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A few words.

18 December 2013

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

Dear Mr Pierce

AEMC Stage 2 Options Paper NEM Financial Market Resilience

AGL Energy Ltd (AGL) welcomes the opportunity to respond to the Australian Energy Market Commission's (the AEMC) *Stage Two Options Paper:NEM Financial Market Resilience* (the Paper).

AGL has given a considerable amount of attention to this review and has been an active participant in the AEMC's working group on this issue for some time. As one of Australia's largest vertically integrated retailers of electricity with more than two million customers and substantial generation capacity in the National Electricity Market (NEM), AGL would be directly affected by any significant reforms in this space. This review has particular gravity because it is examining the NEM's primary risk management mechanism: the Over-The-Counter (OTC) electricity derivative market.

The specific focus of this review is on the risk of contagion from a default in the OTC electricity derivative market and whether any additional measures are required to reduce this risk.

It is understandable after the Global Financial Crisis (GFC) to be concerned about the risk of contagion in OTC pure financial derivative markets (OTC financial markets). However, the GFC should not influence the assessment of risk, or be a driver for the implementation of policies and measures, in the OTC electricity derivative market – as they are two distinct markets. Fundamentally, the OTC commodity (i.e. electricity) derivative markets inherently have less risk than the OTC financial markets because they are used as a risk management tool to hedge the underlying market risk rather than for speculation purposes. Further, while OTC financial markets reportedly contributed to the GFC, the OTC commodity derivative markets (including electricity) were not involved.

AGL considers further that the risk of contagion in the NEM due to a counterparty default is very low because the NEM is a very resilient and robust market. Throughout its 15 year history, the NEM has withstood significant financial pressures as a result of droughts, substantial outages, record heatwaves and financial collapses. There is no evidence to suggest that a counterparty default in the OTC electricity market is likely to result in financial pressures that are more significant than those that the NEM has survived. Moreover, the risk of contagion is even more unlikely in the foreseeable future because

there is less volatility in the NEM given the considerable oversupply of generation capacity that presently exists in the market[1].

In summary, AGL contends that a valid case has not been made for the implementation of additional measures to reduce the risk of contagion in the NEM. This is on account of there being no evidence to suggest that there is a material risk of contagion or that the existing risk management frameworks utilised by participants are inadequate. Furthermore, many of the measures identified in the Paper to mitigate the possibility of contagion may actually have adverse impacts on the market and compromise the National Energy Objective (NEO).

However, in the event that a stronger case for a measure to be implemented is developed, we suggest that a more refined version of the OTC Derivatives survey may be a measure worth pursuing as it is an appropriate, effective and low transaction cost response.

It is also worth highlighting the importance of getting the regulatory settings right on this issue. For example, Deutsche Bank recently indicated that it had decided to stop trading in the Australian electricity market[2]. Deutsche Bank has attributed this decision to the impacts of increased regulation. Although their withdrawal from the market may not have had a significant impact on liquidity, it is a clear example of the potentially detrimental impacts on the contract market of getting the regulatory settings wrong.
AGL's response in relation to the consultation questions contained in the Paper are set out in Appendix A.

If you have any queries about the submission or require further information, please contact Josynta Singh at jsingh@agl.com.au or on 03 8633 6628.

Yours sincerely,

Simon Camroux
Manager Wholesale Markets Regulation
AGL Energy Ltd

[1] The AEMO Electricity Statement of Opportunities 2013 indicates that under a medium growth scenario, there will not be any more additional investment in capacity required in all NEM regions except for Queensland until 2023, AEMO Electricity Statement of Opportunities available at: http://www.aemo.com.au/Electricity/Planning/Electricity-Statement-of-Opportunities.

[2] Deutsche Bank quits commodities under regulatory pressure (viewed 18 December 2013). Available at http://www.reuters.com/article/2013/12/05/deutsche-commodities-idUSL5N0JK3ST20131205

Appendix: Consultation Questions

Risks and Risk Management in the NEM

1. Please provide any additional comments you have on the description of risks and risk management in the NEM.

The Paper provides a good summary of the risks and risk management in the NEM. However, the fundamental point to appreciate is that credit risk is not the biggest risk in the market. There is inherently a degree of credit risk associated with participating in any OTC derivative market. However, physical participants use the OTC electricity derivative market to hedge the much larger market risk in the NEM. So any attempts to reduce the credit risk by regulating the OTC market may have the unintended effect of increasing the market risk and therefore the overall risk, which will have much greater consequences for the NEM and ultimately consumers.

In addition, the market is not as concentrated as the AFMA survey states because the survey does not include data from all the major market participants.3 In reality, there is a much greater diversification of trading between participants.

2. Do you consider there is merit in the Commission exploring the accounting standards for OTC contracts as part of this review?

There is no merit in exploring the accounting standards further in the assessment of the risk of contagion. The key point to understand is that the mark to market valuations required by the accounting standards are a valuable source of determining the credit exposures faced by a market participant. The methodology is prescribed by the accounting standards, so it does not vary significantly across the industry. However, even if the assumptions that participants use in their valuations differ slightly, the methodology is still reliable as it is externally audited and presented in the accounting reports of the participant.

Hedge Accounting is irrelevant for the purposes of reviewing counterparty credit risk because it relates to how derivatives are reported, as opposed to how they are valued.

Measuring the Materiality of Systemic Risk

3. What are the appropriate methods for assessing the materiality of systemic risk in the NEM?

The key factors to consider in assessing the likelihood of systemic risk (contagion) in the NEM are as follows:

- Size of Immediate Loss
  The overriding factor to consider when assessing the likelihood of contagion is the size of the loss immediately after the default event. In the case of the electricity market, the loss is four weeks of derivative payments. The modelling by Seed Advisory demonstrates that this loss is not of a magnitude that is likely to result in contagion[4]. Losses that are crystallised over the medium term such as the replacement cost of hedges are not as material in causing immediate contagion because participants have considerably more time to deal with these losses.

- Credit Risk Management
  Another important factor in assessing the likelihood of contagion is the extent that participants are managing counterparty credit risk. Market participants manage

[3] AFMA reported that the top 3 respondents have almost 60% market share, AFMA, 2013 Australian Financial Markets Report, p51.
[4] NEM Financial Resilience Report, Seed Advisory, 14 August 2013, p.5.

their counterparty credit risk in a comprehensive manner. Fundamentally, they are aware of their interconnectedness with their counterparties through frequent mark to market reporting. They monitor on an ongoing basis the credit worthiness of their counterparties through regular assessments of their counterparties and they implement credit support requirements, credit exposure, trading, maturity and duration limits based on these assessments.

- Market Concentration
  We agree with the AEMC that market concentration is an indicator of contagion. However, we do not consider that the degree of market concentration in the NEM is of concern. As stated earlier, the market is not as concentrated as the AFMA survey suggests. We have shown evidence to the AEMC that counterparty credit exposure is not concentrated between the big three vertically integrated retailer participants, but sufficiently diversified across the NEM with an appropriate level of natural hedge contracting between retailers and generators.

Factors that are not necessarily relevant in assessing the likelihood of contagion are as follows:

- Turnover of OTC Contracts compared to the total demand in the NEM
  It was reported that since the aggregate turnover of OTC contracts exceeded the total underlying demand in the NEM, market participants were speculating and therefore taking on more risk. This reasoning is flawed for two reasons. Firstly, reporting both sides of a hedge derivative contract for a single quantity of electricity demand immediately provides a misleading representation of contracting activity. Secondly, high aggregate turnover does not necessarily reflect speculative behaviour. Moreover it represents active risk management. For example, variability in expectations of customer demand requires adjustments to a hedged position leading to trades that may reverse a previous position.

- Bank and Intermediary Involvement
  It is not accurate to presume that bank and other financial intermediary's low participation in the OTC contract market creates a market of higher risk. Retailers and generators participate in the OTC electricity derivative market to hedge market risk; financial intermediaries participate in the OTC electricity derivative market for speculative gain. A greater involvement by financial intermediaries that engage in speculative trading across multiple markets may actually increase the risk of contagion, because if an intermediary is exposed to a default in an unrelated market, this risk of contagion could spill into the electricity market.

- Collateralisation
  We agree with the AEMC that regulating the degree of collateralisation in the market should be approached with caution. Not only because of the reasons set out in the Paper, but because greater collateralisation may actually exacerbate the risk of contagion by increasing cash flow pressures. It may also result in participants exposing themselves to a greater market risk as it increases the cost associated with hedging. Additionally, it is important to note that collateralisation is not the only way to minimise credit risk. Participants use a variety of tools including credit exposure limits, volume, maturity and duration limits to minimise their credit risk.

4. Is there a material risk of contagion?

Based on the factors above, our conclusion is that there is a very low risk of contagion in the event that a participant defaults in the contract market.

Assessment Framework -options to reduce risk of contagion

5. Do you agree with the assessment framework in assessing options to reduce risk of contagion?

We broadly agree with the factors forming the assessment framework:

1. Whether the existing market and regulatory risk management mechanisms are inadequate or could be enhanced, strengthened or supplemented;
2. Whether a deficiency has been identified that results in a material risk of contagion; and
3. Whether implementation of the measure would be likely to promote efficient investment in, and efficient operation of electrical services for the long term interests of consumers of electricity.

However we have the following comments:

There is no evidence to suggest that the overall risk management framework in the NEM is inadequate. Internal risk management mechanisms must comply with various external requirements. For example, the international risk management standard: AS/NZS ISO31000-2009 Risk Management. As Australian Financial Services Licence (AFSL) holders, participants are also required to have structured and systematic processes in place for identifying, evaluating and managing risks. The mark to market methodology participants use to monitor counterparty credit exposures is also externally audited. In addition, ASIC has extensive regulatory oversight over OTC derivative market activity.

If there is no evidence to suggest that the existing risk management framework is inadequate or that there is a material risk of contagion, then it is difficult to make a case for implementing any additional measures. However, if any additional measure is to be implemented, it must be proportionate to the low risk of contagion.

6. Do you think the concepts of systemic importance and hedging are relevant when considering the scope of applicability of any measure?

Systemic Importance
If any measure should be implemented, it should apply to all participants in the NEM, not just those that are considered to be 'systemically important', as determining who is 'systemically important' is very subjective.

Hedging
It would be ideal if the measures exempted hedging behaviour. However, while AGL contracts in the electricity OTC derivative market for hedging purposes, it is noted that a minority of market participants engage in a small degree of speculation in addition to hedging. Therefore, there may be some complexity in distinguishing some hedging behaviour from speculative behaviour in relation to those participants.

Potential options to reduce systemic risk

7. What is your feedback on the options and are there any alternatives that should be considered?

We do not consider that a strong case has been made to justify an additional measure to reduce the risk of contagion in the NEM. Furthermore, we do not support any of the options presented in the Paper because they may not be effective and, in some cases, may even be counterproductive. The costs of the options also outweigh the benefits.

However, we have suggested an alternative option, which is more proportionate to the very low risk of contagion. The alternative is a refined version of the OTC Derivatives Survey that was conducted by ASIC, APRA and the RBA (the agencies) this year. AGL considers that the survey would provide the agencies with transparency of counterparty

credit risk management in the NEM, without the excessive cost of the G20 trade reporting reform. It asks questions which would give the agencies insight into the risk management practices of participants. It also asks questions about the mark to market exposures of participants. ASIC can use its existing powers to enquire about the data collected from the survey to gain a better insight into the practices and behaviour of participants. We would only recommend that the questions be more refined so that they are better tailored to the electricity industry. We would be happy to work the agencies to make these minor refinements.

Our specific views on each of the options set out in the Paper are as follows:

Trade Reporting
It is questionable whether the level of transparency gained from the trade reporting rules justifies the excessive cost. One Australian bank reported that its estimated IT spend to implement the trading reporting requirements was between $7-10 million dollars. This is in addition to the ongoing operational, legal and compliance costs. This is a significant expense for electricity market participants and may have serious consequences. It may put pressure on the price of electricity to rise. It may also affect competition by increasing the barriers to entry for new entrants.

Moreover, there does not seem to be any other benefits of trade reporting aside from better transparency. Trade information would be of limited value to market participants because it would need to be on a more restricted basis than larger markets, as there would be a greater risk of disclosing commercially sensitive information in a small market such as the NEM.

Stress Test Reporting
There are three main concerns with stress testing. Firstly and most importantly, it is unclear how effective an externally administered stress testing regime would be in reducing the risk of contagion. How can an external body meaningfully evaluate the results of the stress testing without having a comprehensive understanding of each market participant's business plans and strategies? Secondly, it is not feasible for an external body to devise a stress test scenario that would be appropriate for all market participants. Thirdly, the proposed stress testing regime included an assessment of cash flow projections. This borders on prudential regulation, which is outside the scope of this review.

Code of Best Practice for NEM Participants
We do not support a code of best practice. In theory, a code of best practice for market participants seems like an appropriate measure to reduce the risk of contagion. However, in reality it would be challenging trying to create an effective code. Moreover it could lead to perverse behaviour. Specifically, if the code is too prescriptive and heavily enforced, participants may be more focused on adhering to the code than actually trying to manage their own risks. If it is too broad, it may have limited value as a risk management tool. Given the inherent difficulty in getting the balance right, it may become a very costly and prolonged exercise which may not result in any material benefit.

Additional Margin Requirements
Imposing mandatory margin requirements will actually compromise the NEO, not contribute to it. Margining substantially increases the cost associated with hedging, which may have grave repercussions for the NEM. It may put pressure on the price of electricity to increase. It will decrease the liquidity in the contract market. It will also stifle competition in the NEM by increasing barriers to entry. Moreover, it will exacerbate the risk of contagion in periods of high volatility by increasing the cash flow pressures on participants, examples of which we have previously provided to the AEMC.

Additional Supervision and Regulatory powers
There is no case to support additional supervisory and regulatory powers regarding financial market activity. We contend that ASIC's existing powers under the AFSL are sufficient. ASIC has extensive monitoring and information gathering powers regarding the

risk management practices, policies and derivative positions of AFSL holders. It also has the ability to impose additional risk management requirements on AFSL holders as required. Furthermore, additional supervisory and regulatory powers would be disproportionate to the low risk of contagion.

Mandatory central clearing and trading platform
We agree that a mandatory electronic trading platform and central clearing requirement are inappropriate measures for the OTC electricity market. Both facilities require a high degree of standardization. However, the NEM is a dynamic environment and necessitates bespoke derivative products to hedge the risk. Hence requiring all OTC products to be highly standardized would make it difficult for participants to manage the underlying risk in the NEM. Furthermore, central clearing will exacerbate the risk of contagion in periods of high volatility because of margining.

Conclusion

Based on there being a very low likelihood of a financial contagion event following a counterparty default – and little evidence of the existing risk management measures being inadequate, there is no justification for new measures to be implemented at this point in time.

However, in the event that a stronger case for a measure to be implemented is developed, we suggest that a more refined version of the OTC Derivatives survey may be a measure worth pursuing as it is an appropriate, effective and low transaction cost response.