INFORMATION

Reforms in the financial sector – lessons for the NEM

The Australian Energy Market Commission has published a paper which reviews some of the major reforms relating to stability regulation in the financial sector following the global financial crisis and discusses the relevance of these reforms for the National Electricity Market (NEM).

Purpose of this advice

The Council of Australian Governments (COAG) Energy Council has asked the AEMC to provide advice on the risks to financial system stability in the NEM arising from the financial relationships between electricity participants, and to review whether the existing arrangements to manage those risks are sufficiently robust.

In preparing its advice the AEMC was also asked to consider approaches to financial stability regulation in other markets and relevant developments in the regulation of financial markets in Australia and other jurisdictions.

While, the NEM has operated effectively to date, its operating environment has evolved significantly since market start. This includes in terms of industry structure and regulatory obligations. 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.

It is therefore prudent to consider the potential for risks to financial system stability to occur in the NEM and to have in place arrangements to manage those risks. The AEMC has proposed draft recommendations to improve the ability of market arrangements to manage and respond to a participant failure in the NEM. They are set out in its Second Interim Report, published on 14 August 2014.

Overview of reforms in the financial sector

Following the global financial crisis in 2007, the general direction of regulation in the financial sector in Australia and other jurisdictions has been towards increased regulation, higher prudential standards, closer regulatory supervision and broader new regulatory powers. Some of the major areas covered by the reforms are risk management and capital adequacy. They also involve:

- defining certain institutions as ‘systemically important’ and applying additional regulation to them; and
- increasing regulators’ powers to supervise and to direct financial institutions.

While the specific details of how these reforms have been implemented differ between jurisdictions, the broad thrust is similar. These reforms aim to avoid Governments being placed in a situation where their urgent intervention is required to prevent the failure of a large institution, particularly where the extent, nature and terms of such intervention is unknown.

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The paper discusses the lessons for the NEM from reforms to the financial sector following the global financial crisis

Lessons for the AEMC's advice on NEM financial market resilience

The AEMC's Second Interim Report has been informed by regulatory developments in the financial sector, but recognises that there are important differences between the financial sector and the NEM. Notwithstanding the differences, a number of themes from the financial sector reforms have been relevant to the AEMC's advice. These include:

- The importance of considering how markets should plan to manage periods of stress, including those caused by the financial distress of large market participants, in advance of any event occurring. The speed with which markets failed during the GFC and the subsequent need for governments to take immediate action highlights the need for pre-planning and crisis preparedness. It also highlights the need to ensure that market and regulatory arrangements are able to manage the impact of disruptive events in the financial sector without disrupting systemically important functions and services.
- There is no single best mechanism to regulate for system stability. The financial reforms recognise the need to have a mixture of pre-event measures and a range of different post-event options from which to select. The cause of any event will depend on the unique circumstances at that time, and the arrangements need sufficient flexibility to respond to those circumstances.
- Implementing reforms may impose costs on the market prior to any event occurring. Those costs need to be balanced against the materiality of risks to financial system stability, and the extent to which those reforms are likely to reduce costs when a systemically important business experiences severe financial distress or failure.

Next steps

The second interim report on NEM financial market resilience was published on 14 August 2014, and submissions are invited by 25 September 2014.

We will develop our final recommendations and advice to the COAG Energy Council after consideration of stakeholder views.

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