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Mr John Pierce
Mr Neville Henderson
Dr Brian Spalding
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Commissioners,

Re: EMO0024 NEM Financial Market Resilience

A: Introduction

TRUenergy welcomes the opportunity to comment on the Australian Energy Market's (**AEMC**) Issues Paper EMO0024: NEM Financial Market Resilience (**Issues Paper**).

TRUenergy agrees that the NEM financial market is adequately robust to underpin the efficient operation of the NEM and does not consider wide scale intervention is necessary. Market participants adopt a range of internal risk management practices and are typically bound by financial regulation and third party obligations aimed at managing the risk of financial contagion. Over time, the NEM financial market has evolved such that it is sufficiently resilient against major events and changes in market dynamics.

However, a key concern for TRUenergy is that the Issues Paper fails to recognise the financial contagion risks incurred by a retailer when acquiring a Retailer of Last Resort (ROLR) customer in a jurisdiction where a regulated retail price determination fails to adequately reflect the costs incurred by the designated ROLR. Further, the Issues Paper does not properly articulate the risk of cascading retailer failure arising from the disproportionate basis, as between large and small retailers, for calculating the amount of credit support required to be provided to Distribution Network Service Providers (DNSPs) under Chapter 6B of National Electricity Customer Framework (NECF). Finally, we consider that the rules and obligations governing the timing of customer communication, payment of network fees , AEMO prudential and DNSP credit support by designated ROLR's should be relaxed to provide greater flexibility and to mitigate the risk of cascading market failure of the designated ROLR.

B: Key Issues

1. NEM Financial markets and financial interdependency

TRUenergy broadly agrees with the AEMC's description of the NEM financial markets and acknowledges that varying levels of financial interdependency exist between participants. We also agree with AEMC's view that the key risk of financial contagion is the failure of a large retailer, triggering a ROLR event, although, we consider that the likelihood of such an event occurring is remote.

However, we consider that the NEM financial market is adequately robust to underpin the efficient operation of the NEM. Like other prudent market participants, TRUenergy adopts a range of internal risk management practices to manage risk. Additionally, the risk management requirements that apply to participants as a prerequisite to operating in the NEM ensures expenses can be adequately met and mitigates against any operational risks that could lead to unexpected financial difficulties, which in turn could be transmitted to other participants. Participants are also required to meet regulatory compliance requirements of financial regulators and other third party obligations; the aim of which is to mitigate risk of financial contagion.

2. ASIC Consultation and Treasury Consultation Paper

The AEMC refers to two public consultations concerning NEM financial markets in its Issues Paper which are currently being undertaken in Australia including:

- *ASIC, Consultation Paper 177: Electricity derivative market participants: financial requirements (May 2012)* (**ASIC Consultation Paper**)*;* and

- *The Commonwealth Treasury, Implementation of a framework for Australia's G20 over-the-counter derivatives commitments, Consultation Paper (April 2012) (***Treasury Consultation Paper**).

TRUenergy considers that the matters raised in the Treasury Consultation Paper do not establish a case for implementing the proposed amendments to the Corporations Act (2001) for OTC trading in electricity. The application of the proposed measures to the electricity market (i.e. reporting OTC transactions to trade repository and standardised OTC derivative products) would place additional compliance, systems, a centralised clearing house and collateral costs on market participants and reduce the level of financial flexibility. In addition, it would reduce the ability to manage risk and potentially change the way in which electricity is traded in the NEM, increasing the overall level of risk to market participants. This would result in increased costs for consumers and an increased risk profile for the market; the opposite of the intended outcome.

ASIC proposes major changes to the levels of financial requirements that electricity derivative market participants (EDMPs) will need to comply with. However, it fails to provide any evidence that demonstrates that the current financial requirements applied to EDMPs under their AFSLs is inadequate. Therefore, we would caution against any radical changes. Overall, we suggest that:

- ASIC has a key role in the financial markets as a financial regulator but not as a prudential regulator. The scale of proposed changes moves beyond their policy intent.

- ASIC's proposal could force EDMPs into the standardised exchange markets driving business away from the OTC electricity market reducing the ability to effectively manage electricity market risk.

- ASIC's obligation for EDMPs to hold Net Tangible Assets (**NTA**) equal to 10 per cent of average revenue is unnecessarily onerous. It would require TRUenergy to increase the amount of cash and liquid securities we are currently required to hold by about 600%.

- The physical generation that underpins electricity trading positions in derivatives reduces the need to hold financial resources as a financial buffer. Average revenue is a poor proxy for exposure to the OTC market.

- The obligation to hold NTA equal to 10 per cent of average revenue also ignores the fact that 45% of the revenue of electricity retailers reflects network costs that will be passed through to consumers.

- The sound risk management requirements that apply to EDMPs as a prerequisite to operating in the NEM ensures we meet our expected expenses and mitigate against any operational risks that could lead to unexpected losses. Any changes that are approved by ASIC should be proportional to the problem in place.

3. Financial contagion risks that could arise as a result of the failure of a large generator

TRUenergy broadly agrees with the AEMC's description of the potential financial contagion risks that could arise as a result of the failure of a large generator.

However, we consider that the Issues Paper fails to recognise the financial contagion impacts of a generator failure on a retailer counterparty under an AEMO re-allocation arrangement.

Re-allocation arrangements are tripartite in nature and are between AEMO, a generator and a retailer. If a generator falls over, AEMO may decide to terminate the re-allocation arrangement. Consequently, the retailer counterparty would (under the Rules) be required to lodge additional prudentials to compensate for the termination of the re-allocation. Liquidity and cash flow demands resulting from provision of additional prudentials in these circumstances may result in financial contagion to the retailer.

4. Financial contagion risks that could arise as a result of the failure of a large retailer and ROLR

4.1 <u>Retail Price Regulation and ROLR</u>

While some retailers may not be required to offer customers regulated tariffs, the regulated tariff significantly influences the market as a proxy for the benchmark price. TRUenergy considers that regulated prices that don't reflect a retailer's true costs increase the risk of a ROLR event occurring because the retailer has diminished ability to recover costs which exposes the retailer to risk of failure.

To mitigate the risk of a ROLR event, it is imperative that each regulated price determination adequately compensates retailers for the costs incurred by a retailer. Removal of retail price regulation altogether would allow retailers to properly reflect their costs in retail prices and would mitigate adverse financial impacts.

As a result of the frenetic nature of ROLR events, the designated ROLR is likely to face additional costs which it would not incur in a normal market. TRUenergy considers that the Issues Paper fails to recognise the financial contagion risks incurred by a retailer when acquiring a ROLR customer in a jurisdiction where a ROLR price determination fails to adequately reflect the costs incurred by the designated ROLR. Short term liquidity and cash flow pressures on default ROLR's may be increased by constraints on the ability to pass on these costs by increasing retail prices.

In these circumstances, TRUenergy considers that the AEMC consider ways to ensure that the designated ROLR's revenue matches its increased costs in the short term. It is important that the designated ROLR to be able to recover for any additional costs where it can demonstrate such costs are legitimately incurred. TRUenergy encourages the AEMC to consider other industries, such as the telecommunications industry, where events similar to a ROLR event could occur and where a market based solution is adopted. One option may be provision for the recovery of ROLR event costs through the prices charged to ROLR acquired customers. Customers of smaller riskier retailers who are being charged significantly discounted prices run a higher risk of being subject to a ROLR event, resulting in transfer to a designated ROLR. We do not consider it reasonable that designated ROLR's be subject to the risk of financial contagion because they are restricted in the costs they are able to recover from ROLR acquired customers from these risky retailers. Further, we consider it reasonable that those customers are subject to prices reflecting the relatively lower risk rating of the designated ROLR. We suggest this approach is conducive for policy makers that are interested in market based approaches, rather than regulatory intervention.

4.2 AEMO Credit Support and ROLR

TRUenergy broadly agrees with the AEMC's description of the potential financial contagion risks that may arise due to the impact on a designated ROLR by the requirement to provide additional credit support to AEMO due it its increased customer demand.

We understand that there are two public consultations concerning AEMO prudential standards which are currently being undertaken in Australia:

- *AEMO, New Prudential Standard and Framework in the NEM*; and
- *AEMO, Credit Limit Procedures Consultation,*

(**AEMO Prudential Consultations**).

We encourage AEMO and AEMC to consider the risk of financial contagion arising from AEMO prudential standards and ROLR events in assessing public submissions in response to the AEMO Prudential Consultations.

4.3 Network Credit Support and ROLR

As a part of the National Energy Consumer Framework (**NECF**), a new Chapter 6B will be added to the National Electricity Rules which requires retailers to provide credit support to DNSPs.

These new provisions will require the designated ROLR to increase its credit support with DNSPs as a consequence of acquiring additional customers. TRUenergy agrees with the AEMC's views that liquidity and cash flow demands resulting from provision of credit support in accordance with Chapter 6B may result in financial contagion to the designated ROLR. This is especially true if its ability to pass on these costs to customers is constrained by retail price regulation and/or the need to remain competitive with other retailers that are not designated ROLRs (and did not incur similar costs). To mitigate such a risk it is imperative that each regulated price determination adequately compensates retailers for the costs incurred for acquiring a customer.

TRUenergy considers that a key point that is not properly articulated in the Issues Paper is the risk of cascading retailer failure arising from the disproportionate basis, as between large and small retailers, for calculating the amount credit support required to be provided to DNSPs under Chapter 6B. Under the NECF settings larger retailers, which are the default ROLRs for SA, VIC, NSW and QLD, are required to pay a proportionately higher credit support, and smaller more risky retailers pay proportionately less. This approach inequitably distorts the impact of ROLR events in favour of smaller retailers by increasing the financial pressures on large (default ROLR) retailers. If policy makers are interested in lowering the barriers to entry for small and new market entrants, TRUenergy recommends that alternative options are explored.

TRUenergy notes that the NECF DNSP credit support provisions were not subject to any form of consultation nor a cost-benefit analysis. TRUenergy recommends that the AEMC conduct a formal review of the credit support rules under NECF. In the interim, TRUenergy suggests that the Victorian credit support regime (which was outlined in the second consultation on the NECF) should be adopted until a proper industry consultation is convened. The consultation on a credit support regime should cover its purpose, alternative mechanisms to protect distributors and options for balancing the costs between small and large retailers.

4.4 <u>Retailer of Last Resort – Timing</u>

The existing ROLR requirements, and those under the NECF, do not provide ROLRs with the necessary flexibility to manage a ROLR acquisition of more than ~100,000 customers. Specifically, TRUenergy considers that the requirements relating to a ROLR's obligations to:

- communicate with acquired ROLR customers within a specific time frame;
- pay distribution and transmission network costs of ROLR customers within a certain time frame;
- provide credit support to DNSPs within a certain time frame; and
- provide prudentials to AEMO within a certain time frame,

are especially onerous.

In the event of a retailer failure, TRUenergy considers that the rules and obligations governing the compliance time frames relevant to each of the above obligations be reasonably relaxed to provide greater flexibility and to mitigate the risk of cascading retailer failure. Increases to payment terms for network bills will allow a ROLR to "share the pain" across the market without posing risk to the wholesale market as it will allow the ROLR to be in position to meet its wholesale market obligations.

We encourage AEMO and the AEMC to consider this matter in the AEMO Prudential Consultations.

C: Conclusion

TRUenergy looks forward to working with AEMC on the matter of NEM financial markets and financial contagion, especially in relation to ROLR events and the risk of cascading market failure.

We thank the AEMC for the opportunity to make this submission. For any enquiries regarding this submission, please feel free to contact Renee Garner - Corporate Strategy and Advocacy Manager at TRUenergy on Tel: 03 8628 1199.

Yours sincerely

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