NATIONAL
GENERATORS
FORUM

21 December 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

RE: NEM Financial Resilience Review Options Paper

Thank you for the opportunity to respond to the National Electricity Market (NEM) Financial Market Resilience Options Paper (the Options Paper). The National Generators Forum (NGF) concurs with the Australian Energy Market Commission's (AEMC) general finding that the there is a low probability of financial contagion occurring in the NEM. On this basis, we consider it crucial that any change to the current arrangements be proportional to the level of overall risk of financial contagion and should not place any additional unmanageable risks on market participants.

If the AEMC considers it necessary to recommend changes to mitigate the risk of financial contagion, in the event of a large retailer failure, the NGF considers the option to amend the Australian Energy Market Operator (AEMO) credit support arrangements for the Retailer of Last Resort (ROLR) the most effective and practical proposal. It represents the least distorting option to the market. While there is some level of increased risk for the generation sector in the event of a large retailer failure, the market would continue to operate without any substantial interference or disruption and generators would continue to be paid by the ROLR.

Furthermore, it is important to emphasise that these mechanisms are designed to mitigate the risk of financial contagion due to financial stress faced by the designated ROLR (not the failed retailer). Essentially this is a second stage risk and the risk management strategies need to be framed in this context. Given the nature of the risk, changing the arrangements for credit support for the ROLR provide a targeted response without imposing any additional upfront costs on consumers or creating additional market uncertainty (i.e. allows for the most efficient use of capital), which is important given the current concern over rising energy costs to end-users. The NGF suggests the AEMC develop this option in more detail and consider the specific design elements and system requirements.

In terms of the other options presented in the Options Paper, the NGF does not hold firm views on the specific proposals around cost recovery and the role of government in managing the risks of financial contagion. We have focused on the impacts and workability of options with direct impacts for generators' cash flow, hedging arrangements and overall risk management framework in the NEM. A number of these options would result in a disproportionate reallocation of risk to the generation sector without reducing the overall level of risk for the market. The remainder of our submission highlights our concerns in respect to those.

Transfer of hedge contracts to the designated ROLR

Under this option the designated ROLR could be granted an option to acquire some or all of the hedge contracts of the failed retailer. This would occur by way of a legislated novation without the requirement for consent or negotiation with the contract counterparty. While this option would allow the ROLR to access hedges to cover the transferring customer load, it is inconsistent with the insolvency provisions in the Corporation Act and represents a fundamental policy change in this area of corporate law. More importantly, it undermines the integrity of the market and does not support good market governance processes.

Practically, this option also presents difficulties as any contract novation requires considerable lead time to allow the necessary system changes to be made to effect payment to a new counterpart in accordance with contractual obligations. We note the AEMC has largely recognised these concerns and suggests that the drawbacks would outweigh the potential benefits. We recommend this option is not developed any further.

Amending the ROLR event triggers and delayed designation of ROLRs

These options would extend the timeframe for triggering the ROLR arrangements. While we recognise this may avoid the need to assign a ROLR and or result in a more appropriate assignment of the (ROLR(s)), the NGF considers that this raises greater market governance concerns. Allowing a potentially insolvent retailer to continue to operate and accrue liabilities with AEMO is inconsistent with good market governance practice and undermines the integrity of the market. It also extends the period of uncertainty for other market participants.

It is important to note that cross default provisions in International Swaps and Derivative Association (ISDA) agreements between most electricity market participants have the potential to result in the collapse of a market participant in financial distress. The cross default provisions allows a party to close out all open transactions and terminate the ISDA in circumstances where the other party defaults under financial arrangements with a third party. Hence a delayed designation of ROLRs would not delay actions being taken against retailers experiencing financial distress under its ISDA agreements.

Spot market price cap and delayed settlement for designated ROLR to pay AEMO

Under the price cap option, the spot price would be capped at $300/MWh. While appealing given its simplicity in terms of implementation (the framework is already in place with respect to the Cumulative Price Threshold (CPT)), generators' profitability is put at risk. Furthermore, while generators take account of a range of potential market events in formulating business/trading strategies, ROLR events (due to the low level of probability of occurring and the difficulty in forecasting the timing and magnitude of the impact) would not be incorporated into the typical scenario analysis that underpins these business decisions. As recognised by the AEMC, activation of a price cap due to a ROLR event could present cash flow issues for generators and difficulties in meeting other financial commitments, which increases the overall level of contagion risk for the sector. The concept also raises market efficiency issues as a price cap would distort long-term price signals for new investment.

The complexities regarding the application of the price cap also question the viability of the option as it would be difficult to construct an equitable allocation process across the market. A uniform application across the NEM is likely to expose generators, who would otherwise be unaffected by the ROLR event, to an unnecessary price cap. Conversely, allocation on a regional basis may not fully reflect the location of transferring customers (as customers are likely to span state borders). There is also a question regarding the appropriate level at which to set the cap. In reality, depending on prevailing market conditions, a $300/MWh cap may not substantially reduce the ROLR's exposure to the spot market.

The NGF holds serious concerns regarding further consideration of this option given the added risks it presents for the generation sector and its impacts for market efficiency.

With respect to the delayed settlement option, it suffers from the same issues regarding the impacts for generators. Under this option generators would not receive spot revenue required to meet unchanged contractual obligations.

Concluding comments

Given the overall risk assessment related to a ROLR event, the NGF considers that changes to the credit support arrangements present the most practical solution. We note the AEMC has considered two variants of this option including a complete waiver of the credit support arrangements along with staging the provision of credit support to AEMO. We consider the second option strikes a reasonable balance between providing the ROLR with the necessary flexibility to access the required funding while preserving the NEM prudential arrangements that are important to maintaining ongoing confidence in the market.

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The NGF was surprised by the breadth of the options presented in the Draft Report and the extent of potential reallocation of risk to the generation sector. Given a number of these options represents a significant departure from the current arrangements we would welcome the opportunity to further discuss the broad set of options along with our views on how changes to the credit support arrangements could work in practice. Please do not hesitate to contact me directly with any questions.

Yours faithfully

Tim Reardon
Executive Director