



20 July 2012

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South  
NSW 1235

Dear Mr Pierce

### **EMO0024 - NEM financial market resilience**

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comment on the Issues Paper *EMO0024 - NEM financial market resilience* (the Paper). AFMA represents the interests of participants in Australia's wholesale banking, financial and electricity markets. Our members include Australia's major energy companies and other users of over-the-counter (OTC) electricity derivatives.

Whilst acknowledging the importance to NEM stability of the retailer of last resort (ROLR) process, AFMA's focus is on the efficiency and robustness of OTC financial markets. Accordingly, this submission looks at the effectiveness of mechanisms which mitigate against credit, and hence systemic, risk.

We agree with the initial view of the AEMC that "...the financial relationships and markets that underpin the efficient operation of the NEM are generally robust" and that there is a low likelihood of financial contagion. In this regard, to supplement the efficiencies in the NEM, the market itself has taken considerable self-regulatory steps – through AFMA and bilaterally - to manage the market, credit, operational and liquidity risks which arise in OTC energy markets.

The importance of financial markets (OTC and on-exchange) to electricity market participants is demonstrated by data from the 2011 *Australian Financial Markets Report* (AFMR) which shows derivative market turnover in 2010/11 of some 863 million MWh against NEM demand of 192 m MWh. The liquidity ratio<sup>1</sup> of 4.5 is greater than that of Commonwealth Government Bonds.

The Paper reports on the failures of EnergyOne and Jackgreen, to which we would add the demise of Enron in 2001. In all three cases the defaults were handled smoothly with no systemic impact. Enron was reportedly a very active OTC market participant, yet the provisions in the International Swaps and Derivatives Association (ISDA) Master

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<sup>1</sup> Defined as derivatives turnover divided by turnover in the underlying market

Agreement, which was widely used at the time, facilitated a relatively smooth close-out of open portfolios with Enron. The Commission notes that OTC trades are “usually” documented under the ISDA Master Agreement (ISDA MA); our experience is that very few, if any, deals between NEM participants are documented outside the ISDA framework (which is the global standard for OTC markets). Further commonality of documentation is achieved through widespread adoption of the AFMA "Guide to Australian OTC Transactions" (OTC Guide) recommendations which adapt ISDA material for the Australian environment.

At page 31 it is asserted that “...OTC hedge contracts contain force majeure clauses that would allow the generator to reduce its obligations under the contract in the event of an outage that was beyond its reasonable control”. Material to implement such arrangements is certainly contained in the OTC Guide (in Part 3.9), but has not been incorporated into documentation for many years. It would be surprising if any trades negotiated through brokers (30% of turnover in 2010/11 was arranged this way) would be subject to generator FM provisions.

A further issue around documentation is the comment on page 33 relating to the cross-default provisions in an ISDA MA that a consequence of an insolvent generator (or indeed any party to an ISDA MA) not making payments under OTC contracts and hence defaulting “...will result in other counterparties having a termination right under their OTC contracts”. That general (non-party specific) cross-default provision applies only to “Specified Indebtedness”, which is limited to “borrowed money” in the standard MA. The knock-on effect should only occur if “derivatives” was added to this definition. Although possible, it is our understanding that such amendments are not commonly agreed to.

As noted in the Paper, OTC electricity market participants have developed rigorous policies and procedures covering implementation, review and monitoring of counterparty credit limits, which, supplemented by extensive use of the ISDA Credit Support Annex (alluded to in 4.4) makes the likelihood of a default with systemic implications quite remote. Page 8 says that OTC contracts are “... usually entered into between a generator and a retailer” or “... with another financial market participant”. Data from the 2011 AFMR shows electricity derivative transactions (in MWh) with retailers accounted for 37% of OTC turnover, with generators 39% and 17% with intermediaries. Most of these intermediaries are Authorised Deposit-taking Institutions and hence supervised by the Australian Prudential Regulation Authority, which adds an additional layer of comfort.

In summary, the combination of supervision of NEM participants and effective control process implemented by those entities active in OTC electricity derivative markets should give the AEMC considerable comfort that a financial contagion from a default by a NEM participant is unlikely in the extreme.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Allen Young', with a horizontal line underneath.

Allen Young  
Director Rates & Energy Markets