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A few words.

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Mr John Pierce

Australian Energy Market Commission

Level 5 , 201 Elizabeth Street

Sydney NSW 2000

Lodged (online): http://www.aemc.gov.au

Dear Mr Pierce

AEMC First Interim Report: Financial Market Resilience

AGL welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) First Interim Report on Financial Market Resilience (FMR).

AGL operates across the energy supply chain and has investments in energy retailing, energy services, coal-fired electricity generation, gas-fired electricity generation, renewables and upstream gas extraction.

AGL is a member of the AEMC FMR Working group and is supportive of the process that the AEMC has undertaken to progress this matter to this point.

Retailer of Last Resort

Ostensibly, the First Interim Report contains two recommendations, these are as follows:

- **Amendments to the existing Retailer of Last Resort(ROLR) scheme:**

  An easing of initial credit support on the ROLR in order to decrease the pressure it faces to meet the Australian Energy Market Operator's (AEMO) requirements for the additional customer base and allow the Commonwealth government to offer AEMO credit support; and

- **Alternative to ROLR – Special Administration Regime**:

  Further development of a special administration regime – backed by government funding. The administrator's main objective would be to maintain continuity of supply to customers and prevent financial market contagion. The costs incurred by government under such a mechanism would be recovered through the sale of assets under administration.

  The AEMC notes that in order to allow the administrator to act effectively and to minimise adverse impacts on the rest of the company, this solution would likely necessitate retailer ring fencing.

In assessing options to address the possibility of financial market contagion, the AEMC has proposed a number of assessment criteria, including that solutions:

- ensure that risks are allocated efficiently;
- be well targeted to the problem identified;
- be proportionate to the problem, in that any impact from the introduction of
- regulatory measures can be justified by the expected benefit in mitigating the risk
- of contagion; and
- minimise the potential for moral hazard.

With regards to the first recommendation, easing initial credit support requirements, AGL supports this measure and considers that it:

- substantially decreases the pressure on the ROLR to meet credit support obligations for the new customer load; and
- broadly meets the AEMC's criteria in that it is proportionate to the problem – as well as the probability of the problem arising; minimises regulatory burden; and minimises the potential for moral hazard.

Finally, AGL considers that this proposal will increase the likelihood that market participants will offer to be a ROLR.

With regards to the second recommendation, AGL acknowledges that the AEMC, through its proposal to further develop a Special Administrative Regime, is attempting to implement a framework that allows for substantive government involvement in the ROLR process whilst also ensuring that such involvement does not introduce moral hazard. That is, amendments to existing ROLR arrangements do not provide an incentive to market participants to operate confident of government ultimately bailing them out in the event of failure.

However, AGL does not support this recommendation as, from AGL's perspective, this measure:

- is overly intrusive and would significantly increase regulatory burden;
- is completely out of proportion with the probability of such an event occurring – running counter to the AEMC's assessment criteria;
- would increase business costs in a highly competitive market environment;
- runs counter to business models which are aimed at cost minimisation and streamlining. Additional costs would likely be incurred in the following areas; labour, legal, information technology, hedging, prudential/collateral and accommodation;
- given the potential business impacts, the proposal also conflicts with the NEO; and
- would run counter to current insolvency practices and require specific amendment to facilitate its implementation.

AGL also questions whether such a mechanism could operate effectively in the event of the failure of a vertically integrated company. Specifically, the possibility exists that should a vertically integrated company's retail arm fail, its generation portfolio would also be under duress as AEMO would have sought payment for the retail operations debt in the first instance – prior to it being declared insolvent and prior to a ROLR event being triggered.

In its initial submission to the Financial Market Resilience Options Paper, AGL noted that it is unlikely that a single measure could be a panacea given the possible scope and scale of the impacts arising from the failure of a large retailer. AGL maintains this view.

Given the adverse implications of adopting a Special Administrative Regime identified in this submission, AGL suggest that the AEMC should further investigate the costs and benefits of:

- Amendments to Distribution Network Service Provider (DNSP) credit support provisions. This option would reduce the ROLR obligations to DNSPs – which will assist them with transitioning the new customer load into their business;
- Partial market suspension; and
- The delayed designation of ROLRs.

G20 Over-the-Counter Reforms

In preparing its second interim report the AEMC notes that it will focus on whether the G20 reforms should be applied to over-the-counter electricity derivatives. AGL understands that greater focus may be placed on these reforms if the special administrative regime is not adopted. Therefore, we would like to reiterate our initial concerns with the G20 reforms in light of the three step analysis that the AEMC proposes.

1. Are there other matters that create a material risk of financial contagion in the NEM?

We agree with the AEMC's view that the likelihood of financial contagion in the NEM is low. Apart from a large retailer failure, we don't believe that there are other events that could create a material risk of financial contagion in the NEM.

Historically, there have been significant events that have affected individual participants but have not resulted in widespread contagion or systemic impact in the NEM. For example, certain thermal and hydro generators suffered supply side shock during the 2006-2008 drought, however this did not spread financial contagion to other participants in the NEM. The collapse of a large derivatives trader such as Enron in 2001 also did not create systemic risks with participants in the OTC electricity derivatives market.

2. Do the existing regulatory mechanisms and risk management practices appropriately manage the risk?

Even if there were potential sources of financial contagion in the NEM, there are significant regulatory mechanisms and risk management practices in place to prevent financial contagion. This is supported by the fact that the significant events referred to in the paragraph above did not result in widespread financial contagion.

Market participants are subject to prudential and margining requirements by AEMO. Most participants have entered into derivatives to manage their financial risks and are therefore subject to financial requirements related to holding an Australian Financial Services Licence and participating on the Futures Exchange.

Participants also have robust internal risk management frameworks – which are routinely monitored – to manage credit, market, operational and liquidity risk.

3. If the existing mechanisms and practices are not adequate, are there additional regulatory measures that would effectively and proportionately manage the relevant risks?

Any additional regulatory measures may have a significant impact on the electricity market. Therefore, we agree with the AEMC's proposal to assess each option on a cost benefit basis. Specifically, the AEMC should consider the significant compliance costs that the G20 reforms will impose on the OTC electricity derivatives market and the implications of such costs. The value of entering into OTC derivatives is that it enables participants to enter into contracts that are tailored to the exposures they may face. However if additional costs are placed on OTC derivatives, participants may move more towards the standardised products on the exchange and thus reduce their ability to effectively hedge against their risks. If participants face increased costs in the derivatives markets, such costs may also ultimately be borne by consumers.

Furthermore, the AEMC should also consider the broader implications of the G20 reforms, and whether they will actually increase the risk of financial contagion rather than mitigate it. For example, in the event that there was a failure of a large participant, it would create significant market volatility. The margining requirements under a centralised exchange or bilateral agreement in a volatile market would actually increase the strain on cash flows of participants, which would exacerbate the risk of financial contagion. AGL considers that it would be worth considering whether the significant events in the history of the NEM, which were otherwise managed, could have led to a greater risk of financial contagion, had some of the OTC reforms been in place at the time.

Should you have any questions on issues raised in AGL's submission, please contact Josynta Singh on (03) 8633 6628.

Yours sincerely,

Simon Camroux
Manager Wholesale Market Regulation