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19 December 2013

Mr John Pierce
Mr Neville Henderson
Dr Brian Spalding
Australian Energy Market Commission

Lodged electronically: www.aemc.gov.au (EMO0024)

Dear Commissioners,

RE: EMO0024 Stage Two Options Paper – NEM Financial Market Resilience

By way of background InterGen Australia (**InterGen**) is owned by InterGen N.V. and the China HuaNeng Group (**CHG**), China's largest generation company. InterGen and CHG are leading developers and operators of electricity generation facilities worldwide. In Australia, InterGen is the operator and majority owner of the 851MW Millmerran Power Station and a 50% owner of the 850MW Callide C Power Station.

The Australian Energy Market Commission (**AEMC**) has sought stakeholder submissions to the Stage Two Options Paper, NEM Financial Market Resilience dated 8 November 2013 (**Options Paper**). The AEMC is specifically seeking stakeholder views on the issues raised in the Options Paper and to develop a better understanding of:

- the potential for financial contagion due to interdependencies between market participants, particularly those resulting from their hedging arrangements;
- the adequacy of current risk management arrangements to mitigate the risk of financial contagion;
- the potential benefits of a range of measures, in terms of their capacity to increase transparency and reduce systemic risk; and
- the potential disadvantages and costs associated with each option.

InterGen's position is set out below.

General Comments

InterGen believes the National Electricity Market (**NEM**) has developed into a sufficiently robust and mature market. It's participants are sophisticated investors in energy infrastructure (i.e. generation) and energy services (i.e. retail), well experienced in dealing with critical financial market (e.g. the recent Global Financial Collapse) and non-market (e.g. droughts, flood or fire) events that typically

test the resilience of markets. This view is supported by both the Options Paper and the Seed Advisory report¹, which in their respective analyses, do not identify any problem or market failure that suggests that additional market intervention is required.

Further, InterGen sees continued regulatory intervention as the key risk it faces in the NEM. This intervention has previously, and continues to, impact on our ability to efficiently and cost effectively manage our risk exposure to the NEM. Managing spot, cashflow and operational risk are the next key concerns and our OTC hedging activities are geared towards optimising the interplay between these risks.

Our concern is that the implementation of additional compliance measures may in fact dissuade the prudent use of existing hedging avenues to manage risk and in doing so increase the market instability risk the consultation process is seeking to reduce.

NEM design and the risk of contagion

The NEM is a physical market. A key risk for its participants is market risk. Participants seek to mitigate or transfer market risk through asset backed means (i.e. vertical integration) or financial means (e.g. OTC and SFE hedge derivatives). In addition, participants also operate within the governance and regulatory frameworks set out in the National Electricity Law (**NEL**). The key objective of the NEL is to ensure the reliable supply of electricity, which is supported when necessary, by the Government and the market operator's power to direct.

The risk of contagion is therefore mitigated by the very nature of the NEM structure – where generators and retailers collectively manage their risk through interplay between the physical NEM and financial markets. All participants in the NEM are motivated to ensure that the market continues during times of financial stress. Electricity flows and retail customers will continue to be served regardless of participant failures or risk (real or perceived) in hedge markets.

Assessment Framework

InterGen supports the AEMC's use of a clear assessment framework when developing recommendations on the potential application of its identified options. However, we caution against any attempt to apply this framework to definitively ensure that participants' risk management practices are sufficient to prevent financial contagion following counterparty default². In fact, we query the necessity of putting forward any option whilst the case to address risk of contagion in the NEM has not been demonstrated.

The options presented by the AEMC have potential to create new distortions, impose additional costs and exacerbate participants' risk, disproportionate to the benefits that may be gained. It is impractical to design in advance measures that will contain all future events that may trigger contagion. However, it is conceivable that participants will continue to innovate their own risk management practices in tune with developments in the NEM.

¹ <http://www.aemc.gov.au/Media/docs/Consultancy-report-by-Seed-Advisory-61a83f79-d4d6-4444-81c2-2cd990bd6e58-0.PDF>

² See AEMC update to AFMA on NEM Financial Market Resilience, 2 December 2013. Page 20

Potential Options to reduce systemic risk

As a participant in the NEM for well over 10 years, InterGen's experience is that participants it interacts with in the OTC market already have in place appropriate risk management systems and are supported by experienced staff to ensure they can operate effectively in the NEM. We do not see any of the proposed options as improvements to the NEM's financial resilience, rather, apart from option 1 – no new measures, they act to add to the already significant compliance burden faced by the industry.

InterGen contends that reform proposals should instead focus on changes to electricity market design that are likely to affect the market's performance in the event of a default. These include:

- Reforming RoLR arrangements;
- Ensuring generators are able to continue operations in the market whilst in administration; and
- Reviewing prudential requirements to make better use of existing risk capital.

Our specific views on each of the options are presented below:

Option 1 – No new measures (supported)

Option 1 is our preferred outcome. Since commencement of the NEM, participants have actively developed the electricity OTC market and support systems to suit their respective needs (e.g. in relation to credit, flexibility/contracting ease and cashflow management), the idiosyncrasies of the market and the changing regulatory scene. Participants are likely to continue this development to meet any future challenges.

NEM participants continuously monitor their exposure to counterparties against their risk appetite. This approach to addressing credit in the OTC market is self-regulating in the sense that where a party's credit is weak or weakening, its counterparties react by requiring additional credit support in lieu of 'turning them off'. This incentivises the weaker credit party to take immediate steps to improve its financial position to avoid being cut off from accessing the OTC market.

Further, there is already in existence strong governance and regulatory oversight in the NEM. ASIC can readily access information regarding a participant's risk management practices, as well as its derivatives position (SFE and OTC) under its existing surveillance and licensing powers. For example, ASIC has recently undertaken regular surveys of participant OTC positions. This process (after further refinement) can deliver at low cost, similar transparency as mandatory trade reporting.

Option 2 - Trade reporting (not supported)

InterGen concurs with the AEMC's view that

"Participants in the electricity market primarily enter into OTC contracts to offset risk on the physical commodity market. Without information about the physical side of the trade, or a participant's consumer book or positions in the futures market, information about OTC activity may not be sufficient to get a complete picture of systemic risk. For example, a certain transaction on the OTC derivative market could appear to be 'risky' at face value, but it could be that this transaction is in fact entered into to offset a position by the same market participant on the futures market.

The incompleteness of the information could potentially hamper the effectiveness of a trade reporting regime as a forward-looking risk management tool"³

³ Stage Two Options paper – NEM Financial Market Resilience, Australian Energy Market Commission page 57

InterGen is concerned that the data collected under trade reporting could lead to 'false positive' reactions. This is where regulators undertake inappropriate market interventions in an effort to forestall non-existent contagion risk on the basis of an incomplete understanding of NEM participants' true exposure to risk. It is this very risk of unnecessary intervention driven by data made available by trade reporting that should caution the AEMC from recommending this option.

As one of the smaller participants in the NEM, InterGen is also concerned that trade reporting will weaken our ability to commercially and competitively deal in the OTC market if data from trade reporting is publicly released in other than very high level summary form.

We also note that one of the AEMC's stated benefit of trade reporting is that

"it might also improve price discovery in the NEM if the data provided is used to create forward price curves, or industry benchmark indices. Such publication of the data on the aggregated basis could improve the efficiency of the market, while still protecting the confidentiality nature of the data"⁴.

A forward market with quoted prices currently exists in the OTC market. Participants can readily access OTC broker screens for pricing information (that extend out several years), the SFE and/or paid subscription services (for example, as provided by ICAP). Each of these "quotes" are for a standardised product from which participants can then adjust to reflect specific terms of delivery under their "off market" OTC transactions.

The disadvantage of using price discovery achieved through trade reporting is that the market will have most certainly moved between the time a deal was transacted, reported and the aggregated data released to the public. This non-time sensitive data may then have little use especially in times of market volatility. In addition, given the bespoke nature of OTC transactions, trade reported prices do not convey the special terms of delivery (i.e. shaping, credit enhancements, etc.) which may result in a premium or discount to the prevailing standard product offering. Therefore its use as a price discovery tool is an overstated benefit.

Option 3 - Stress testing (not supported)

InterGen believes that stress testing is an integral part of a robust risk management system and is a practice that we have readily incorporated into our processes. We use stress testing to inform ourselves of potential trends in forward cashflows and to provide guidance to prudent levels of hedging (OTC and/or SFE).

However, we do not support the implementation of stress tests against prescribed scenarios. InterGen contents that mandated stress testing effectively acts as a quasi-prudential standard that imposes on participants, significant resource costs for minor informational benefit. It is impractical for participants to act upon the information derived from prescribed scenarios given their likely design to test extreme downside cases. Further, as stress testing is essentially a snapshot, it fails to recognise participants' real time response to market events.

Introducing a stress testing regime also raises other concerns such as:

- Whether scenarios can be defined that provide actionable information to both regulators and participants
- Reducing the incentive for participants to adopt prudent risk management process in lieu of reliance on a stress testing standard
- Potential to shift risk management priorities to address the outcome of a contrived stress test rather than real and present risk in the market

⁴ Stage Two Options paper – NEM Financial Market Resilience, Australian Energy Market Commission page 52

- The diversion of enterprise resources to comply with a mandated stress test regime where the results are of little value to its effective and efficient operations.

Of note is that stress testing is likely to show greater financial contagion risk if there are reduced levels of financial hedging. Financial hedges provide a degree of downside protection against price volatility that occurs at a contagion event. They therefore provide a buffering effect that may act to contain widespread participant default. On this basis, any intervention that reduces the attractiveness of hedging could have the perverse effect of triggering contagion where that risk did not previously exist.

It is InterGen's preference that any decision to stress test is left to participants to incorporate in their own risk management processes as appropriate.

Option 4 - Best Practice Risk Standards (not supported)

InterGen believes that NEM participants already employ sophisticated risk management practices. These practices reflect each participant's risk appetite, ownership structure and business interests as well as the various requirements from existing licensing and regulatory frameworks. While we support the broad application of best practice risk management, we believe that a regulated code would be too rigid to cater to the diversity of NEM participants. It would also potentially impede innovation in risk management approaches.

Option 5 – Trade reporting plus additional margin requirements (not supported)

InterGen believes that the imposition of additional margins defeats the key purpose of why participants use OTC derivatives, that is, to manage cashflow risk. Analysis undertaken by Seed Advisory⁵ highlights that margining does little toward containing contagion as the greater risk lies in a non-defaulting party's ability to recontract lost hedges previously underwritten by the defaulting party.

In short, margining unnecessarily limits the risk management options available to NEM participants.

Option 6 – Stress test reporting plus additional supervision and regulatory powers (not supported)

This option is akin to prudential regulation for the electricity industry. It presupposes a regulator is able to accurately identify and apply the correct intervention to prevent market contagion as long as it has prior access to the appropriate data. It introduces the potential for "too big to fail" intervention, thereby reducing the efficacy of the NEM. It also potentially leads to the requirement for regulators to be intricately involved in the day to day running of at least the systemically important participants. As described, this option appears to inappropriately provide regulators with open ended powers to intervene.

⁵ NEM Financial Resilience, Seed Advisory Section 4 page 32

Conclusion

InterGen welcomes the thoroughness of approach undertaken by the AEMC with respect to the Options Paper and we trust that the AEMC will carefully consider the issues we have raised. Please feel free to contact Mr. Robert Pane on 07 3001 7124 regarding any queries on this submission.

Yours sincerely,



Sam Bristow
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