energy sector development

Financial Market Resilience Review - Issues for Victoria

Submission to the AEMC

26 July 2012

The Department of Primary Industries (DPI) welcomes the opportunity to comment on the Australian Energy Market Commission (AEMC)'s National Electricity Market (NEM) financial market resilience review.

Victoria has a long standing commitment to market provision of electricity services, having effected a full privatisation of the electricity sector in the late 1990s, and having relied upon the proper functioning of the NEM since then to deliver timely investment in generation infrastructure, and a contestable retail market to deliver efficiently priced energy to consumers.

In this respect, the NEM and the introduction of full retail contestability has been very effective. A substantial amount of new generation has been delivered, mostly of the peaking variety, by private firms responding to market price signals alone since the 1990s. In the retail market, Victoria's market is ranked among the most competitive in the world by some indicators.

In this context, the Review is of keen interest to DPI, which makes comment as follows on the issues paper.

1 Price regulation

It should be recognised that Victoria, alone among the NEM jurisdictions, has removed price controls on the electricity retail sector. The reduction in business risk associated with this step has contributed to reducing the likelihood of market turmoil forcing the bankruptcy of a major retailer, as occurred in the 2001/01 California crisis. However, the NEM is a national market, and other jurisdictions have yet to follow. Major participants in the market now operate throughout most NEM regions. Therefore, Victoria could still bear significant risks that may spill over from the failure of a major market participant, exacerbated by retail price regulation in other parts of the NEM.

Victoria - as a leading jurisdiction in energy market reform - considers promoting market efficiency and discipline a first-order issue, and the AEMC should recognise, consistently with its past reviews, the role that price regulation plays in increasing business risks and market distortions in the NEM.

2 Inherent risks

The AEMC has proposed to focus on the risk of systemic destabilisation of the NEM caused by transmission of financial distress from one market

participant to another. This focus is justifiable because the operation of the NEM as a gross pool necessitates market participants engaging in complex risk hedging in financial markets. This in turn makes such financial contagion a significant risk to the electricity sector.

However, systemic market risk can emerge in another way - specifically, through the build up of vulnerabilities in broader financial markets that affect several major market participants coincidentally. The global financial crisis of the 2000's showed the prevalence of such systemic externalities characterised by correlated risks and clustered failures of financial institutions. In such circumstances a credit crunch could occur, adding pressure on the spot electricity price as a result of increased financing costs and credit spreads for generators. This would increase the risk exposure for those market participants with inadequate capital reserves, exacerbating the instability of the NEM financial system.

DPI believes that there is merit in examining this category of risk alongside those already identified by the Commission. The rationale for a broader approach to risk assessment is twofold. First, it responds to the Standing Council on Energy and Resources (SCER) request for the Commission to "identify the nature of any risks to the efficient functioning of the market (emphasis added; p. 2)". Second, it opens an opportunity to examine in greater detail the potential process of risk propagation (as opposed to specific risk triggers). Different types of systemic market risk in the NEM financial system, if existent, may require different measures to address them.

3 Approach

DPI suggests that, for this review, the AEMC should progress through a series of questions in order to identify any significant potential problems and discover appropriate solutions.

Firstly, a comprehensive, evidence-based appraisal of the risk and consequences needs to be undertaken. The AEMC states in its report that:

> "The Commission considers that there is low likelihood of an unexpected event or series of events in the NEM causing financial contagion." (p. ii)

"Low" may be an inherently subjective term, but the documented examples of major participant failure in overseas electricity markets mean that even this low level of risk warrants careful consideration by the AEMC, because of the potential consequence of severe impacts on customers and jurisdictional economies. In the event of such risk being realised, the market and the regulator could have a limited time window within which to respond and avert a full-scale crisis. On top of this, there are inherent risks, referred to above, that the AEMC does not appear to have contemplated.

Secondly, the AEMC should arrive at a view as to the adequacy of existing regulatory mechanisms for mitigating market destabilisation. Some of

these are presented in part 4 of the issues paper inasmuch as they relate to financial contagion. Other risks that the AEMC should investigate further include the potential for the financial distress of market participants to lead to opportunistic, exploitative and damaging market behaviour such as strategic withholding of generation or transmission capacity from the market.

Thirdly, to the extent that these are deemed inadequate, the AEMC should consider ways to strengthen market discipline. These may take many forms but market-based solutions are preferable, including measures to increase market transparency and solicit market response to uphold trading confidence and prevent liquidity drying up.

Finally, the AEMC needs to consider the mechanisms to ensure minimal supply interruption and these could, for example, include step-in powers of governments – although these powers should only be considered for use as a last resort.

4 Principles

The principles DPI would like to see adhered to in this review are as follows:

- Risk mitigation options should be proportionate to risks, their probability, severity of consequences and permissible timeframe for market response. The options should not advantage one group of industry participants (or prospective participants) over another and should not impede vigorous competition.
- The beneficiaries of risk mitigation measures should pay for those measures.
- The role that market confidence plays in the outworkings of financial upheaval should be acknowledged, hence the importance of a sound framework of risk oversight, trading and mitigation.
- Governments must not re-assume any commercial risks that have been privatised and that can be addressed through a transparent, efficient market. Once appropriate market and regulatory rules are put in place, any role for governments in market intervention should be short-term and a last resort.
- To the extent that governments *create* commercial risks, however, it is in principle appropriate for those governments to share in those risks. Unnecessary retail price regulation in a normal market situation is an example of this.
- The greater financial resources of the Commonwealth and its vertical fiscal imbalance with State and Territory jurisdictions should be acknowledged in allocating any last-resort role for government intervention.

5 Specific comments

DPI suggests that the AEMC specifically consider the following issues:

5.1 On the nature of financial interdependencies between NEM participants

The AEMC should broadly interpret the intent of SCER with respect to the types of risk to be considered in this review. As discussed above, 'interdependencies' are only one factor that contributes to the presence of systemic risks.

5.2 On the evidence of risk propagation and mitigation

An extended analysis of prominent failures in overseas electricity markets would be instructive. Specific triggers and underlying causes of such failures may not be present in the NEM. However, these failures could provide lessons relevant to a focus of this review: namely, "the impacts that such an event could have on other participants and ultimately the achievement of the National Electricity Objective (p. 34)".

The Issues Paper outlines how prudent business practices and existing regulatory mechanisms work to minimise counterparty risks. Whilst these arrangements minimise these risks for prudent companies, regulatory practices should not necessarily assume prudent behaviour and do not necessarily deal with the issue of systemic risks.

5.3 On the proposed over-the-counter derivatives reform

DPI would encourage the AEMC to engage with the Commonwealth Treasury review as well as Council of Financial Regulators review. This engagement could influence review outcomes by providing a balanced view between pursuing necessary regulatory rigour and avoiding unnecessary regulatory burden on the industry.

5.4 On the Retailer of Last Resort arrangements

The failure of a major retailer seems to be the major electricity industry specific risk. It is not clear that the rapid transfer of the customer base to another (major) retailer is credible. In the short term, issues of capital adequacy and hedging cover will be acute. In the event of a longer-term transfer, if the major retailer is successful in absorbing the customer base then a significant increase market concentration may occur.

It seems useful to examine the adequacy or otherwise of this mechanism in ensuing orderly transfer of customers between retailers as well as ensuring liquidity as necessary to keep up market confidence in a desperate market.

5.5 On the implications of substantial vertical integration for the analysis of financial market resilience on the NEM

Structurally the NEM has seen a process of both consolidation and vertical integration of retailing and generation. To the extent that risks are internalised within a single integrated entity they may be less transparent to third parties or regulators.

There may be a case for risk mitigation requirements on businesses to take account of the degree of transparency within vertically integrated structures.

DPI would also like to understand how additional financial supervision arrangements or compulsory exchange based trading affect the relative market position of merchant generators and stand alone retailers relative to vertically integrated entities. Is there a risk that greater regulation would advantage vertically integrated entities and thus encourage greater market concentration and integration? If so, the severity of risks associated with the failure of a single entity may increase further.