18 December 2013

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

Lodged electronically via www.aemc.gov.au

Dear Commissioners,

NEM Financial Market Resilience – Stage Two Options Paper

Alinta Energy welcomes the opportunity to make a submission in response to the *NEM Financial Market Resilience – Stage Two Options Paper* (the options paper), released by the Australian Energy Market Commission (AEMC).

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia. Alinta Energy has over 2500MW of generation facilities in Australia (and New Zealand), and a growing customer base of approximately 750,000 retail energy customers in Western Australia and across the National Electricity Market (NEM).

Overview

Alinta Energy has been deeply involved in the AEMC's working group processes and has watched the analysis and analytical framework develop over the course of the two stages of the review.

Following stage one of the review Alinta Energy concluded, and this view appears to be widely shared, that regulatory flaws, not market flaws, with the Retailer of Last Resort scheme may create potential contagion risks and that reform to that scheme was warranted. Alinta Energy did not support, and it appears few, if any, stakeholders support the introduction of a special administration regime to replace the Retailer of Last Resort scheme. The recommendation for a special administration regime is disproportionate, costly, intrusive and unlikely to deliver better outcomes in practise regardless of well-intentioned arguments on paper.

Stage two of the review on its face focused on financial contagion but from the perspective of financial markets. While stage two of the review has yet to conclude, it is clear the analysis which purports to justify the examination of the range and scope of possible interventions contained in the options paper is insufficient to recommend such further interventions.

While Alinta Energy believes the AEMC has undertaken a good job in analysing risks and risk management in the NEM at one level, the review has been unable to draw out any meaningful measure of "systemic" risk or credible incidence of likely contagion. In short, there is no market failure and the reluctance of the AEMC to draw this conclusion remains disappointing.

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The licensing conditions and data collection arrangements used by the Australian Securities and Investment Commission (ASIC), the regulator for the financial markets, is both robust and well established. With some incremental improvements it will continue to serve ASIC and the industry well.

As the Government will consider the AEMC's advice before determining the treatment of electricity derivatives, the AEMC needs to quickly draw conclusions on the costs, benefits and risks of extending the G20 measures to electricity derivatives. It remains unclear why this stage of the review has yet to conclusively determine that the G20 derivative reform agenda should not be extended to the energy sector and that current regulatory powers are adequate.

Instead, the AEMC has canvassed a number of additional regulatory options; this is despite the absence of market failure being demonstrated and despite the absence of credible contagion scenarios driven by over-the-counter (OTC) derivative positions.

Nonetheless, the AEMC has provided a thorough background on risk management and risk in the NEM and Alinta Energy now encourages the AEMC to draw robust evidence based conclusions in the area of financial market contagion.

SEED Advisory report

Alinta Energy appreciates that the issue of financial contagion can be somewhat nebulous and difficult to explore. To this end, the Energy Supply Association of Australia, the Private Generators Group and the National Generators Forum commissioned analysis by SEED Advisory. The SEED Advisory report provides a quantitative basis on which to consider the proposed reforms.

The SEED Advisory report has since been submitted to the AEMC by the Energy Supply Association of Australia and requires careful consideration by the AEMC. Importantly the SEED Advisory report makes a number of important conclusions.

- There is no case to impose new obligations or restrictions on the OTC electricity derivative markets, based on analysis of the risks to the economy, the financial sector or the NEM.
- The case for mandatory reporting of electricity derivatives is weak with the existing market and regulatory frameworks being robust and suitably transparent.
- Margining reduces credit risk but creates other costs and risks and hence it is not appropriate for all circumstances and should not be mandated.
    - Margining increases capital requirements and increases cash flow risk but does not mitigate the risk of post default market changes.
    - Three-quarters of the potential losses in the 'stress test' analysis arise from changes in the spot and derivative markets post default. Margining has no impact on these.
- Reform proposals should prioritise changes to electricity market design likely to affect the market's performance in the event of a default. These are not major reforms but targeted areas.
    - Reforming Retailer of Last Resort arrangements.
    - Ensuring a generator is able participate in the market while in administration, this requires a rule change that can be progressed immediately.
    - Reviewing prudential requirements to make better use of existing risk capital.
    - Ensuring the Cumulative Price Threshold is set based on market risk tolerances.

    - Introducing a shorter settlement cycle.
- Requiring participants to maintain increased capital is inefficient and poorly targeted and should not be considered at any level.

Risk management in the NEM

As stated, Alinta Energy believes the AEMC have competently assessed and explained risk and risk management arrangements in the NEM. Alinta Energy's experiences, and engagement since commencement of the review on the industry working group, lead it to draw a number of additional conclusions.

- Risk arises as a result of the market structure. The nature of the gross pool facilitated market requires the use of derivatives, notably OTCs, to manage that risk. In the absence of a new market structure risk can only be moved from one part of the market to another.
- Removing or making OTCs more expensive will reduce participants' ability to manage risks in the market as OTCs are an important hedging instrument.
- Market risk is of greater concern than credit risk which always suggests reducing market risk through some OTC exposure is a good thing. The myopic assessment of OTCs in isolation fails to capture the sophistication of large energy businesses.
- Structured OTCs are important for new entrant retailers and increased costs will increase barriers to entry and stifle competition. These entities want to manage market risk exposures in specific ways as their businesses evolve.
- No one company is too big to fail as concentration risk is not considered significant. There is no demonstrated material risk of contagion between big players, or the big three to be precise.
- Electricity flows and retail customers will continue to be served regardless of failures or risk in OTC market. In other words, the physical market is not in jeopardy even if an individual companies OTC position" explodes", the lights won't turn off.
- Risk management practices have been shown to be adequate and the level of risk carried by participants reflects individual risk tolerances. Further, good risk management practices are driven by prudent board decisions not regulatory drivers. The role of each board is first and foremost to manage risk to ensure the companies survives and protects it's capital.
- All analyses have illustrated that the OTC market for energy is not a risk to the financial system and is not a risk to the economy. In fact, the exposure to exchange rate fluctuations for many large energy companies is of greater concern that any dramatic change in OTC positions.

Way forward

Alinta Energy supports the assessment framework in the options paper whereby interventions in the market should only be justified where clear failures can be demonstrated and interventions would be consistent with the National Electricity Objective.

Applying this framework Alinta Energy concludes that the risks and costs associated with imposing central clearing, trade execution and increased capital requirements for non-centrally cleared derivatives would outweigh the benefits. In fact, there are already incentives to apply margining requirements and use of trading platforms where considered appropriate.

As for mandatory reporting, it appears the driver for this may be more closely aligned with energy sector governance body and regulator curiosity than any benefit to the market. While trade reporting can be suggested to be light-handed, it is anything but the case.

Mandatory reporting will be difficult to implement, creates centralisation risk of commercially sensitive information, and is likely to be very difficult to analyse or make sense of. For instance, the derivative transaction information in the trade repository would provide little or no information about the risk position of electricity market participants. A generator would be naturally long, whereas a retailer naturally short; their derivative position is not particularly meaningful without an understanding of their physical position. Therefore, it is not unexpected that no one has made a sensible case as to how such data would be used by the market or regulators and have fallen back to catch-all phrases such as 'transparency' and 'integrity'.

This lack of clarity also creates the appearance that some in the policy space may believe there could be cause for future interventions in the OTC market. This is highly undesirable and such a view illustrates a lack of understanding of how the energy OTC market functions. This also reinforces the conclusions, Alinta Energy has reached: that trade reporting as conceived by the G20 derivative reform agenda is not viable.

Alinta Energy does support refinement of data collection arrangements already used by the ASIC; however, this is not dependent on any action by the AEMC and reflects the status quo where ASIC continues to develop and refine its energy market participant surveys as it engages with the industry.

This suggests that the AEMC should recommend option 1 from the options paper: no new measures.

Option 1 is consistent with the quantitative analysis in the SEED Advisory report and analysis in the options paper that the market is sufficiently transparent, there are strong governance and regulatory frameworks in place for the physical market and for the financial market, ASIC can access all information about participants risk management process, futures and OTC positions at any time under their existing surveillance and licensing powers, and the NEM has proven robust in the face of failures over the course of the past 15 years.

The alternative options

The options paper includes a range of additional potential regulatory interventions. All of these options will increase participant costs and Alinta Energy does not believe the options paper, or any other work, has provided a justifiable case to implement these alternative options.

Stress testing, option 3, sounds appealing in its simplicity but in actual fact it is likely to impose significant distortions and costs. It would effectively act as a prudential standard and distort participant risk management decisions towards the stress test and specific risks when a portfolio approach would otherwise be appropriate. Further, it is unlikely any one test would be applicable to all entities or capture information regarding their key risks.

The code of practice, or option 4, is also undesirable. Entities already work to best practice standards and a code of practice would form an arbitrary tool which is likely to become out-dated or be set at such a level as to be meaningless. A code would not enhance existing arrangements.

The concept of additional prudential regulation, or powers of intervention, would substantially increase participant costs, create barriers to entry and reduce innovation and competition to the significant detriment of electricity consumers.

Such a system would likely emphasise stability over competition and lead to inefficient levels of capital being held by a few large entities. It would be pushing the industry back towards a few large vertically integrated entities with little agility as opposed to one where product creativity should flourish and entry and exit in response to successful commercial decisions is the norm. The AEMC countenance of such an option, despite the absence of evidence of failure, is of concern and of questionable constructive value.

Conclusion

The AEMC have undertaken a detailed assessment of a range of matters concerning risk and risk management.

Alinta Energy has been engaged in the review process for its duration and is yet to see any compelling case or evidence to justify significant change or further intervention.

Alinta Energy remains confident that ASIC, in its role as financial market regulator, has the powers and the growing expertise to engage and draw relevant information from energy sector participants as necessary. Thus the case for no further regulatory interventions should be endorsed by the AEMC.

Should you have any queries in relation to this matter please do not hesitate to contact me on, telephone, (02) 9372 2633.

Yours sincerely

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