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Australian Energy Market Commission
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Sydney South NSW 1235

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NEM Financial Market Resilience – Issues Paper

The NGF welcomes the opportunity to respond to the Issues Paper – NEM Financial Market Resilience, June 2012.

The NGF is the national industry association representing private and government owned electricity generators. NGF members operate across all states and territories and all generation technologies, including coal-fired plant, gas-fired plant, solar, bio-waste, hydroelectric plant and wind farms.

The AEMC Issues Paper was written in response to SCER's request for advice on:

- the nature of the 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.

The AEMC poses a number of questions related to the financial interdependencies between NEM Participants and the potential risks associated with these interdependencies, and the potential financial contagion risk that could arise as a result of the failure of a large retailer or a large generator.

The NGF agrees with the Commission that the "financial relationships and markets that underpin the efficient operation of the NEM are generally robust."

The NGF strongly advocates that any review of the existing mechanisms to mitigate financial risks should take into account of existing market safeguards and regulatory measures that ensure the on-going integrity of the NEM. These features and measures include:

- The NEM is comprised of sophisticated financial participants who are already subjected to multiple requirements in order to transact. These include and are not limited to:
    - ASIC requirements to hold a AFSL and be able to transact in OTC products;
    - AEMO credit limit requirements; and
    - Internal company corporate governance which include risk management frameworks and credit risk assessments.

- The wholesale electricity market is highly regulated by the National Electricity Law and Rules. The NEM has an independent system operator (AEMO) who is responsible for managing the spot market and market settlement, and an independent national energy market regulator (AER) who administers the Rules.

- AEMO has strict prudential arrangements and a robust risk management program in place. AEMO closely monitors the activities of all participants in the market and has a strict timetable in place for the entire settlement process, which includes the default of a participant.

- AEMO calculates a maximum credit limit and prudential margin which sets the credit support that must be posted by each market customer with reference to the "reasonable worst case" of monies that could be expected to be owed over the effective 35-day settlement period and 7-day 'reaction period'.

- The National Energy Retail Law includes provision for a Retailer of Last Resort (ROLR) scheme to ensure that if a retailer exits the market at short notice, arrangements are in place to transfer the customers of the defaulting retailer to another retailer.

- The broad terms of OTC derivative transactions are determined by the International Swaps and Derivatives Association's global Master Agreement on a bilateral basis between participants. The economic terms of each transaction under a Master Agreement are agreed between the parties by exchange of confirmations.

All these requirements and standard industry practices ensure that Participants have sufficient financial resources to trade and that these trading activities won't compromise the integrity of other financial transactions in the NEM.

The NGF believes no change is required to the existing financial market mechanisms that are used to manage risk. We do concur with the AEMC that more analysis may be warranted to determine the adequacy of the new ROLR arrangements under the National Energy Retail Law.

<u>Comments on the nature of financial interdependencies between NEM participants</u>

The AEMC has done a good job of identifying the financial interdependencies in the NEM. These interdependencies are inherently complex but the market is comprised of a relatively small number of sophisticated market participants who have both the acumen and financial resources to understand these interdependencies.

Comments on the potential risks associated with those financial interdependencies.

The AEMC has expansively identified potential risks associated with financial interdependencies. Where the AEMC lacks analysis is the probability of the potential risks occurring. It is the probability multiplied by the cost or consequence of the event that determines the risk associated with these independencies. In other words, what is the materiality associated with the risks imposed by the nature of these financial interdependencies?

The NGF believes that the materiality of the risks is in fact very low on the basis that:

- Generators generally sell forward contracts that constitute only 70 to 80% of their physical capacity. This practice is commonly used in the NEM as it caters for the loss of single generating unit within a power station. Hence contracting to this level should not force undue financial distress on the generator under the situation it losses a generating unit.

- Large Retailers tend to also be vertically integrated with portfolios of generation capacity to hedge any wholesale price exposure. Any exogenous risk caused by the failure of a third party generator can effectively be managed through the generation of the Gentailers own generation plant. Hence, the risk of a Large Retailer going broke and causing contagion is considered extremely low.

- The risk associated with simultaneous multiple contingency events is extremely low given modern control systems are designed to isolate fault events and limit its impact spreading to other parts of the power system.

- Demand and volatility in the market has dropped off considerably over the last 24 months. There are many well documented factors that have brought this about such as slow economic growth, increase in renewable energy, increase in solar voltaic roof top installations, increase demand side response, and increase in retail electricity costs due to rising network charges. All these factors are likely to persist in the medium term and hence it is envisioned that the sustained high price and high volatility events which the AEMC has characterised as being more conducive to a ROLR event is less likely to occur in the future.

Comments on the potential financial contagion risks that could arise as a result of the failure of a large retailer.

The NGF believes the AEMC are right on focusing on the new ROLR arrangements which are untested.

The failure of Retailers Energy One in 2007 and Jackgreen in 2009 showed that the relevant ROLR jurisdictional arrangements functioned satisfactorily at the time. Both these Retailers were relatively small with Jackgreen having 75000 residential customers. As highlighted by the AEMC the new RORL arrangements in the National Energy Retail Law (NERL) contain many features of the previous jurisdictional ROLR schemes. Hence it is envisioned that the failure of a relatively small Retailer under the new NERL arrangements should be handled adequately and would cause minimal market disruption.

The NGF agrees with the AEMC that the failure of a large Retailer remains untested. As highlighted earlier in this submission large Retailers are also vertically integrated businesses with both the financial and generation resources to mitigate the risk of a ROLR event.

Having said this there are features of the new ROLR arrangement that may cause uncertainty to all Participants. The AEMC has done a good job of articulating these in section 5.3.2 of the Issues Paper.

In particular the NGF believes that too much discretion is provided to the AER to appoint designated ROLR(s) without the consent of the Retailer, and that the cost recovery provisions for the designated ROLR(s) is also untested. These factors create increased uncertainty and risk for Retailers in general.

The NGF is of the view that these factors support the argument for the AER to also have a pre-determined methodology to allocate the customers of a "large Retailer" to remaining Retailers in the applicable region in case of a ROLR event of a large Retailer. The AER would need to determine what constitutes a "large Retailer" to trigger the application of this relevant methodology. The methodology itself may also require consultation but the NGF envisages that it would involve smearing of the customers across all remaining Retailers operating in the relevant Region.

Comments on the potential financial contagion risks that could arise as a result of the failure of a large generator.

Section 5.2 of the Issues paper highlights analysis on potential contagion from a generator to a retailer.

The AEMC states a generation outage could expose the generator and retailers with which it has entered into contracts to significant financial risks and that these risks are most likely to arise if:

a) the power station is large;
b) the outage affects **all** generating units of the power station simultaneously (emphasis added);
c) the outage lasts for a significant period (i.e. several days or more);
d) the generating units are part of a vertically integrated business and are critical for supporting the retail load of the business;
e) the generator has a high level of hedge contracts that are concentrated with relatively few market participants; and
f) the outage occurs during a period of high demand or when the output of other power stations is also constrained.

It is difficult to envisage a situation where all these factors are present simultaneously or in quick succession. For instance, it is extremely rare to have an outage that affects all generating units of a power station simultaneously (thereby discounting condition b), generators tend to only sell hedge contracts up to 70 to 80% of their capacity (thereby discounting condition e), the NEM has been and will continue to be over supplied with more generation capacity than demand. Furthermore demand growth is expected to be non-existent in the medium term (thereby discounting condition f). Hence the NGF believes the potential financial contagion risks that could arise as a result of the failure of a large generator are extremely small and should not be the focus of this review.

Summary

The NGF believes the financial market arrangements in the NEM are sufficiently robust to deal with a ROLR event. The existing financial market mechanisms and products are sufficiently mature, liquid, and deep to mitigate these risks. Regulatory certainty is an important pre-requisite for investor confidence to continue to operate and make investments in the NEM.

The industry is already subjected to unnecessary uncertainty and potentially increased costs from the ASIC review and the G20 review of OTC products.

In the context of this review the NGF would seek to ensure that the AEMC is mindful of not exacerbating uncertainty associated with the above mentioned other reviews.

The NGF believes that there is merit in the AEMC further analysing the adequacy of the ROLR mechanisms to deal with the failure of a large Retailer.

The NGF appreciates the opportunity to comment on this review. Should you have any questions regarding this response please contact Kevin Ly on 02 9278 1862.

Yours faithfully

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