alintaenergy

20 December 2012

Mr Richard Owens
Australian Energy market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Owens

NEM financial market resilience

Alinta Energy welcomes the opportunity to make this submission in response to the Australian Energy Market Commission's (AEMC) options paper *NEM financial market resilience* flowing from the 8 June 2012 issues paper instigated by the Standing Council on Energy and Resources.

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia, including in the NEM. Alinta Energy has over 2500MW of generation facilities in Australia (and New Zealand), with retail energy customers in Western Australia, South Australia and Victoria and a commitment to growth across the NEM.

General discussion

Prudential and financial regulatory developments

As stated in response to the earlier issues paper, Alinta Energy endorses the AEMC's approach, and especially the engagement of industry that has characterised the development of this review process. Alinta Energy supports industry engagement generally but especially where matters are of growing interest to policy makers and regulators and as a consequence there is a risk of unnecessary or ill-fitting regulation. This is clearly the case with a number of prudential and financial matters.

As an entity challenging industry incumbents, Alinta Energy is particularly sensitive to significant or unfavourable policy and regulatory changes which increase prudential obligations or could hamper Alinta Energy's ability to enter into financial relationships with counter-parties. It is Alinta Energy's view, that the risk of ill-conceived regulation is best managed through the adoption of practices akin to those used by the AEMC in the development of the issues and options paper. For this, the AEMC is again commended.

Issues addressed to date

Alinta Energy retains the view that the financial relationships and financial markets that underpin the operation of the National Electricity Market are robust. As such, the counterfactual for any change should be less prescription and regulatory intervention not more.

While a range of concerns have been expressed there has been little in the way of concrete evidence that there has been, is, or will be any significant financial risks that can be regulated out of existence. On the contrary, the market continues to operate efficiently and entities have well developed and sophisticated risk management expertise underpinned by continued market participation. This is true of major load, generators, retailers and vertically integrated entities.

The out workings of the issues paper, and the subject of the options paper, demonstrate that the markets shortcomings are not driven by the practices of participants but relate to the regulatory interventions themselves.

As Alinta Energy has previously indicated, regulatory interventions and burdens continue to undermine the delivery of cost-reflective energy to consumers and damage the financial viability of otherwise prudently operated businesses. Alinta Energy has been particularly focussed on the risks arising from regulated retail prices and loss of asset value associated with climate change policies.

Selection of the ROLR and the need for less regulation not more

In the options paper the Retailer of Last Resort mechanism (ROLR) is rightfully identified as the weak link in the event of failure of a large retailer. Given the issues of regulatory intervention and the risks of failure associated with those interventions are not the subjects of this review we agree that it is appropriate to focus on the ROLR.

Nevertheless, we retain the view that the counterfactual should be less not more regulatory intervention. It is unfortunate that weaknesses created by a regulatory mechanism, the ROLR, are seen as only resolvable through further market distortions and interventions by some parties. Creating a new range of regulatory requirements and potential levers in the face of financial failure of a single participant is untested and in all likelihood will be counterproductive despite best intentions.

To the AEMC's credit, and consistent with the approach they have taken over the course of this review to date, each intervention is appropriately assessed for the real and often dramatic short-comings that further intervention would herald.

Alinta Energy's high-level view on the ROLR and next steps

Alinta Energy's preferred option is progress on a workable option for removal of the ROLR that would place electricity more in line with any other industry but with additional protections for consumers to ensure reliability of supply. Having now had the benefit of the AEMC's analysis, and having been a member of the industry working group, upon reflection Alinta Energy is coming to the view that the ROLR is actually a problematic instrument which creates a number of unintended outcomes which may be best avoided.

Alinta Energy is now of the view that building upon the options paper requires further investigation of the removal of the ROLR to ascertain the value of allowing normal administration and liquidation processes to run. It should not be assumed that enabling an administrator to liquidate assets, including retail customers, or administer the business until trade sale, will be an inferior outcome to implementation of the ROLR and its associated short-comings. In fact, the case for this outcome seems more beneficial in the event of a large retailer default.

The primary justification for ROLR is reliability of supply in the event of insolvency; however, Alinta Energy suggests this can be achieved through a number of cost recovery mechanisms and not necessarily the ROLR. Further, this protection seems most necessary for mass market customers not commercial and industrial loads that often have more sophisticated energy purchase arrangements.

Whether this 'public good', of reliability of supply for mass market customers in the event of default, requires bridging support to allow the administrator to trade out or on-sell assets, requires further analysis.

Additional comments of the AEMC's general analysis

Alinta Energy agrees with the view that when it relates to large retailer failure there is no easy answer. It is for this reason Alinta Energy favours less regulation and notes the disadvantages of the most intrusive recommendations, which the AEMC has outlined in detail.

The view that an arbitrary threshold could be used to determine the size at which a large retailer leads to material financial contagion risk is rejected. This approach is misguided and ignores the possibility that completely unknown or unidentified factors could drive financial distress in the National Electricity Market.

<u>Comments on specific options</u>

Leaving aside the conclusions drawn above, the rest of this submission outlines Alinta Energy's positions on the general content of the options paper and the specific options outlined by the AEMC.

Options to improve the ROLR regimes (Chapter 5)

Alinta Energy supports existing cost recovery mechanisms (with or without ROLR) being amended to give the designated retailer (or ROLR) greater certainty that it can quickly recover its costs.

Nevertheless, Alinta Energy has some concern with lumpy charges and suggests any cost recovery mechanism needs to be smoothed to ensure any affected customer is not disadvantaged and acknowledges that lumpy charges may be counterproductive. This may be best managed by locking in customers for six months to the ROLR using a varied retail tariff but making sure the ROLR can only recover specific costs.

Alinta Energy agrees that the following clarity is required:

- a clear process for cost recovery applications to be made to the regulator;
- a right for recovery of reasonable costs;
- a limited period during which costs can be recovered, three months appears appropriate as a guide at this stage; and
- clear timelines for a regulatory determination to be made.

Alinta Energy does not support augmenting the existing ROLR provisions to give Australian Energy Regulator (AER) better powers to prepare for a ROLR event in relation to large retailers.

This option suggests the AER through analysis can determine how and when financial contagion will and won't impact on the market in specific circumstances and is able to draw intelligible conclusions from commercially sensitive information at a point in time. This is unfounded and should be dismissed before any additional costs are imposed.

The reality is that if one of the large retailer fails, assuming that an administrator is not permitted to run the company and sell assets off accordingly, then it is a question of who can integrate those customers while ensuring that they continue to receive power. In such an environment existing companies can only take on the number of customers that they advise, not more, and special measures, be it distribution network cost recovery, are needed outside of this.

Alinta Energy favours the AER maintaining up to date nominations from retailers on the number of customers they could absorb in light of a major retailer event and is open to minimum requirements being a compulsory condition of retailer licensing to assist with allocating customers across a number of retailers. The AER making allocative decisions based on its own criteria, using information gathering powers, is not supported and will merely introduce an additional parameter at a time when regulatory imposts may induce financial contagion.

Alinta Energy also does not support the transfer of failed retailer contracts to the designated ROLR. As articulated by the AEMC this raises cross-default risks, may involve the taking of property without proper compensation, would require legislative provisions to be enacted, and will likely only have the effect of increasing the risk of cascading default. The advice of NERA Economic Consulting and Allens Arthur Robinson is noteworthy in this instance and highlights the significant risk of this option.

Alinta Energy is not comfortable amending the National Electricity Market suspension provisions to delay the triggering of a ROLR event given the related prudential changes that would be required. While changing the trigger conditions could allow better management of the defaulting retailer, this suggestion further illustrates that the use of the ROLR itself is problematic and introduces more risk, and hence more functions for a regulator with limited experience, in an attempt blunt the effects of the ROLR, is not a desirable outcome.

The leads to support for delaying the implementation of a designated ROLR and allowing greater flexibility in management of an event by administrators while ensuring the regulator can facilitate a transition (should it be deemed necessary) to a number of volunteering ROLRs. This options needs to ensure the failed retailer remains responsible until such a time as customers are transferred over to a ROLR or otherwise.

Options to address the designated ROLR's increased credit support obligations

As a general rule Alinta Energy does not support the waiving or delaying of credit support arrangements unless there is complete assurance that the parties placed at risk can recover any short payments arsing from the waived obligations.

As such, Alinta Energy does not support reductions associated with credit obligations and payments that would otherwise be made by the retailer (or designated ROLR) to the Australian Energy Market Operator (AEMO) to meet the costs of energy. These proposals expose generators to non-payment risk beyond that which has previously been deemed acceptable and introduces the risk of generator default in the face of retailer failure. It exacerbates the risk of cascading default by imposing risk and costs on otherwise financially sound market participants.

The option to reduce credit support obligations to AEMO could therefore only be accepted if market customers accepted the risk via AEMO.

Distribution network credit support obligations could be amended if appropriate cost-recover provisions were in place for those networks; however, it seems the real issue here is: are the levels of credit support required by distribution networks appropriate given the level of risk they bear? The differences highlighted by the AEMC suggests a general revision of network support (given retailers cannot choose their networks) may be more beneficial than seeking to delay credit support. Nevertheless, with appropriate pass-through provisions this recommendation may be viable.

Options to address the designated ROLR's increased costs and risks

Alinta Energy does not support market distortions like: the introduction of a spot market cap following a retailer failure; allowing the designated ROLR to paying a transitional tariff instead of the spot price;

or delaying settlement. These proposals are extremely distortionary, transfer risks and wealth, would be very complex to implement, and harm all participants and market incentives for questionable benefit.

Delayed settlement for distribution network charges again may be feasible if distribution networks could be appropriately protected; however, it is agreed the benefits are likely to be marginal.

Alinta Energy is interested in the AEMC's view on the shorter settlement cycle. The shorter settlement cycle of itself could be a positive benefit to the market and would likely reduce risk; however, AEMO has no plans to progress this reform and it has been strongly opposed by some vertically integrated entities as a consequence of their commercial positions.

Alinta Energy is opposed to co-insurance funds and believes such funds are likely to tie up capital unnecessarily, are disproportionate, provide the wrong incentives, and can become institutionalised for marginal benefit. This is especially the case when it is not even apparent that the fund would meet the costs associated with a large retailer event. The criteria for contributions alone and the additional costs to all retailers is enough to suggest this measure is unwieldy and undesirable.

Options for a last resort government response

Alinta Energy agrees government intervention should be last resort if not entirely avoided given the nature of those interventions and the likely costs to taxpayers. Ironically, while it is agreed government intervention should be a last resort in many respects the ROLR regime is a form of government intervention in a market that could otherwise function without this intervention aided by measures to facilitate cost recovery.

The posting of credit support by government is one proposed option that is open to government if the ROLR mechanism is maintained. It is also the least intrusive for industry but exposes consumers to additional cost and risk in order to facilitate continued and reliable supply of electricity (that is arguably not under threat in any case).

The recommendation of a government appointed administrator is closest to Alinta Energy's preferred position of allowing normal administration arrangements to prevail but with mechanisms ensuring cost recovery to facilitate continued energy supply (if that is considered under threat). This may form a special administration regime but requires further analysis.

Alinta Energy supports further investigation of this option and the mechanism for using existing insolvency arrangements versus a special administration arrangement for electricity company insolvency.

Yours sincerely

Jamie Lowe
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