

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

**NEM FINANCIAL MARKET RESILIENCE**

Dear Mr Pierce 

I am writing to you, in my capacity as Chair of the Ministerial Council on Energy (MCE), seeking advice from the Australian Energy Market Commission (AEMC) on the resilience of the financial market associated with the National Electricity Market (NEM).

**Context**

The Ministerial Council is confident that the existing electricity market framework is in the main resilient and able to accommodate major changes. The Council also recognises that the environment in which the NEM operates has evolved significantly since market start. At the Standing Council on Energy and Resources (SCER) meeting on 9 December 2011 Ministers acknowledged that the challenges facing the NEM over the coming years may test its resilience. In this context Ministers considered it appropriate for policy makers to understand how these challenges could potentially impact the market.

While market participants need to manage their own financial and commercial positions, Ministers noted that significant financial interdependencies exist between market participants in the NEM, arising through participants' exposure to a common spot price and hedging arrangements.

Ministers agreed that it is important that these financial interdependencies and any associated risks to the stability of the market are well understood by market participants and policy makers. SCER Ministers for Energy requested that, with the input of market participants and other stakeholders, the AEMC identify the nature of risks to the efficient functioning of the market arising from these interdependencies and the effectiveness of existing mitigation mechanisms, and recommend to the SCER whether any enhancements are necessary to minimise the risks and consequences identified.

## Request for advice

The AEMC is to identify risks that may give rise to financial instability in the NEM. This will involve the AEMC engaging and working with stakeholders to confirm their views on risks to financial stability in the NEM, and to develop, if deemed necessary, for the SCER's consideration, recommendations on mechanisms to minimise identified risks and consequences.

Under section 6 of the *Australian Energy Market Commission Establishment Act 2004 (SA)* the Ministerial Council on Energy (MCE) may request the Australian Energy Market Commission (AEMC) to provide advice. In September 2011, the Council of Australian Governments (COAG) created SCER, which includes Ministers responsible for Energy. These Ministers comprise the membership of the legally enduring MCE. SCER Ministers responsible for Energy are entitled to make requests under section 6 and have requested the AEMC to provide advice on:

- the nature of risks to the National Electricity Market (NEM) arising from financial interdependencies between market participants; and
- appropriate mechanisms to minimise those risks and consequences if deemed necessary. Both preventative and responsive mechanisms should be considered.

## Content of advice

The SCER seeks to understand better:

- the risks to financial stability in the NEM arising from the financial interdependencies between market participants, and the impacts of those risks if they materialise and result in financial instability. Instability has the potential to result in adverse implications for the secure and reliable supply of electricity, pricing and, ultimately, investment, thereby compromising the achievement of the National Electricity Objective (NEO);
- the existing mechanisms to mitigate risks to financial stability and manage the consequences in the NEM and whether they are adequate. These mechanisms can be distinguished from mechanisms to mitigate risks to the physical integrity of the electricity system which are well established. If they are inadequate, the AEMC is requested to make recommendations to the SCER to strengthen and enhance and, if necessary, supplement the mechanisms for minimising the risks and consequences; and
- any other mechanisms for minimising risks.

## Consultation during preparation of advice

Any conclusions drawn, and recommendations developed to minimise the risks to financial system stability and manage the consequences in the NEM should give confidence to the SCER that the recommendations can be implemented and the risks and consequences can be appropriately managed.

In undertaking this work, the AEMC is requested to engage with stakeholders. In particular, it is envisaged that the AEMC will work with market participants to draw on their relevant experience and technical expertise in confirming the nature of risks to financial stability in the NEM arising from financial interdependencies and developing options for addressing those risks.

Issues on which the AEMC may wish to seek input from market participants include but are not limited to:

- Internal practices of market participants designed to mitigate risks to financial stability;
- Current regulatory arrangements that may mitigate risks to financial stability;
- Opportunities to enhance financial stability in a dynamic market environment; and
- Reviewing current Retailer of Last Resort arrangements with a view to minimising risks to financial stability, taking account of mechanisms in other jurisdictions or industries that may be appropriate.

The AEMC may publish issues papers and other documents to facilitate this engagement as required.

### **Advisory Committee**

To help ensure that any recommendations made to the SCER meet all relevant policy and regulatory requirements, the AEMC should establish and chair an advisory committee, comprising representatives from the:

- Australian Energy Regulator;
- Australian Energy Market Operator;
- Australian Securities and Investments Commission; and
- SCER Senior Committee of Officials (SCO).

The SCER anticipates that the advisory committee will comment and provide input at each stage of the process including on any options developed. The views of the advisory committee are to be taken into account by the AEMC in drawing conclusions and developing recommendations.

### **Relevant considerations**

Amongst other things, in preparing the advice the AEMC is to consider:

- The National Electricity Objective;
- Relevant developments in electricity markets in other jurisdictions;
- Approaches to financial stability regulation in other markets;
- Relevant developments in the regulation of financial markets in Australia and other jurisdictions;

- Relevant work being undertaken by the Council of Financial Regulators;
- The role of ASIC, and obligations on participants, under the Corporations Act; and
- Transitional mechanisms related to the introduction of a price on carbon.

### **Timeframes and deliverables**

It is expected that the AEMC would commence this work by publishing a statement setting out the process for developing this advice and the timeframe for the provision of the advice.

The advice the AEMC provides to the SCER is expected to include reports setting out:

- conclusions on the nature of the risks to market stability from systemic financial interdependencies, and on any regulatory gaps/deficiencies; and
- recommendations on mechanisms to minimise the risks and consequences if deemed necessary.

I understand that the AEMC has agreed to fund this work within its existing budget.

Thank you for your contribution to this process and I look forward to receiving your response.

Yours sincerely



Martin Ferguson  
**Chair**

Standing Council on Energy and Resources

- 7 JUN 2012