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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH, NSW 1235

Dear Mr Pierce

Submission: NEM Financial Market Resilience Stage 2 Options Paper

Thank you for the opportunity to make this submission on the Australian Energy Market Commission's (AEMC) Stage 2 Options Paper on NEM Financial Market Resilience (the options paper).

AEMO takes an active interest in the AEMC's work on NEM Financial Market Resilience, and is committed to helping identify, develop and implement constructive improvements to the financial arrangements in the energy markets. AEMO completed a review of NEM prudential arrangements in 2010[1], which identified a range of options to reduce risk and better utilise capital in the NEM. As a result of that work, the prudential quality of the NEM physical market was recently improved from approximately 4% probability of loss given default, to 2%, with minimal change to prudential costs. It is now important to identify and pursue further opportunities to build on that foundation through measures that help participants to manage risk while also supporting the NEO.

One example is the Futures Offsets Arrangements (FOA) proposal, which aims to include consideration of exchange-based trading in the assessment of NEM prudentials. This proposal was previously considered by the AEMC in 2010, and AEMO intends to continue that work by exploring FOA models that provide capital efficiency benefits to market participants within the established 2% prudential standard. In advance of that, there is potential to reduce the risk that participants with 'in the money' futures contracts face in making daily margin payments to AEMO – in this regard, a Rule change proposal was lodged by AEMO in July 2013, to allow additional time for participants to make these payments to AEMO prior to initiating the formal Call Notice process, this has potential to support cash flow for hedged participants.

In this submission AEMO offers an alternative perspective on the options proposed by the AEMC, and also provides feedback on a number of the consultation questions posed in the options paper.

Context of the AEMC's review

The general context in which the AEMC is carrying out its review is particularly relevant in this case. We note that the Commonwealth is currently working through Australia's

[1] AEMO's Energy Market Prudential Readiness Review is located at: http://www.aemo.com.au/Consultations/National-Electricity-Market/Closed/Energy-Market-Prudential-Readiness-Review

implementation of its commitments made to the “Group of 20” (G20) recommendations on reforms to the over-the-counter (OTC) derivatives markets. Closer to the NEM, recent reviews done by AEMO[2] and the AEMC[3] identified the potential to achieve efficiency gains and risk reduction in the energy markets by pursuing means of netting the clearing of the wholesale physical and derivative markets. Within this context, NEMMCO[4] developed with stakeholder input, an arrangement to facilitate optional netting of OTC contracts with physical trades – the Swap and Option Offset Reallocations (SOOR) arrangement. To allow this process to be commenced, NEMMCO applied for an exemption from a Clearing and Settlement Facility Licence (CSFL) in 2007 and this has been actively supported by AEMO since its formation. Regulatory processes reached an advanced stage before final approval became uncertain, apparently due to concern that it could be viewed as inconsistent with the G20 initiatives noted above.

Assessment framework

AEMO supports an assessment framework centred on the NEO as identified in the options paper. This is an appropriate means of evaluating the application of potential measures that affect the NEM, by considering the range of potential interventions together with any benefits that can be delivered against the NEO through those interventions, with a view to identifying the one that delivers the most value overall. However, AEMO is concerned that the options paper may have prematurely restricted the range of potential measures based on a preliminary assessment that is not consistent with the assessment framework.

As an example, central clearing through the G20 measure of central counterparties (CCP) is discussed in section 7.2.1 of the paper, together with a cursory discussion of some of its attributes. The option appears to have been dismissed on the basis of that discussion and, in particular, concern that it may have limited use given the often bespoke nature of OTC contracts[5]. AEMO considers that all central clearing options should not be dismissed based on this type of cursory analysis. A more balanced approach would seek to identify a design that maximises the full range of benefits for NEM participants and the NEO, then to weigh up the upsides and downsides.

Potential options to reduce systemic risk

AEMO does not have a view on the question posed by the AEMC as to the materiality of systemic risk. It is possible to postulate a set of circumstances that could lead to the financial collapse of the market, but such a set of circumstances has a very low probability of occurring. The real world risk is difficult or even impossible to assess. AEMO also does not have a role in deciding whether any particular regulatory measures should be imposed externally to the NEM – those are matters for the relevant regulatory bodies to determine.

However, we suggest that there are opportunities such as the SOOR and OFA mechanisms noted above, to reduce systemic risk, while also advancing the NEO. The AEMC’s review of

[2] AEMO’s Energy Market Prudential Readiness Review is located at: http://www.aemo.com.au/Consultations/National-Electricity-Market/Closed/Energy-Market-Prudential-Readiness-Review

[3] The AEMC’s Review into the Role of Hedging contracts in the existing NEM prudential framework is located at: http://www.aemc.gov.au/market-reviews/completed/review-into-the-role-of-hedging-contracts-in-the-existing-nem-prudential-framework.html

[4] National Electricity Market Management Company, which became part of AEMO in 2009.

[5] Options paper, p. 63

systemic risk provides an opportunity to find ways of advancing such initiatives in the complex regulatory environment currently at play.

It follows from this that the AEMC's option of adopting no new measures (Option 1) is inadequate. We note that the other options outlined are all proposals for mandatory measures. We consider that any such mandatory approaches would need to be justified by extensive analysis. In AEMO's view, approaches which provide participants with a greater range of options to manage their prudential obligations would be more attractive and could work to deliver more efficient outcomes and diversify risks in the overall pool. This is particularly the case given the different size and nature of businesses operating in the market.

Options that have been identified from within the industry itself, such as the optional SOOR mechanism, can mitigate systemic risk without the need for external interventions, even though their original motivation was to advance the NEO. This option is already being progressed voluntarily by the industry, but can only deliver benefits if a way can be found to finalise its regulatory approvals.

By way of example, the following scenario sets out, at a high level, one potential model for advancing the SOOR mechanism as a voluntary industry measure, building on the trade reporting option noted in the AEMC's paper.

Trade repositories have the potential to provide a range of benefits to the industry, as outlined in the options paper. In addition to helping reduce systemic risk, they support improved transparency by providing a platform on which benchmarks could be developed, such as a forward price curve. A full trade repository operated by a commercial provider would have usage costs and may involve significant administrative burden, including the setup of new processes and electronic interfaces. Such a trade repository may be imposed for other reasons but, of itself, would be unlikely to provide direct benefits to the market or its participants.

However, if operated by AEMO, a record of transactions managing the key data normally in a trade repository could be provided at low cost, potentially using the existing platform and processes developed for reallocations. AEMO notes that many market participants use the existing reallocation process, which would minimise the implementation cost of the service. This would also allow reported trades to potentially be used in conjunction with AEMO's Swap and Option Offset Reallocations (SOOR), thereby facilitating netting of OTC and physical positions in the clearing process.

Such a trade reporting model might have characteristics along the following lines:

- AEMO would establish a database similar to a trade repository, taking into account the rules set out by ASIC[6]. An important difference between a voluntary service established by AEMO, and a licenced trade repository would be the amount of information captured for each transaction – AEMO would propose to only capture the key information necessary to support SOORs and any other services sought by industry as discussed below. In combination with this service, there might be a need for AEMO to convert its application for exemption from a CSFL to a licence application in order to finalise its regulatory approval to operate the SOOR mechanism – this would need to be considered with the relevant regulatory bodies.

[6] The requirements to hold an Australian derivative trade repository licence are published by ASIC at: https://www.asic.gov.au/asic/asic.nsf/byheadline/Derivative+trade+repositories?openDocument

- Market participants could then be offered the option of accessing the SOOR mechanism through the voluntary trade repository. This would be done through an electronic interface that provides matching of trade information between counterparties. Note that systems to support the SOOR are already in place
- Through the SOOR mechanism AEMO would then be able to consider the reallocated OTC transactions in the calculation of prudential obligations, and settle the transactions with the spot market. This would provide netting benefits both in respect to initial margins (through the Credit Limits Procedures) and daily margining with respect to actual trading, giving rise to a range of benefits:
  - Less capital tied up in prudentials, while the prudential standard is still met.
  - Reduced risk of default arising from the risk of meeting margin and settlement payments.
  - Reduced shortfall in settlement payments in the unlikely case of default and a shortage in collateral (this would be an event that falls outside the 2% prudential standard). This reduces the payment risk for generators, and therefore supports resilience of the market.
  - Provides a potential benefit to participants that are better managing their risks through the contract market.
- AEMO would, if required, provide access to the information contained in the database to prudential regulators as required by any regulatory obligations, as would be the case from any other trade repository.
- Once established, an AEMO trade repository may be able to be leveraged by its users to provide added value through initiatives such as a forward price index.
- Although the AEMO trade repository would be offered on a voluntary basis, the aim would be attract a large proportion of the OTC derivatives that are structured in a way which is consistent with the SOOR arrangements. When combined with the reporting of exchange-traded derivatives, the level of trade reporting may be sufficient to address systemic risk and provide transparency to the market and prudential regulators.

The above is put forward as an example of how voluntary approaches driven largely by the NEO, have potential to also reduce systemic risks in the market. In this example, the provision of a voluntary trade repository by AEMO is arguably a small concession if it can deliver real market benefits, whilst supporting the broader objectives of addressing Australia's G20 commitments and allowing AEMO to gain its exemption from a CSFL or preferably, a licence. A benefits driven approach of this type is also consistent with the recommendation for incremental improvement made by AEMO in its 2010 prudential review, as the outcome lends itself to further development when opportunities arise.

AEMO does not propose to promote advancement of an approach such as the one set out above without first consulting with stakeholders to seek their support. However, AEMO encourages the AEMC to keep scenarios and options of this type open when developing and reporting its findings to SCER on the FMR, to avoid closing off potentially beneficial development paths, and we seek AEMC's support for AEMO to further consider broader options of this type with NEM stakeholders.

Additional feedback on consultation questions

We note that as a result of the carbon tax repeal legislation[7] the Energy Security Council (ESC) is no longer operating[8]. As identified in the AEMC's first interim report, in the event of a large participant failing it is likely that government assistance would be required. In the absence of the ESC providing a key advisory role and a point of coordination, the development of timely intervention measures would be more challenging. Consideration should be given to some alternative forum.

In the prudential review conducted in 2010, AEMO considered how the Corporations Act may interact with the NEM where a market participant becomes insolvent. Under certain circumstances, an insolvency official could apply to a court to set aside all (or "claw back") or part of a transaction that constitutes an unfair preference. As part of implementing the National Energy Customer Framework (NECF), Corporations Act displacement provisions were included in the National Electricity Law, which may serve to reduce the risk of claw back of security deposits provided to AEMO. However if there is any residual risk of claw back of settlement payments or credit support, this could represent a form of systemic risk in the NEM. AEMO is currently exploring additional measures to further reduce the risk of claw back, including through coverage under the Payment Systems and Netting Act, and would appreciate support from the AEMC for resolution of this matter.

If you would like to discuss any aspect of the submission, please contact Murray Chapman, Group Manager Market Policy Development on (03) 9609 8486, or myself on (08) 8201 7371.

Yours sincerely

David Swift
Executive General Manager Corporate Development

[7] Information on the repeal of the carbon tax is provided by the Australian Government at the following location: http://www.environment.gov.au/carbon-tax-repeal/
[8] Treasury notes that the ESC was abolished on 22 October 2013: http://www.treasury.gov.au/Policy-Topics/PeopleAndSociety/completed-programs-initiatives