Energy Supply Association of Australia
www.esaa.com.au
ABN 98 052 416 083
Level 2
451 Little Bourke St
Melbourne
GPO Box 1823
Melbourne
Victoria 3001
P +61 3 **9205 3100**
F +61 3 **9670 1069**
E info@esaa.com.au

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Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Lodged online: www.aemc.gov.au

NEM Financial Market Resilience – Stage 2 Options Paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission (AEMC) on the NEM Financial Market Resilience – Stage 2 Options Paper.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 34 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

The focus of this stage of the review is whether the over the counter (OTC) contract market could spread financial contagion. This focus is driven by the G20 financial reforms, which were part of the response to the failure of financial markets during the global financial crisis.

Before any additional regulation is applied to the sector it needs to be established that there is a material risk that OTC contracts could spread financial contagion leading to a systemic failure. If this found to be the case, the benefits of the proposed solution need to outweigh the costs.

The gross pool market design of the National Electricity Market means participants need derivative contracts to manage risk. While exchange contracts are used to manage part of the risk, the bespoke nature of OTC contracts means businesses are better able to tailor contracts to their specific needs.

The electricity financial markets, like other commodity markets, are different to "pure" financial markets[1]. Contracting in commodity markets is undertaken to manage an underlying risk in the physical market. Electricity derivatives are underpinned by a physical asset (generation output/retail book) and involve limited leverage. In "pure" financial markets, while some trade is undertaken to manage a risk, there is a significant degree of speculation, with trades often being leveraged. As there are material differences between the use of OTC contracts in different markets, there is not a prima facie case for harmonisation of regulatory approach. As such, it needs to be established that electricity OTC contracts require greater regulation on their merits, rather than simply arguing that this is the treatment for other OTC markets.

[1] For example exchange and interest rate derivative markets.

The paper notes that a failure in the electricity financial markets will not have an impact on the broader financial sector, but could impact the economy through affecting the supply of electricity. It is this broader impact that the paper argues represents a systemic risk. Electricity financial markets are not an essential service, they merely help manage the risks in the physical market. If there is an adverse event in the electricity financial markets it will not impact the physical supply of electricity to consumers. As such, it is hard to see how the OTC market could cause systemic risk. Further, there is currently oversupply in the wholesale market and Australian Energy Market Operator forecasts that new generation capacity is not required in the medium term suggests even if a risk theoretically exists it will not materialise for the foreseeable future.

esaa believes that the proposals in the paper will have an adverse impact on businesses ability to manage their risks. Any attempt to push businesses towards one element of the risk triangle[2] limits their ability to be in the best place, optimising risk against the three elements as circumstances change. There is a risk that options such as trading reporting and margining will reduce the use of OTC contracts. Ultimately any option that limits the ability of businesses to manage risk has to increase prices. Further, if measures are adopted that increase the amount of capital businesses have to hold on their balance sheets and/or impose greater regulator costs it is likely to lead to greater concentration in the sector, as only large businesses will be able to cope.

A significant proportion of the costs from the failure of a counter party occurs after the event. To ensure these costs don’t impose financial risks on the sector, retailers need to be able to pass on any increase in costs to customers, as all money in the sector comes from customers. As such, deregulated retail prices are a key risk management tool.

ASIC, as part of its governance of Australian Financial Services Licence holders, already has the power to request that a market participant provide its hedge book and risk management manuals. Rather than imposing new regulatory burdens or capital costs, esaa suggests ASIC continues to work with industry to improve their survey to ensure ASIC has sufficient information to assess the risks in the market.

Please see **Additional Information** for our views on the options set out in the paper.

Any questions about our submission should be addressed to Ben Pryor, by email to ben.pryor@esaa.com.au or by telephone on (03) 9205 3103.

Yours sincerely

Kieran Donoghue
General Manager Policy

[2] Figure 3.1, pg 19.

Additional Information

The esaa does not believe any further regulatory action is warranted in the electricity OTC contract market. Our preference would be for ASIC to continue to work with industry to improve their survey to ensure ASIC has sufficient information to assess the risks in the sector.

Trade reporting

Transparency is a worthwhile objective, but not at any cost. There would be up front and ongoing costs to market participants to comply with trade reporting. ASIC can already access any information they need to allow them to make a judgement about the risk in the market. As there does not appear to be a need to have near real time information provided to ASIC, the additional costs of trading reporting are not justified. Further refinement of the current survey process would represent a more fit for purpose approach to reporting.

Stress test reporting

Internal stress tests are a key part of good practice risk management. That said external stress tests can be challenging to design as there is a risk that they are either set too low and become meaningless or too high/unrealistic such that no business would likely pass.

A question arises of who should develop/administer a stress test. Given ASIC's current role and powers it would seem to be the most suitable body. But ASIC already has the power to request the necessary information to assess the risk levels of individual participant and through this, the market as a whole.

Code of practice

Electricity businesses have sound internal risk management practices. This option seems to be premised on the assumption that internal risk management practices are currently insufficient, without providing any evidence to substantiate this view. While the idea of a code of practice sounds benign, how it is implemented can have a material adverse impact on businesses. If the code is prescriptive it will limit the options of businesses to deal with any risks they may face, ultimately making the situation worse. The esaa notes that ASIC currently recommends businesses use the international standard AS/NZS ISO31000-2009 Risk Management, to identify, evaluate and manage risks. As such, there does not appear to be a need for a code of practice.

Trade reporting and additional margining requirements

The Seed report[3] found that the total cost of an OTC market default is dominated by the spot and derivative market behaviour after the default. Assuming this is correct, then introducing mandated credit support for all OTC derivatives or requiring

[3] Seed Advisory - *NEM Financial Resilience Report for the Private Generators Group, the National Generators Forum and the Energy Supply Association of Australia,* 14 August 2013.

margining has the potential to increase the capital required of industry participants without necessarily reducing all the risks to those participants

Margining creates cash flow issues at the point businesses are under pressure and as the derivatives market is underpinned by the physical market can create perverse outcomes. From a contract market perspective a high wholesale spot price appears as a negative for generators if the strike price is low. In this situation a generator would be required to submit extra capital to margin off, but the generator would also be receiving the high wholesale spot price. This was the case during the drought.

Stress test reporting and additional supervision and regulatory powers

If it is accepted that OTC contracts are used as a risk management tool, and rarely used for speculation, this approach is essentially saying that businesses are not able to appropriately manage their risks and require assistance from government to make sure they run their businesses appropriately. While oversight and feedback is useful, businesses are best placed to manage their operations.