy costs due to retail price caps has contributed to the problem. The Californian energy crisis and the TXU Europe collapse were both exacerbated by retailers' inability to pass on high wholesale spot prices.

If the Commission believes that a period of high wholesale spot prices is likely to be a precipitating factor to the spread of financial contagion in the NEM, greater flexibility for retailers to adjust their prices in responses to market movements would seem to be an appropriate measure to reduce the risk of cascading collapses. Further, the Issues paper noted that short term liquidity and cash flow issues due to ROLR event may be increased by constraints on the ability to pass on these costs by increasing retail prices.

[1] This could include the type of costs that can be recovered by a ROLR and the prices they can charge their ROLR customers.

Australian Securities and Investment Commission (ASIC) and Treasury reviews

ASIC and the Commonwealth Treasury[2] are currently examining elements of the NEM financial market architecture. esaa and other industry participants have raised concerns with the options canvassed in these two reviews. As noted in our submissions, the proposals are likely to impose costs for little to no benefit and at worst could be counterproductive. In both instances the need for change has not been established based on any risks with the current architecture. Indeed, to the extent that any changes arising from these reviews inhibit participation by NEM participants in the electricity derivatives market, they may serve to *increase* financial risks.

Similarly, with the Commission's work on NEM financial market resilience, any potential changes to the National Electricity Rules arising from this process should be clearly linked to a material underlying risk with the existing framework. As there is already a high level of sophistication in how risk in managed in the NEM, we do not anticipate the need for any substantive changes.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

Matthew Warren
Chief Executive Officer

[2] The review is examining all of Australia's OTC markets, as part of Australia's G20 commitments.