20 December 2012

John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

Dear Mr Pierce,

National Electricity Market (NEM) Financial Market Resilience Review – Options Paper

Thank you for the opportunity to comment on the AEMC's excellent Options Paper. It is a positive step for the AEMC to examine in detail possible reforms of the "retailer of last resort" provisions. The paper also explicitly considered the real 'last resort' of a NEM financial meltdown: a government bailout, which would be necessary to prevent a disruption to electricity supply. This is also a positive development, as the previous paper on this topic didn't consider this possibility in any detail.[1] I don't have any specific comments on the options presented. However, I do have some comments about the future direction of the AEMC's review.

Risk of crisis in the NEM and poor financial risk management

Further to my earlier submission, I'd like to reiterate my concerns about the AEMC's continued statements about 'low risk' in the NEM, given recent comments by Australian financial regulators. For instance, in a recent report on the OTC derivative market in Australia by the Council of Financial Regulators (comprising the Reserve Bank, ASIC, and APRA), it was found that:

> the responses from OTC electricity market participants highlighted some important divergences from standard practices seen in other OTC derivatives markets… [I]t appears to be uncommon for counterparties to exchange cash or other property to collateralise their OTC electricity derivatives exposures, especially if they are perceived as a significant entity with good credit standing. Instead, these market participants effectively establish a line of credit for their trading counterparties through setting trading limits, which in turn are based on assessments of counterparty creditworthiness.[2]

References to "credit standing" and "creditworthiness" above likely refer only to an entity's rating as bestowed by one of the credit rating agencies – as it was clear from the financial statements of NEM participants that they did not have robust credit assessment capacities. The report continues:

> Where bilateral trading limits have been reached, some market participants indicated that additional transactions would be executed on-exchange (through ASX 24) and collateralised pursuant to the exchange's standard clearing processes. However, the responses indicate that, overall, very low volumes of transactions are conducted on-exchange.[3]

[1] See my previous submission, 5.
[2] Council of Financial Regulators, *Report on the Australian OTC Derivatives Market,* October 2012. See: http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201210-otc-der-mkt-rep-au/risk-management-and-infrastructure-usage-in-australia.html
[3] Ibid.

This finding appears to be inconsistent with the Australian Energy Regulator's statements that OTC derivatives only make up one-third of derivatives traded on the NEM.[4] The report then notes:

> These responses suggest that participants in the OTC electricity derivatives market sometimes have large uncollateralised exposures, thus making them vulnerable in the event of a counterparty default. Because market participants in the OTC electricity derivatives market are predominantly corporates transacting with similar corporates, **the quality of each of these entities' risk management practices is important to ensuring the resilience and stability of this market**.[5]

The obverse of this is that where the risk management practices of NEM participants is not of high quality, the resilience and stability of the NEM is undermined. Another example of this sort of commentary came from ASIC Chairman Greg Medcraft, who stated that:

> ASIC remains of the view that market participants could benefit from some enhanced risk management due to the highly concentrated nature of the OTC derivatives electricity market.[6]

This was in response to a flurry of energy companies decrying the increased risk management measures proposed in an ASIC consultation paper.[7] In its response to the submissions, ASIC noted:

> counterparty risk is a key risk in OTC electricity derivative markets… [this risk] may be intensified by some distinctive characteristics of this market. These include:
>
> > (a) the concentration of the market, and interdependency of key players—just over 90% of OTC market trading in electricity derivatives is engaged in by eight entities, and over 70% of trading by the three most significant entities; and
> >
> > (b) the lack of bank intermediation in the OTC derivative market—data gathered in a recent survey of electricity derivative market participants indicated about 25% of electricity derivatives were traded with banks and financial institutions, while the bulk were traded among generators and retailers (74%).[8]

ASIC then stated that it would consider consulting on requiring credit support in the NEM and requiring energy companies to have 'a comprehensive risk management policy, approved by directors.'[9]

Given these comments by financial regulators about the need for greater financial risk management among electricity companies, it is difficult to explain the AEMC's continued stance regarding the low probability of a financial contagion in the NEM. The above comments show that the AEMC would have to be very comfortable about the risk management practices of NEM participants to come to such a conclusion.

AEMC's assessment of risk in the NEM will be of critical importance. ASIC, like the AEMC, has elected to wait for Treasury to decide whether or not electricity derivatives will be subject to the G20 requirements on OTC derivatives. The government was heavily lobbied by energy companies to

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[4] Australian Energy Regulator, 'Implementing a framework for Australia's G20 commitments on OTC derivatives', *Submission to Department of Treasury*, 15 June 2012.
[5] Ibid.
[6] ASIC, 'ASIC response to submissions on revised financial requirements for electricity derivative issuers' (Media Release, 12-315MR, 13 December 2012). See http://asic.gov.au/asic/asic.nsf/byHeadline/12-315MR%20ASIC%20response%20to%20submissions%20on%20revised%20financial%20requirements%20for%20electricity%20derivative%20issuers?opendocument
[7] ASIC, 'CP 177 Electricity derivative market participants: Financial requirements – submissions', http://asic.gov.au/asic/asic.nsf/byheadline/CP177-Electricity-derivative-market-participants--Financial-requirements--submissions?openDocument
[8] ASIC, 'Response to submissions on CP177 Electricity derivative market participants: Financial requirements', Report 320, 13. Available at: http://asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep320-published-13-December-2012.pdf/$file/rep320-published-13-December-2012.pdf
[9] Ibid, 15.

exempt electricity derivatives from these requirements, both in consultations on the draft Bill[10] and at the Senate committee stage.[11] Interestingly, some of this lobbying relied quite heavily on the AEMC's statement about low probability of financial crisis in the NEM.[12] Perhaps because of this lobbying, Treasury has released a draft amendment to the Regulations that would require ASIC to consult with AEMC prior to making any changes to the way derivative transactions are handled in the NEM.[13] As a result, the final word on the necessity of the G20 requirements for electricity derivatives will likely lie with the AEMC**.** Because of this fact, it is important that the AEMC makes a fully evidenced assessment of financial risk in the NEM.

Over-concentration on last resort measures

The Options Paper asked for submissions on options which it did not canvas. Both the proposed retailer of last resort changes and the last resort government action changes are exactly what they sound like: measures of *last resort.* There are no options which seek to do more than merely 'soften the landing' of a financial crisis in the NEM. This kind of attitude to financial risk is broadly analogous to the attitude of central bankers in the years prior to the GFC. In 2004, in reference to the tech bubble, Alan Greenspan, the former Federal Reserve Chairman, noted that

> Instead of trying to contain a putative bubble by drastic actions with largely unpredictable consequences, we chose… to focus on policies 'to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion'".[14]

That is, Greenspan thought that rather than trying to figure out whether a rise in asset prices is a bubble or a genuine shift, regulators should take a hands-off attitude until a bust actually occurs, at which point they should step in to bailout failing companies. This policy has been referred to one of 'benign neglect'.[15] As Roubini & Mihm note, this strategy "generates moral hazard on a grand scale."[16] This problem was acknowledged by the AEMC in the Options Paper.[17] However, the Options Paper also states that the AEMC considers that:

> **the appropriate role of governments is limited to a last resort role to avoid financial contagion** in circumstances where market-based mechanisms are expected to be insufficient to adequately mitigate contagion.[18]

The AEMC thus appears to advocate a policy of benign neglect, and as such is lagging behind regulators around the world and out of step with events in financial markets in recent years. Many economists now believe benign neglect caused weak market discipline and excessive risk-taking, which led to the GFC.[19] By regulating and supervising risk management in financial markets *before* a crisis emerges, regulators can produce better outcomes at lower cost to government. As noted in a

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[10] The Treasury, 'Implementation of a framework for Australia's G20 Over-the-counter derivatives commitments – Submissions', http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Over-the-counter-derivatives-commitments-consultation-paper/Submissions

[11] Parliament of Australia, 'Senate Committees – Corporations Legislation Amendment (Derivative Transactions) Bill 2012', http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2010-13/derivatives/submissions.htm

[12] Origin Energy, *Submission to Senate Committee on the* Corporations Legislation Amendment (Derivative Transactions) Bill 2012, 2, available at: https://senate.aph.gov.au/submissions/comittees/viewdocument.aspx?id=23e87e97-6382-4577-ba51-653ffdbb94c9.

[13] Exposure Draft of Regulations, available at: http://financialmarkets.tspace.gov.au/.

[14] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (2010) 234.

[15] Giovanni Dell'Ariccia, 'Property Prices and Bank Risk-taking', in Alexandra Heath, Frank Packer, Callan Windsor (eds) "Property Markets and Financial Stability: Proceedings of a Conference Held in Sydney on 20-21 August 2012" 208.

[16] Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (2010) 234.

[17] Options Paper, 93.

[18] Ibid, 94.

[19] Piti Disyatat, 'Discussion', in Alexandra Heath, Frank Packer, Callan Windsor (eds) "Property Markets and Financial Stability: Proceedings of a Conference Held in Sydney on 20-21 August 2012", 225.

speech by RBA Chairman Glenn Stevens, since the GFC: "[p]olicymakers have discovered - or maybe I should say rediscovered - the importance of prudential supervision."[20]

With the foregoing in mind, why does the AEMC think that attempting to mitigate the effects of a financial crisis in the NEM after it occurs is a better option than sensible regulation designed to prevent the crisis occurring in the first place? Why did the AEMC Options Paper contain an effective "no comment" on the question of implementing compulsory clearing, margining, and reporting requirements for derivatives in the NEM? Where are the options recommending greater prudential oversight and supervision of NEM participants? Where are the recommendations of more robust risk management frameworks which are publicly available and approved at Board level?

The SCER request for advice to the AEMC concerned not only ways to mitigate risks to NEM financial markets, but also on how to minimise those risks. It is unfortunate that AEMC appears to have prioritised harm mitigation over harm minimisation. In doing so, the AEMC could be perceived to have prioritised large electricity companies seeking to minimise their transaction costs at the expense of the long term interests of electricity consumers.

Thank you again for the opportunity to respond to the Options Paper.

Yours sincerely,

Lorne Franks

[20] Glenn Stevens, 'Opening Remarks', in Alexandra Heath, Frank Packer, Callan Windsor (eds) "Property Markets and Financial Stability: Proceedings of a Conference Held in Sydney on 20-21 August 2012" 10.