REVIEW

Australian Energy Market Commission

SECOND INTERIM REPORT - OVERVIEW

NEM financial market resilience

14 August 2014

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Second interim report - Overview

Inquiries

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

E: aemc@aemc.gov.au
T: (02) 8296 7800
F: (02) 8296 7899

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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1 Introduction

The Council of Australian Governments (COAG) Energy Council has asked the Australian Energy Market Commission (AEMC or Commission) to advise on risks to financial system stability in the National Electricity Market (NEM) that arise from the financial interdependencies between participants.[1]

The aim of the request is to consider whether the financial relationships and market arrangements underpinning the NEM are sufficiently robust to manage the financial risks caused by a market participant (or participants) defaulting on its obligations. Where current arrangements to address those risks are inadequate, the Commission is to make recommendations on how to enhance and strengthen them.

The Commission's second interim report presents its analysis and conclusions on the risks to financial system stability in the NEM and the ability of current arrangements to manage those risks. It also presents a proposed package of recommendations to improve the market's ability to manage and respond to the financial distress and failure of participants in the NEM.

This accompanying overview summarises the second interim report.

Submissions on the second interim report are due by 25 September 2014.

1.1 Key concepts

Generators, retailers and other businesses that participate in the NEM have complex financial relationships with each other. There are different channels through which financial payments flow to and from market participants. These financial interdependencies contribute to the efficient operation of, but also introduce potential risks to financial system stability in, the NEM.

Financial system stability in the NEM refers to the smooth flow of funds between market participants occurring due to these financial relationships, so that the buying and selling of electricity continues to operate as intended. It relates to the stability of the financial arrangements as a whole, and not the financial position of an individual market participant.

The financial interdependencies between market participants mean that the financial position of one market participant can impact other market participants. One participant experiencing some form of financial distress can affect others. If this becomes extreme, it is referred to as financial contagion. **Financial contagion** has the potential to threaten financial system stability through causing the cascading failure of multiple participants. This is also referred to as **systemic risk**.

Financial system stability in the NEM is dependent upon the market being able to absorb shocks. Whilst the likelihood of such shocks is uncertain, the failure of a large market participant could have severe flow-on effects in the market. This would include damage to consumer and investor confidence.

1 The COAG Energy Council was formerly the Standing Council on Energy and Resources.

The emergence of financial contagion could therefore lead to **financial system instability** in the NEM. In the extreme, financial system instability could compromise the physical supply of electricity and the achievement of the national electricity objective (NEO) and the national energy retail objective (NERO).

1.2 Context for this advice

The experience of the global financial crisis (GFC) demonstrated how quickly confidence can be eroded and funding and liquidity problems arise. The GFC demonstrated the potential for financial difficulties to be transmitted quickly from one business to others, resulting in financial system instability that had widespread negative effects.

We will publish, as part of this advice, a separate paper which explains the reforms being introduced, both in Australia and overseas, to improve the resilience of the financial sector following the GFC.

This experience has also caused regulators and policy makers for other markets in which participants are financially linked to consider whether financial contagion, and the potential for system instability, could occur and, if so, what could be done to address it. One such market is the NEM. It is against this background that the COAG Energy Council requested the Commission to provide its advice.

The NEM has operated effectively, with businesses entering and exiting the market without causing financial contagion. NEM financial markets are generally robust and have been able to evolve to accommodate major events and changes in market circumstances.

While recognising the strong track record of the NEM to date, the importance of ensuring the effective functioning of financial flows within the NEM makes it timely to:

- determine the extent to which risks to financial system stability exist in the NEM; and
- consider possible strategies to manage those risks or mitigate any threats to financial system stability in the NEM.

The environment in which the NEM operates has evolved significantly since market start, including in terms of the industry structure and regulatory obligations that apply. The range of challenges that the NEM has faced, and may face over the coming years, increases the importance of:

- understanding risks to financial system stability in the NEM; and
- being prepared to manage and respond to those risks, should they materialise.

1.3 Financial market resilience and other Commission work

We need a resilient, sustainable market, which is able to support economic growth. This is reflected in one of our strategic priorities: developing market arrangements that encourage efficient investment and flexibility. The market should be capable of responding to the challenges presented to it.

This financial market resilience advice can be seen as part of a broader package of work that the Commission is undertaking to develop the energy market to face the future. Other such projects include the optional firm access model development and assessment as well as the competition in metering and related services rule change request.[2]

1.4 Our approach

In responding to the request for advice, we have been informed by the NEO and the NERO. We are only proposing a measure if existing arrangements need to be enhanced and implementation of the measure would be likely to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers.

We have considered a wide range of issues and potential options. In our assessment, we have taken into account the impact of these proposals on the allocation of risk across various stakeholders.

The COAG Energy Council's request for advice states that market participants need to manage their own financial and commercial positions. Our recommendations seek to maintain commercial incentives on participants to manage their own risks to the extent that they can, and to allocate risks to the party best able to manage them. The aim is not to prevent an individual participant failing or leaving the market; rather the focus is on maintaining the continuity of supply to consumers and the stability of the NEM as a whole.

Our recommendations seek to minimise the expectation of government financial support when there are risks to financial system stability in the NEM. Market arrangements should not foster any perceived expectation that governments would step in and support participants if risks to financial system stability in the NEM materialise. Having in place appropriate and planned market responses is one way to achieve this, and minimise the likelihood of government support being required. This point has been made in a report published as part of the current inquiry into the Australian financial system.[3]

1.5 Stakeholder participation

Stakeholder participation has been extensive and very valuable to the development of the recommendations presented in the second interim report. The Commission has benefited from the advice and input of an industry working group and an advisory committee. We appreciate the advice and evidence provided by various stakeholders, including their time and resources committed to the review.

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2 AEMC, *Optional Firm Access, Design and Testing*, EPR0039; and AEMC, *Expanding competition in metering and related services rule change*, ERC0169. More information on these projects can be found on the AEMC website: www.aemc.gov.au.

3 The Financial System Inquiry 2014 (Murray), *Interim Report*, 15 July 2014, p3-9.

2 Risks to financial system stability in the NEM

2.1 Financial interdependencies

Market participants in the NEM are constantly engaged in the process of accruing and discharging a range of financial obligations between each other, the Australian Energy Market Operator (AEMO) and other parties.

The three main channels through which market participants in the NEM are financially interconnected are:

- in the spot market, via the settlements process that is managed by AEMO. In particular, generators are dependent on retailers making payments for the purchase of electricity through the spot market;
- through ASX 24, which is a centralised exchange that offers standardised electricity derivative products. Exchange traded derivatives are used to manage the risk of variations in spot prices; and
- through bilateral over-the-counter hedge contracts (OTC contracts) between participants and sometimes intermediaries. Participants also use OTC contracts to manage the risk of variations in spot prices.

Of these relationships, OTC contract counterparty default creates the most likely potential risk to financial system stability in the NEM.

OTC contracts

A failure of a counterparty to meet its OTC contract obligations could result in other participants:

- being exposed to spot prices for a substantial part of their retail load or generation capacity; and
- experiencing losses associated with a counterparty failing to meet payments under its contract obligations.

While the probability is uncertain, there is a risk of financial contagion occurring through OTC contract counterparty default. Whether this would occur and threaten financial system stability in the NEM would depend on a broad spectrum of variables at the time, including:

- the size of the participant's retail load;
- whether the participant holds sufficient capital reserves to absorb the impact of financial shocks;
- the ability of the participant to source additional funding to manage any short term cash flow impacts;
- the participant’s internal finance thresholds (eg, debt covenants, margin ratios) or external reserves obligations. Settlement losses from OTC counterparty default could trigger financial covenants and obligations, thereby causing additional financial distress for the participant;

- whether default coincides with unfavourable events occurring. For example, high spot prices together with generation plant outages and a squeeze on the general availability of credit would magnify the impacts of a counterparty default. Such events tend to be unexpected and not reflective of normal market conditions;
- the degree of concentration of hedge contracts between participants. Where there are fewer participants, the concentrations of hedge contracts would likely be higher and the impacts of the counterparty default could be more severe; and
- the hedging strategies adopted by market participants, such as the percentage of retail load or generation capacity which is hedged.

The risk of financial contagion would be more likely where a retailer has a high concentration of hedge contracts with a large generator and that generator defaults on its OTC contracts. A generator experiencing counterparty failure would generally not suffer as extreme a financial loss as a retailer, primarily because of the highly asymmetric nature of spot prices.

Spot market and exchange traded derivatives

For the spot market and exchange traded derivatives, arrangements are in place to manage, respectively, the risk of settlement shortfall and counterparty default. Such arrangements:

- act to diversify the risk of participant failure across a large number of businesses and the impacts are, therefore, not concentrated upon a single participant. For example, under the AEMO settlement process, all generators are exposed to any shortfall in settlement payments; and
- include financial requirements on participants in order to build up financial reserves, eg, credit support or margining requirements. Such reserves act as a buffer to protect against, and absorb impacts of, a participant failing.

2.2 Retailer of last resort scheme

The retailer of last resort (ROLR) scheme applies in the case of a suspension of a retailer from the NEM. This scheme is intended to enable continued supply to, and orderly transfer of, the failed retailer's customers while preserving the integrity of the settlement of the spot market.

A threat to financial system stability in the NEM would arise if a large retailer experienced financial distress and triggered the application of the ROLR scheme in its current form. This is because of the additional financial obligations placed on a ROLR if it acquires a large number of customers, to be met in a very short timeframe. If these obligations cannot be met by the ROLR(s), further failures may occur.

The key challenges for a ROLR are:

- **Cash flow risk:** that is, that the ROLR would not be able to meet payment obligations due to a mismatch between the timing of money received and payments due. The ROLR would need to make additional purchases of electricity in the spot market to cover the inherited retail load and also would be initially unhedged. As wholesale market settlement occurs roughly four weeks in arrears, the ROLR would have to find the additional cash required for settlement within that time. Retailers commonly invoice residential customers every quarter in arrears, but would be incurring the costs of purchasing electricity in the spot market for the transferred customers during those three months. The ROLR may not have sufficient working capital to manage the extra costs related to the acquired customers. If spot market prices were high, this burden could be compounded; and

- **Additional credit support:** in relation to the acquired customers, which a) must be provided to AEMO and b) may be required by distribution network service providers (DNSPs). Under the current rules, this credit support is required within short timeframes. If the ROLR event occurs at a time when the financial market faces a degree of distress, it may be difficult to find sources of finance, or finance may be provided at a higher cost than under normal circumstances.

The magnitude of these additional financial obligations would depend upon both the size of the failed retailer load and the market conditions at the time. Initially, the ROLR(s) would be unhedged for the additional customers and exposed to spot prices, until it entered into additional hedge contracts.

In addition, there are likely to be **information** and **systems challenges** involved in transferring large numbers of customers. If customer information is not transferred efficiently from the failed retailer to the ROLR, it would inhibit the ROLR's ability to hedge the new load since it would have incomplete information about load characteristics. It would also make it difficult to establish effective customer communication and billing arrangements.

The Australian Energy Regulator (AER), AEMO and market participants all agree that the ROLR scheme could exacerbate the risk that the financial failure of a large retailer could lead to cascading retailer failure and undermine financial system stability in the NEM.[4]

In a scenario where:

- the failed retailer accounts for 20 per cent of NEM market share;
- market conditions are similar to those experienced by the NEM during the 2007 drought; and
- all the customers were transferred to one ROLR

we estimate that the ROLR would need to organise additional credit support of $672 million to AEMO; up to $372 million of additional credit support to DNSPs; and fund an extra $42 million wholesale market payments each week.[5]

Our analysis and draft recommendations have been developed using the ROLR scheme included in the National Energy Customer Framework (NECF). We have assumed that this ROLR scheme applies across the NEM. The NECF has not been adopted in all jurisdictions. New South Wales, South Australia, Tasmania, and the Australian Capital

4 See section 3.3 of the second interim report.

5 Explanation on the modelling and assumptions used in calculating these estimates is provided in chapter 3 and appendix E of the second interim report.

Territory have already adopted the NECF, and Queensland is scheduled to adopt the NECF on 1 July 2015.

The risks to financial system stability may be different in the non-NECF jurisdictions, given the differences in the ROLR schemes, especially in regard to the ability of the ROLR to recover costs. Differences in the ROLR schemes across NEM jurisdictions could also make it difficult to coordinate a response to a large retailer failure.

3 Assessment of current arrangements to address risks to financial system stability in the NEM

Current arrangements addressing risks to financial system stability in the NEM fall into two categories.

First, there are arrangements that relate to how such risks are identified and mitigated in advance of a participant's distress or failure. These include:

- participants' risk management practices; and
- external regulatory arrangements.

Secondly, there are arrangements regarding how the market would respond to events that threaten financial system stability in the NEM. These include the ROLR scheme and arrangements under the National Electricity Rules (NER) for suspending a market participant that has failed to meet its financial obligations.

A summary of the Commission's assessment of these arrangements is set out below.

3.1 Current arrangements to identify and mitigate risks to financial stability in advance

Participants' risk management practices reflect their commercial incentives to adequately manage their risks and protect themselves from the impacts of other participants' failures. There are also some external regulatory arrangements and transparency and reporting obligations.

3.1.1 Participants' risk management practices

Participants' internal risk management practices - ie, documentation of procedures and policies, as well as how these procedures and policies are applied in practice - determine how participants manage the risk of OTC counterparty default and their ability to absorb financial shocks.

It would be inappropriate to assume that participants' risk management practices can be solely relied on, or expected, to eliminate all risk to financial system stability in the NEM. Even with very diligent risk management by participants, there could still be a remaining risk because:

- a participant's incentives to manage risk carefully would not necessarily take account of the potential systemic consequences of its failure;
- the potential for participant failure to trigger financial contagion would depend on a wide range of factors and the circumstances at the time, all of which are difficult to quantify or judge in advance;
- risk management practices are unlikely to allow for the additional liabilities associated with becoming a ROLR under a large retailer failure situation;
- industry structure may limit the possibility for participants to adequately diversify risk among a wide number of counterparties; and

- it would be impossible for participants to have all the information needed to correctly assess the probability of counterparty failure under OTC contracts and the impacts of such a failure on their businesses.

The Australian Securities and Investment Commission (ASIC) recently conducted a review into participants' written risk management documentation and concluded that participants' documentation appeared to be appropriate to the nature of their business, taking into account the size and complexity of the financial services business they conduct.

ASIC's conclusions must be viewed in that context and, more broadly, having regard to ASIC's functions of promoting market integrity and consumer protection. The Commission also notes that commercial attitudes may change over time, and existing risk management practices may not be maintained into the future.

3.1.2 External regulatory requirements

Participants dealing in OTC contracts must also hold an Australian Financial Services Licence (AFSL). Requirements under those licences relate to financial capacity measures and risk management, plus the obligation to have in place adequate systems to manage these requirements.

AFSL requirements have some relevance to (aspects of) risk management, but these requirements do not have, as their objective, the preservation of financial system stability in the NEM.

The AFSL financial requirements imposed on licence holders are minimum financial requirements to promote appropriate financial risk management, taking into account the nature, scale and complexity of a licensee's business. They "are intended to help ensure that cash shortfalls do not put compliance with the licensee's obligations at risk".[6]

These requirements are unlikely to be the main driver in determining the actual level of financial buffer held by participants to manage risks. The level of buffer is linked more broadly to participants' risk appetite, their ability to access additional financing, and, in some cases, requirements imposed by lenders under debt covenants.

In addition, information to adequately assess systemic risks from the financial interdependencies that exist between participants in the NEM is not routinely collected under the current AFSL regulatory framework.

3.1.3 Accounting and auditing standards

Participants in the NEM are subject to Australian accounting and auditing standards. To help understand the relationship between such standards and risk management practices in the NEM, the Commission sought advice from Deloitte. Deloitte's report is published in conjunction with the second interim report.[7]

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6 ASIC, *Response to submissions on CP177 electricity derivative market participants: financial requirements* - Report 320, December 2012, p5.

7 Deloitte, *Accounting and Auditing requirements of market participants in the NEM – derivative valuation*. Report to the AEMC, May 2014.

In their report, Deloitte recognised that financial reporting and risk management are vastly different functions. Deloitte advised that the only inherent link between risk management and financial reporting is through ensuring consistency between valuation of reported financial instruments, such as derivatives, and how participants value risk under their risk management practices. We note that this is important from the perspective of financial system stability because financial reporting is used by participants as one source of information when assessing the creditworthiness of counterparties.

3.2 Current arrangements to respond to events that threaten financial system stability

Under current arrangements, the ROLR scheme is the main mechanism to respond to participant failure in the NEM. In addition there are a number of other arrangements that apply in response to a participant experiencing financial distress or its failure. They include:

- provisions under various instruments that have the effect of restricting or ceasing the operations of a participant where it can no longer meet its financial obligations. Examples here are market suspension provisions under the NER, applied by AEMO, and retailer authorisation revocations under the NERL, applied by the AER;
- general insolvency arrangements under the Corporations Act; and
- security of supply provisions that may be relevant if a participant failure coincides with physical supply concerns. Related to this is the question of whether the current arrangements could enable the generation assets of a failed participant to continue operating in the market.

We have already identified the application of the ROLR scheme as a source of risk to financial system stability in the NEM in the case of a large retailer failure. Taken together, the other arrangements are not adequate for responding to a large participant failure because:

- a large participant failure would be complex, and the circumstances would be different in each case. Managing such a failure would require a clear and flexible 'toolkit' of potential response options from which to choose. Any response would need to be tailored to the specific case of the defaulting participant and the market situation at that time. This is not available under current arrangements;
- in the event of a large participant failure, decisions need to be made in a coordinated manner in order to avoid contradictory outcomes. Under the current arrangements, there is no comprehensive framework for decision-making and coordination across all relevant governments and market bodies;
- responding to a large participant failure would require consideration of a wide range of issues. Under the current arrangements, there is a risk that not all relevant issues, including financial market stability considerations, could be taken into account by the various decision-makers, and on the basis of the information available to them; and

- governments would be critically interested in a large participant default and would seek to maintain consumer and market confidence and ultimately, if needed, step in with support. There is no formal, institutional structure for involving and advising government.

In addition to the above points, existing insolvency laws cannot be relied upon to ensure an outcome consistent with policy objectives to provide continuity of supply to customers, and the maintenance of financial system stability in the NEM. The primary objective of an insolvency practitioner is to obtain the best financial recovery possible for the creditors of the business, not to maintain electricity supply. The existence of the ROLR scheme acknowledges this situation and the need for special arrangements.

4 Overview of conclusions

We have identified counterparty default under OTC contracts as one source of risk to financial system stability in the NEM. This risk would be greater where the participant experiencing the counterparty default is a large retailer. Another source is the application of the ROLR scheme in its current form to a large retailer failure.

This section provides a summary of our conclusions on current measures to identify and mitigate risks to financial system stability in the NEM in advance, as well as measures to manage, and respond to, a large participant failure with significant retail load.

4.1 Identification and mitigation of risks

As we stated above, participants’ risk management practices and existing external obligations such as AFSL requirements cannot be relied upon to reduce significantly, or eliminate all, risks to financial system stability in the NEM.

Given this, we have considered additional regulatory measures that seek to reduce the probability of financial contagion through counterparty failures by identifying and mitigating risks in advance. They included prudential regulation, mandatory stress testing and increased transparency measures. Currently, the case is not established for mandating such additional measures in the NEM for the following reasons:

- Introducing such measures would require substantial resources and expertise to be effective. The costs of doing so would likely outweigh the potential benefit of reducing risk in the NEM.
- The nature and magnitude of risks to system stability in the electricity sector differ from those in the financial sector, where such measures are common.
- The measures would not address a key source of financial contagion in the NEM - the ROLR scheme.

The electricity market and its participants are small compared to the broader financial market and its participants. The nature of risks to financial system stability in the NEM compared to other financial markets is also different, as electricity market participants appear to use derivative contracts to hedge against price volatility on the spot market, as opposed to speculative trade.

Also we consider that the case for implementing the proposed reforms relating to OTC derivatives, developed by the G20 countries, for electricity participants has not yet been made.

Our conclusions regarding the potential application of the G20 measures for electricity businesses are that:

- transaction-level trade reporting would place significant costs and regulatory burdens on participants' OTC activities while the benefits of such a measure as a tool to analyse risks to financial system stability are less clear;
- mandatory central clearing could discourage the use of OTCs as a hedging instrument. While mandatory central clearing can help to mitigate counterparty

risk from causing financial contagion, contagion may still arise through other mechanisms, such as the cash flow risks associated with margining requirements;

- margining and capital requirements would increase the cost of hedging as participants would have to obtain and deploy additional working capital to manage the associated cash flow risk; and
- development of electronic trading platforms is more appropriately driven by participants' demand for such services rather than through rules-mandated use of such platforms.

We note that the Australian Securities Exchange (ASX) and AEMO have been collaborating to explore solutions to clear and settle energy markets more efficiently.[8] Approaches to combine the clearing of both wholesale and derivatives trades could, in principle, result in more effective use of collateral in the industry and lower hedging costs.

In theory such approaches could also remove a level of counterparty risk from the market and could improve transparency. This could address part of the systemic risk in the NEM and achieve some of the intention behind the G20 OTC reforms. However, greater understanding on the design of such an approach is needed.

4.2 Managing and responding to threats to financial system stability in the NEM

Current arrangements are inadequate for managing and responding to the failure of a large participant with a retail load. There is a risk that such an event would trigger further failures of participants leading to financial instability in the NEM, especially if the ROLR scheme in its current form was applied. In such a situation, government may need to step in to protect the physical and financial integrity of the NEM.

At the time the current arrangements were designed, the industry structure included a number of comparatively smaller to medium sized stand-alone retailers, operating predominantly in one region only. Now, there are fewer, larger retailers operating on a NEM wide basis. The larger retailers are also part of businesses that include significant generation assets. Arrangements for managing and responding to the failure of a large participant need to reflect this structure.

Attention should be focussed on improving the resilience of the NEM to withstand future challenges. In this regard we propose a package to improve how market arrangements manage and respond to the failure of a large participant with a significant retail load. They involve a separate decision-making framework catered specifically for such a participant, as well as expanding the range of options available to manage and respond to such a failure. This is explained in section 6. We also propose:

- **amendments to the ROLR scheme** so that it can operate in a broader set of circumstances without exacerbating risks to financial system stability in the NEM. See section 5 below; and

8 AEMO, Energy Market Update, June 2014, p9.

- **clarification of market suspension provisions in the National Electricity Rules** to allow the possibility of not suspending a participant of parts of its activities from the NEM when it is under external administration in some circumstances. See section 5 below.

5 Proposed recommendations for improving existing arrangements

5.1 Amendments to the ROLR scheme

We are proposing a number of amendments to the ROLR scheme in order to address the financial challenges facing the ROLR(s):

- In order to reduce the impact of increased cash flow requirements, we propose to:
  - give the ROLR greater certainty that it can quickly recover the reasonable costs of undertaking the obligations of being the ROLR;
  - extend the time available for the AER to appoint the ROLR, to allow the AER to make a more considered allocation of customers; and
  - limit the extent to which the ROLR arrangements apply to very large customers (those with over 10GWh annual consumption at an individual connection point), who instead will have the opportunity to negotiate their own back-up retailer should a ROLR event occur.
- In order to reduce the impact of the ROLR's increased credit support requirements, we are proposing the following changes to AEMO and DNSP credit support arrangements:
  - the increased credit support required to be provided by the ROLR to AEMO for the energy volumes of the acquired customers would be waived for one week, and then ramped up over the following four weeks; and
  - any requirement for the ROLR to provide increased credit support to DNSPs following a ROLR event would be deferred for five weeks.

Benefits of the proposed ROLR amendments

Taken together, these measures may encourage more retailers to offer to become additional ROLRs, and increase the potential for multiple ROLRs to be appointed. This may reduce the risk of cascading retailer failure and financial contagion by spreading the customers, obligations and risks of the ROLR event between several retailers. Spreading customers across several retailers may also have longer term competition benefits.

The proposed changes to credit support arrangements aim to mitigate one of the main risks of financial contagion we have identified - the possibility that the an otherwise solvent ROLR would be unable to provide large amounts of credit support to AEMO almost immediately after the ROLR event.

Relative to the current arrangements, the changes proposed would enable the ROLR scheme to operate effectively in a broader set of circumstances, without exacerbating the risk of financial contagion. This would be achieved by reducing the financial obligations imposed on the ROLR following appointment, or by providing more time for those obligations to be met. If implemented, financial shocks to the NEM could be absorbed more readily through a more effective sharing of the risk across the market.

We recommend that the proposed changes apply to all ROLR events, irrespective of the size of the failing retailer. We see benefit in the simplicity and certainty that derives from having the same rules under the ROLR scheme, irrespective of the specific circumstances of that ROLR event.

Finally, AEMO and AER should continue to improve information and systems to enable the smooth transfer of customers.

Very large customers

We also propose to change the ROLR arrangements applying to very large customers, defined as those who have a connection point consuming 10GWh per annum or greater. The proposed consumption threshold involves a relatively small number of customers in total but offers significant potential benefits to the ROLR(s) in terms of substantially reducing their financial obligations. Data from AEMO suggest there are less than 1,000 connection points in the NEM with annual consumption of 10GWh or more, and that these connection points account for 15 per cent to 20 per cent of total NEM demand.

The revised ROLR arrangements would also offer potential benefits to those very large customers. They would avoid the possibility that such customers would automatically be transferred to the ROLR and be subject to the ROLR's standard terms and conditions. For such large customers this could include the pass through of spot market prices, plus a margin.

It also provides very large customers with an opportunity to negotiate more favourable terms in advance than those they might negotiate once their retailer has been affected by a ROLR event.

Our draft recommendations also include a ‘safety net’ for very large customers so that they are not subject to immediate loss of supply, even if they have not negotiated a back-up retailer before a ROLR event occurs.[9]

Commonwealth provision of credit support

The first interim report included a proposal to amend the NER to permit the Commonwealth Government to provide credit support.[10] Such an amendment would enable the Commonwealth Government to provide credit support, but would not place any obligation on the Government to do so.

We consider that if the proposed amendments to the ROLR scheme are implemented, the ROLR would be more able to manage the additional financial obligations without any external support. Therefore it is likely that there would be no need for this amendment and we have not included this in our draft recommendations.

We note that the possibility of the Commonwealth Government providing credit support to NEM participants might be part of any alternative arrangements to be applied instead of the ROLR. Therefore consideration of this amendment, and the appropriate mechanisms to give effect to such an arrangement, could be part of the

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9 Any very large customers that had not nominated a back-up retailer prior to their retailer failing would have a seven day 'period of grace' within which to organise a back-up retailer. They would continue to be supplied for this one week period of grace following the ROLR event.

10 AEMC, *First interim report, NEM financial market resilience*, page 73.

further work into stability arrangements, which are discussed in section 6.2 of this Overview.

5.2 Permitting continued operations of a participant in external administration

The timeframes governing activities in the NEM may make it challenging to resolve a major corporate failure before the relevant participant is suspended from the spot market. Also, the NER are uncertain as to whether a generator could remain operating in the market if it is in administration or if it is part of a registration that includes a retail business and that business was suspended.

To allow more time to respond to and manage a failure, we recommend that the NER be amended to clarify the ability not to suspend a participant that has entered into external administration. This would only apply if certain conditions are met regarding the ability of the participant to continue to meet its financial obligations to the spot market and comply with the rules. The need to clarify the NER in this regard was raised by AEMO, AER and participants.[11]

Permitting a participant, or parts of its activities, to remain operating in the market while under external administration could be beneficial in two ways. It could help to maintain both the physical integrity of the system, and financial system stability in the NEM, at times of stress. If designed appropriately, this would not increase costs to participants or expose them to additional risk, given the circumstances. Not allowing the continued market operation of such a participant could further aggravate the distress being experienced by the market at that time.

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11 Submission by the AER to the first interim report, 15 July 2014, p5. Also see, for example, submissions to the stage two options paper by Alinta Energy, 18 December 2013, p2; GDF Suez, 19 November 2013, p5; and InterGen, 19 December 2013, p3.

6 Proposed recommendations for new arrangements to manage a large participant failure

We recommend the establishment of a separate decision-making framework to facilitate a timely, proportionate and suitable response to a large participant experiencing significant financial distress or failure. It also includes an alternative mechanism to the ROLR scheme for managing and responding to a large participant failure - which we refer to as stability arrangements. For other participants, the current arrangements, appropriately enhanced by our recommendations summarised in section 5, would apply.

6.1 Decision-making for systemically important market participants

The key elements of the proposed new set of arrangements to manage and respond to the distress and failure of a large market participant are as follows:

- Participants whose failure, because of the size of their retail loads, would cause significant and immediate financial disruption to the electricity market and would likely threaten financial system stability in the NEM, should be classified as 'systemically important market participants' (SIMPs).
- All of the decisions on the management of, and response to, a SIMP failure should be gathered to, and made at, a single decision-making point. To facilitate this, decisions regarding suspension and revocation of retailer authorisations that are currently taken by AEMO and the AER would also be made at that single decision point. The key decisions to be made under the proposed framework would be:
  - subject to certain conditions being met, whether to allow the SIMP time to rectify its financial situation. This would enable all viable market-based solutions for resolving the situation to be explored before any regulatory arrangements may have to be applied; and
  - where the SIMP must be suspended from the market, a choice between applying the ROLR scheme, or an alternative stability arrangement. For the latter, see below.
- Decision-making would be guided by an objective to maintain financial system stability in the NEM by minimising the impact of the failure of a SIMP on consumers and the market in accordance with the NEO and NERO. The objective would focus on protecting the market and maintaining the supply of electricity to consumers, and not on the failed business or its creditors.

Given the extreme nature of such a situation, decision-making would best be held by a body that has overall responsibility for the market. Under the current NEM governance arrangements, government has responsibility for the market as a whole and can take into account the factors and considerations relevant to the circumstances. Government is best placed to make these decisions.

Within government, there needs to be a single decision-maker, for accountability and transparency. Due to the national character of SIMPs, the Chair of the COAG Energy

Council should be the ultimate decision-maker, in close cooperation with State and Territory energy ministers.

To assist government in decision-making, we recommend that relevant market bodies provide advice in a collective and coordinated way, through a 'NEM Resilience Council'. It would comprise the AER, AEMO, the AEMC and ASIC.

Amongst other things, the NEM Resilience Council would:

- advise on the best course of action where a SIMP is experience financial distress or has failed;
- escalate instances where a SIMP may be imminently facing financial distress and prepare advice for government when it becomes aware of such circumstances; and
- consider potential risks to financial market stability in the NEM on an ongoing basis.

6.2 Expanding the range of options to address risks to financial system stability - stability arrangements

Even taking into account our recommendations to amend it, the ROLR scheme may not be effective in all situations of a SIMP failure. If the ROLR scheme is not effective then external administration provisions under the Corporations Act would apply. These provisions cannot be relied upon to maintain continuity of supply to consumers, and to maintain financial system stability in the NEM.

In the absence of a suitable plan for how to manage and respond to a SIMP failure, the stability of the NEM could be threatened and the expectation for government to intervene could arise. Without planning, government intervention could be costly, inappropriately targeted, and not effective.

For this reason, there is merit in having in place an alternative - which we have termed stability arrangements - which could apply when a SIMP fails. This would involve a form of special external administration or management.

There are precedents for establishing specific forms of external administration to address particular industries or important State interests to deal with situations that are not able to be satisfactorily dealt with by traditional forms of external administration – examples include the judicial management regime for the Australian insurance sector and the special administration regime for energy supply companies in Britain.

Further work needs to be undertaken to develop stability arrangements as an alternative to the ROLR scheme when a SIMP fails. The aim of stability arrangements would be to manage and respond to the failure of a SIMP while the continuity of supply to consumers, the integrity of the wholesale market, and financial stability in the NEM are maintained.

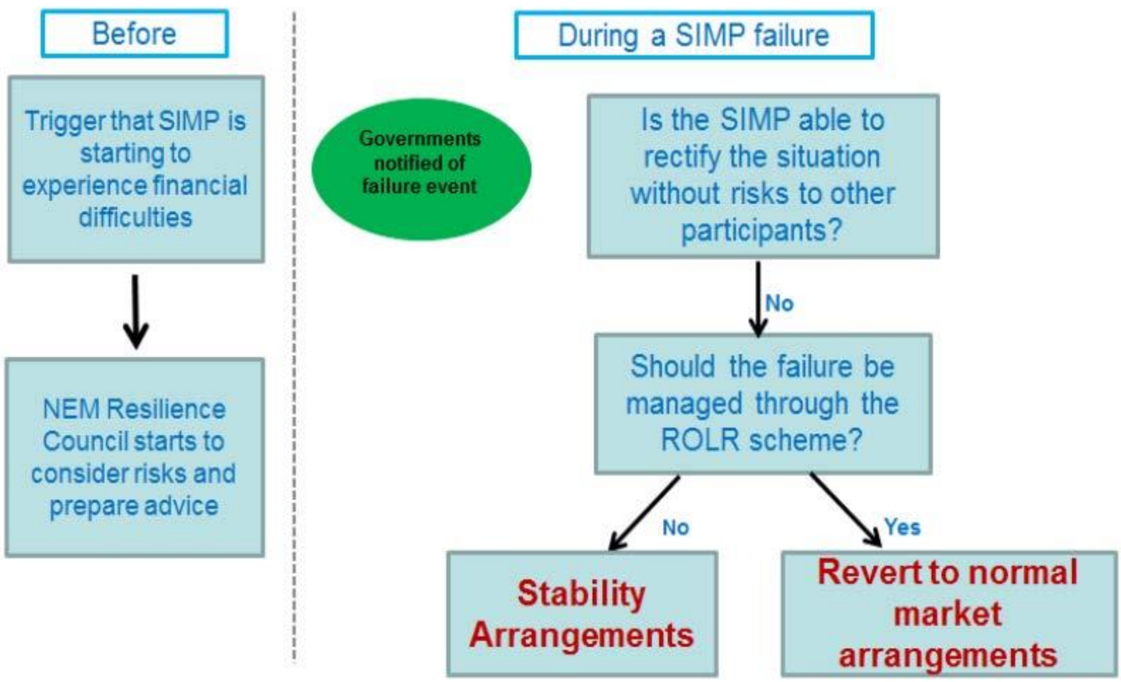
Given the breadth of issues raised when considering potential stability arrangements, including insolvency processes and the potential for significant funding requirements, we are not making detailed recommendations about the design of suitable stability arrangements.

Any stability arrangement would require a package of legislative changes and funding provisions, extending beyond the electricity regulatory framework. The assessment, design and implementation of stability arrangements would be a complex exercise and would need to involve a range of stakeholders, both within the electricity sector and outside it. It would also involve trade-offs between different interests which are a matter for public policy and best considered at government level.

We recommend that the COAG Energy Council request energy departments, in consultation with Commonwealth, State and Territory Treasuries, form a working group to develop the detailed design of stability arrangements for the NEM, incorporating a form of special external administration.

The steps and decision-points under the framework outlined above are shown at a high level in figure 6.1.

Figure 6.1 Summary of proposed SIMP decision-making framework



Responding to the financial distress or failure of a large retail business would require consideration of many issues within a short time. These include financial stability considerations, broader consumer and investor confidence, competition impacts and factors outside the energy market. The purpose of this framework is therefore to facilitate a timely, proportionate and suitable response when a risk to financial system stability in the NEM arises.

In doing so, the market would be better prepared and more capable to withstand challenges. There would be more options available to respond to the failure and an improved ability to make appropriate, timely decisions.

Under the proposed recommendations, the need for government support would be minimised and only used as a last resort, after opportunities for commercial solutions have been explored.

7 Implementation of proposed recommendations

This overview provides a summary of the package of recommendations to change current market arrangements in order to effectively manage the risks to financial system stability. We recognise that more detailed design and implementation work is required and we welcome stakeholder views on the recommendations.

The implementation of the proposed recommendations would require a number of legislative changes and further work on the framework for responding to a SIMP failure. The package of recommendations can be separated into a number of different implementation stages for the COAG Energy Council to consider as part of their response to the recommendations. These stages are:

(A) For the proposed ROLR amendments, to develop changes to the national energy retail law and submit changes to both the national electricity rules and national electricity retail rules.

(B) For the recommended change to allow the ability for participants in external administration to continue to operate in the NEM, to submit the proposed change to the national electricity rules.

(C) For the implementation of the framework for SIMPs, the COAG Energy Council would make the necessary legislative amendments and submit rule changes.

(D) Regarding the development of the stability arrangements, we suggest that the COAG Energy Council commission energy departments, in consultation with Commonwealth and State and Territory Treasuries, to form a working group to develop the detailed design of stability arrangements for the NEM, involving a form of special external administration.

We are also advising against the implementation of the G20 reforms to OTC derivatives to NEM participants. We ask that the COAG Energy Council considers our draft advice.

8 Submissions

The Commission welcomes submissions on any of the issues raised in the second interim report. Written submissions from stakeholders and interested parties in response to the second interim report must be lodged with the Commission by no later than 25 September 2014.

Submissions should quote project number "EMO0024" and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235.

Abbreviations

AEMC or Commission	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AFSL	Australian Financial Services Licence
ASIC	Australian Securities and Investment Commission
ASX	Australian Securities Exchange
COAG	Council of Australian Governments
DNSPs	distribution network service providers
GFC	global financial crisis
NECF	National Energy Customer Framework
NEM	National Electricity Market
NEO	national electricity objective
NER	National Electricity Rules
NERO	national electricity retail objective
OTC	over-the-counter
ROLR	retailer of last resort
SIMP	systemically important market participant