INFORMATION

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Electricity market financial resilience

Second interim report released for stakeholder comment

The AEMC's second interim report includes draft recommendations to improve the ability of market arrangements to manage and respond to a participant failure in the National Electricity Market.

This work is part of the Commission's work program to provide a resilient, sustainable market which is able to accommodate future changes.

Purpose of this advice

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

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.

Risks to financial system stability in the NEM

A participant with a large retail business experiencing financial distress or failure could cause flow-on effects to other participants, potentially leading to financial system instability. We have found that current arrangements are not adequate to manage such a situation because:

- the retailer of last resort (ROLR) scheme could act to transmit financial distress, potentially exacerbating financial system instability in the NEM. This is due to the very large and immediate financial obligations that would be placed on the retailers that become ROLRs
- the arrangements do not support consideration of financial system stability issues
- the arrangements do not provide for co-ordinated decision making across all relevant government and market bodies.

Overview of the draft recommendations

In response, we are recommending a package of recommendations that would improve the resilience of the NEM in the event of a failure of a participant with a large retail load. Such a failure would be complex and the circumstances would be different in each case.

Our recommendations include:

- gathering to a single decision making point those decisions that would make up the response to a large participant failure and making government responsible for those decisions

The second interim report sets out draft recommendations to manage the risks related to the failure of a participant with a large retail business.

- establish a council of the market bodies to provide advice to government
- developing alternatives to the ROLR which could apply in such an event – which we refer to as stability arrangements
- 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
- a rule change to clarify that participants entering into external administration may not be suspend from the market

Benefits of the draft recommendations

This package focusses on enabling better, more informed, timely decisions to be made when the risks arises and providing the flexibility to tailor the respond to the specific circumstances.

Our recommendations have been developed with a view of maintaining the commercial incentives on participants to manage their own risks and avoiding moral hazard. They focus on ensuring continuity of supply to customers and maintenance of stability, rather than on protecting a business or its creditors.

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 government would step in and support participants when risks to financial system stability in the NEM occur. Having in place appropriate market responses is one way to achieve this, and minimise the likelihood of government support being required.

G20 reforms to OTC derivatives

The AEMC has been asked to provide advice to Government on the potential application of the G20 measures for OTC reform in the NEM.

At this stage we are not recommending any further regulatory measures to identify or mitigate in advance risks to financial system stability in the NEM, including the proposed G20 reforms. The case is not established for mandating such additional measures in the NEM, given the different nature of risks in electricity sector compared to the financial sector and because of the costs and impacts of introducing such measures.

Next steps

The package of proposed recommendations would require a number of legislative changes and changes to the National Electricity Rules. The package of reforms is presented in the second interim report at the principle level. The report highlights some of the questions that would need to be addressed when implementing these recommendations.

Submissions are invited by 25 September 2014. We will develop our final recommendations and advice to COAG Energy Council after consideration of stakeholder views. We expect to publish our final report by the end of 2014.

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