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Our Ref:

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Dear Mr Pierce

DPI Submission to the AEMC NEM financial market resilience review EMO0024 Options Paper

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy market development in Victoria, is pleased to make this submission in response to the Australian Energy Market Commission's NEM financial market resilience review Options Paper.

Any queries in relation to the submission should be directed to Ben Ferguson by email at benjamin.ferguson@dpi.vic.gov.au or by phone on (03) 9658 4436.

Yours sincerely

Mark Feather
Executive Director, Energy Sector Development

Victoria
The Place To Be

DPI Submission to the AEMC NEM financial market resilience review – Options Paper

Key messages

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria, welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) National Electricity Market (NEM) financial market resilience review Options Paper, released on 9 November 2012.

DPI endorse focus on failure of large retailer

DPI endorses the focus of the AEMC's work program on the failure of a large retailer and the triggering of an associated retailer of last resort (ROLR) event. Although there is a low probability of a large retailer failure, the outcomes for the NEM and for customers are potentially serious and are unlikely to be well managed under current market arrangements.

The Options Paper also deals with possible contagion risk. Insofar that contagion is defined as an extreme negative event or shock that spreads to third parties DPI endorses the use of the term. However, contagion is often used in financial and banking literature to relate to the transmission of shocks to entities that are not traditionally linked through commercial channels such as trade, prices, contracts, loans or investment flows. This latter definition is concerned with the management of shocks that arise from expectations and market sentiment, which spread informally and unpredictably across markets. Such shocks are much more difficult to control. It is DPI's view that in this analysis we are dealing with the first and narrower definition of contagion. That is, we are primarily concerned with the transmission of shocks through existing regulatory and market linkages. It follows that the focus of the analysis should be on options to mitigate the risk of serious flow on effects through the NEM.

Low probability means ex post action likely to be most cost effective

Given the low probability but high impact of a large retailer failure, DPI considers that it is appropriate that this review predominantly focus on *ex post* mechanisms to manage the event i.e. to address the failure if and when it occurs. Significant *ex ante* action is unlikely to materially reduce or eliminate the already small risk of a large retailer failure but in some cases is likely to be very costly e.g. by requiring ongoing monitoring of the financial position of large retailers or the establishment of an fund to underwrite firms in the event of a retailer failure.

However, one important *ex ante* action which could materially reduce the risk of retailer failure and associated financial contagion and therefore should proceed with greater haste is the deregulation of retail prices across the NEM. As indicated in our previous submission and as widely recognised, current retail price regulation exacerbates the risk of a large retailer failure.[1] The Council of Australian Governments (COAG) has recently endorsed universal retail price deregulation where effective competition exists and a work program to achieve this.[2] Every effort should be made to ensure that this reform proceeds without delay across all jurisdictions.

1 Price regulation constrains retailers' ability to recover reasonable costs, undermines the ability of retailers to manage market risk and at the extreme can lead to insolvency.

2 *Council of Australian Governments Meeting –Communiqué* Canberra, 7 December 2012, p. 4 and *COAG Energy Market Reform - Implementation Plan, Final Version*, 28 November 2012, p.7.

DPI's assessment of the risk mitigation options

DPI supports well designed cost recovery arrangements for any mechanisms utilised to manage a large retailer failure and associated contagion risk.

Amendments to ROLR regimes

Where a ROLR event is triggered, DPI supports the utilisation of multiple ROLRs. This would reduce risks for any individual retailer and hence the potential for contagion. The proposal for expanded planning processes could also lead to improved operation and hence success of the ROLR arrangements. As explained within our submission, the other proposals for ROLR amendments are not supported.

Feasibility of ROLR response to large retailer failure

ROLR arrangements, especially those that are enhanced by the administrative reforms proposed (e.g. cost recovery) are suitable for managing small retailer failure, when the risks of knock on effects are low. However, in DPI's view the process of assessing the risk mitigation options presented in the Options Paper highlights that no form of ROLR (including the enhanced forms discussed in the Options Paper) is likely to adequately manage a large retailer failure and associated contagion risk. Furthermore, DPI believes that the possible long term competition consequences of a transfer of a substantial number of customers to remaining retailers should be carefully considered.

The AEMC acknowledges that a ROLR response may not be adequate or suited to managing a large retailer failure (e.g. see pages 47, 93 & 111 of the Options Paper). In concurring with this observation DPI considers that far more comprehensive analysis of this threshold question is thus required as this will profoundly change the specification of the problem being addressed and the nature of any appropriate policy responses. This analysis should consider, among other issues:

- Whether ROLRs are in practice likely to be able to meet the operational challenges associated with being a ROLR in the event of a large retailer failure. This would include the need to rapidly expand billing to avoid cash flow problems and to expand customer service systems.

- The likely impacts on the competitiveness of the national retail market in the event of a large retailer failure and the likely response or role of the ACCC in approving the transfer of customers.

Options with large up-front costs or significant market intervention not supported

DPI does not support those options that are clearly a disproportionate response in that they impose large, unnecessary up-front costs or substantially intervene and distort normal market functioning. These options include the option of an industry co-insurance fund and any options that cap or modify the wholesale market prices.

Improved analysis of government intervention option required

An option that appears to have merit is a (last resort) government-supported, administered arrangement. However, further analysis is also needed to develop this option. A key concern with this approach is the moral hazard problem it can raise. If retailers and their investors know that their business may receive government support and that they may avoid some or all of the costs of insolvency, this could encourage excessive risk taking and fundamentally undermine the incentives for sound businesses management. Options to minimise or address the moral hazard problem are needed e.g. limiting the distribution of sale proceeds to the failed business where the government has intervened to provide support.

Any option involving government intervention would need to be at the national level, as the large retailers operate across multiple NEM regions. Hence the Commonwealth Government and national market institutions would most efficiently pool market risk and provide any last resort intervention. As raised in our previous submission, the greater financial resources of the Commonwealth and its vertical fiscal imbalance with State and Territory jurisdictions would also lend weight to Commonwealth responsibility.

Additional hedging option

DPI requests that the AEMC explore further options for short-term arrangements to maintain hedging cover for the failed retailer load. The hedges could operate in the context of a special administration arrangement or in the context of an amended ROLR arrangement for a large retailer failure. This could substantially reduce contagion risks and the requirement for government support and would limit the energy costs associated with meeting the failed retailer's load.

1. Large retailer failure and contagion risk

Before addressing the specific proposals in the AEMC's Options Paper, the following comments are offered on the likelihood and contributors to a large retailer failure and resulting contagion risk and the implications for potential policy responses or interventions.

1.1 Likelihood of large retailer failure

In terms of likelihood, it is reasonable to expect that the failure of a large NEM retailer would be both a low probability and an unpredictable event, but one which would have significant and wide-reaching impacts on consumers and market participants. The fact that these are exceptional but rare circumstances with the potential to lead to substantial external costs establishes *prima facie* grounds for intervention. However, this action may take a variety of forms, from *ex ante* regulation, including market design and prudential requirements, which attempt to minimise the probability of an event arising, to *ex post* action undertaken if a retailer failure occurs.

The optimal balance between *ex ante* and *ex post* interventions will depend upon the relative cost effectiveness of the alternative intervention options. This appraisal will be influenced by a number of considerations, including an assessment of whether *ex ante* interventions can measurably reduce the likelihood of low probability events actually occurring. This appraisal presents a significant measurement problem. For low probability/high impact events it is generally very difficult to determine whether an investment in *ex ante* measures leads to incremental improvement in the likelihood of such low probability events, let alone to estimate the quantum of this improvement.

This means that:

- An evaluation of intervention options tends to be subjective rather than empirical.
- It will be important to ensure that accountabilities are clear, sanctions or compensation arrangements are well specified in advance, and regulatory arrangements do not unduly undermine the flexibility of firms to respond to and manage market risks and to meet their regulatory obligations (including meeting prudential obligations). We note it will be important that these governance and regulatory settings should also avoid moral hazard and be cost effective.
- Beyond confirming good governance and regulatory arrangements are in place, for low probability, high impact events there is often a preference for *ex post* measures. This is because it may not make good economic sense to invest heavily in up front regulatory activities for which the benefits cannot be discerned and hence is impossible to determine whether there is over or under investment in *ex ante* risk mitigation activities. For such low probability events it may be more cost effective to deal with the consequences, should they arise.

Given the low probability but high impact of a large retailer failure, DPI considers that it is appropriate that this review predominantly focus on *ex post* mechanisms to manage the event i.e. to address the failure if and when it occurs. Significant *ex ante* action is unlikely to materially reduce or eliminate the already small risk of a large retailer failure but in some cases is likely to be very costly, for example by requiring ongoing monitoring of the financial position of large retailers or the establishment of a fund to underwrite firms in the event of a retailer failure.

However, one important *ex ante* action which could materially reduce the risk of retailer failure and associated financial contagion and therefore should proceed with greater haste is the deregulation of retail prices across the NEM. As indicated in our previous submission and as widely recognised, current retail price regulation exacerbates the risk of a large retailer failure.[3] The Council of Australian Governments (COAG) has recently endorsed universal retail price deregulation where effective competition exists and a work program to achieve this.[4] Every effort should be made to ensure that this reform proceeds without delay across all jurisdictions.

1.2 Contributors to financial contagion

Any effective action to mitigate financial contagion risk must adequately address its identified causes. DPI considers that there are three key contributors to financial contagion arising from the failure of a large retailer in the NEM:

1. Retail price regulation

Retail price regulation not only contributes to the potential for an initial large retailer failure, it could also add to contagion risk by limiting the ability of ROLRs and other retailers to recover increased costs.

2. Unhedged load of failed retailer

The customer load served by the failed retailer will no longer have hedging cover, potentially exposing generators and ROLRs to significant windfall gains and losses. This is a key contributor to the financial burden associated with serving the load of a failed retailer. Options should be considered for managing this price risk.

3. Inflexible market protection mechanisms including ROLR

The current NEM prudential requirements and market suspension triggers (that also trigger a ROLR event), impose significant financial burdens that must be addressed in very short time frames.

Both the ROLR regime and the prudential arrangements serve an important role in the efficient operation of the NEM. The ROLR regime provides certainty of supply to customers and creates strong incentives on retailers to remain solvent and effectively manage risk (or face the loss of their key asset - their customers should a ROLR event be triggered).

However, DPI agrees with the views expressed by the AEMC and others (as reported in the Options Paper e.g. p.i and p. 22) that the *current* ROLR regimes, including the national regime, are unlikely to appropriately manage the failure of the large retailer to minimise financial contagion or result in the best outcomes for consumers and businesses. This is not unreasonable or unexpected as the ROLR arrangements were not designed to manage a large retailer failure.

Therefore, while sound prudential standards and market stability must be maintained, and it is not proposed that these be changed, DPI consider that there is scope to develop less burdensome arrangements for the specific and rare event of a major retailer failure that best support market stability and minimise financial contagion.

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3 Price regulation constrains retailers' ability to recover reasonable costs, undermines the ability of retailers to manage market risk and at the extreme can lead to insolvency.

4 *Council of Australian Governments Meeting –Communiqué* Canberra, 7 December 2012, p. 4 and *COAG Energy Market Reform - Implementation Plan, Final Version*, 28 November 2012, p.7.

1.3 Feasibility of ROLR response to large retailer failure

The process of assessing the risk mitigation options presented in the Options Paper highlights that no form of ROLR (including the enhanced forms discussed in the Options Paper) is likely to adequately manage a large retailer failure and the associated contagion risk.

The AEMC acknowledges these challenges and recognises that a ROLR response may not be adequate or suited to managing a large retailer failure (e.g. see pages 47, 93 & 111 of the Options Paper). DPI considers that far more comprehensive analysis of this threshold question is required than has been provided to date as this will profoundly change the specification of the problem being addressed and the nature of any appropriate policy responses. Furthermore, DPI believes that the possible long term competition consequences of a transfer of a substantial number of customers to remaining retailers should be carefully considered.

The analysis should consider, among other issues:

- Whether ROLRs are in practice likely to be able to meet the operational challenges associated with being a ROLR in the event of a large retailer failure. This would include the need to rapidly expand billing to avoid cash flow problems and to expand customer service systems.
- The likely impacts on the competitiveness of the national retail market in the event of a large retailer failure and the likely response or role of the ACCC in approving the transfer of customers.

This analysis would also provide a clearer indication of whether any form of action or intervention is needed to address a large retailer failure.

1.4 Improved analysis of government intervention option required

An option that appears to have merit is a (last resort) government-supported, administered arrangement. However, greater depth of analysis is also needed to develop the government intervention option.

Government intervention may have efficiency benefits

While strongly supporting the proposition that any government intervention should be short-term and as a last resort (as outlined in our previous submission), both from a risk management and political point of view, DPI recognises that governments retain a strong interest in ensuring the failure of a large retailer would be properly managed and consequently may have a role to play. Aside from the political considerations of ensuring continuity of supply, given the ability of government to pool risk it is possible that a last resort and limited support role could represent an efficient policy response.

The NEM is a "constructed market" designed to achieve both efficiency and equity objectives. As indicated above, the risk of contagion or flow on effects creates costs on businesses and customers beyond the failed retailer. These external costs are a source of market failure and create an in-principal role for government. In addition there are important equity issues at stake, in this case the requirement to maintain continuity of electricity supply to consumers. Although this obligation is imposed on the industry, it is the source of many of the costs which exacerbate the risk of cascading retailer failure. In effect, to achieve desirable policy objectives the market rules impose restrictions that place limits on the ability of firms to limit financial risks.

Aditionally, a principle of good insurance is that risk should be borne by the party(ies) who place the lowest cost on bearing risk and are in the best position to pool risk in order to lower the total variance (and cost) of risk faced. Risk should also, as far as possible, be allocated to party (ies) that are best placed to manage the risks (to the extent that the risks are "manageable"). One conclusion of the literature on high impact low probability events is that it may be efficient for government to pool the risks and provide financial support or compensation should the event occur.[5]

Significant moral hazard concerns raised

A key concern with this approach is the moral hazard problem it can raise. If retailers and their investors know that their business may receive government support and that they may avoid some or all of the costs of insolvency this could encourage excessive risk taking and fundamentally undermine the incentives for sound businesses management. Options to minimise or address the moral hazard problem are needed e.g. limiting the distribution of sale proceeds to the failed business where the government has intervened to provide support.

Any government intervention or support must be by Commonwealth Government

Any option involving government intervention would need to be at the national level, as the large retailers operate across multiple NEM regions. Hence the Commonwealth Government and national market institutions would most efficiently pool market risk and provide any last resort intervention.

As raised in our previous submission, the greater financial resources of the Commonwealth and its vertical fiscal imbalance with State and Territory jurisdictions would also lend weight to Commonwealth responsibility.

5 See Gans, J and King, S (2004) *Extraordinary Circumstances and Regulatory Pricing*, Agenda 11 (4) 349-362.

2. Assessment of risk mitigation options

DPI has undertaken a high-level assessment of the fifteen options presented by the AEMC against a set of objectives and criteria. The analysis provides guidance on which options merit further development. However, detailed analysis including of costs would need to be undertaken by the AEMC.

DPI proposes that the AEMC formally consider an additional option at the next stage of the NEM financial market resilience review. The option is for short-term arrangements to maintain hedging cover for the failed retailer load that would replace the discontinued hedging cover e.g. time limited, administered or default hedge agreements for some or all of the failed retailer load. The hedges could operate in the context of a special administration arrangement (Chapter 8 of the Options Paper) or in the context of an amended ROLR arrangement for a large retailer failure.

DPI notes that this option has also previously been suggested by the AER (emergency arrangements to support hedging following a large retailer failure as reported on p.19 of the Options Paper) and could be a more workable alternative to the AEMC's option of transferring existing hedge contracts to the designated ROLR. This option is described in Section 2.3 below.

2.1 Assessment criteria

Building on the principles in our previous submission, which in many cases were supported by the AEMC, DPI has developed a set of objectives and criteria to support our high level analysis of the risk mitigation options presented by the AEMC.

In order to be supported, options must first pass the hurdle of meeting the overarching objectives. The criteria are then used to assess the relative merits of options.

Objectives

Objective 1. Consistent with the National Electricity Objective

The National Electricity Objective (NEO), as stated in the National Electricity Law is: to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

1. price, quality, safety, reliability, and security of supply of electricity; and
2. the reliability, safety and security of the national electricity system.

Objective 2. Effective in mitigating the risks of financial contagion

The key objective of the financial market resilience review is to develop recommended mechanisms or actions that would be effective in mitigating the risks of financial contagion following the financial distress of a large electricity retailer.

Criteria

Criterion 1. Risk mitigation is proportionate to risk

We note that the AEMC supports this principle from DPI's previous submission. Proportionality will be supported by mechanisms that are:

- *Necessary:* the additional mitigation of contagion risks must be established to be necessary e.g. market failure or other aspects of the market framework mean that existing arrangements would not be sufficient to manage the risk.
- *Designed for the circumstance:* i.e. reflect that the option will be addressing a low probability, high impact, high uncertainty event and will be comprehensive enough to deal with such an event. For example, it is likely to be more cost effective to address consequences should they arise rather than incur high up-front costs.
- *Target the source of the risk of contagion:* How well does an option manage the contributors to contagion risk associated with the failure of a large retailer which include the unhedged load of the failed retailer and the application of the current NEM rules to maintain market integrity including the prudential requirements and ROLR.

Criterion 2. Aligned with the interests of consumers

This encompasses:

- short term management of the large retailer failure in the interest of consumers i.e. maintaining continuity of supply and minimising the cost of the risk mitigation action and
- longer term impacts for the interest of consumers i.e. maintaining competitive market structures.

Criterion 3. Maintains the integrity of the wholesale market arrangements

This includes the payments between retailers and generators and network service providers.

Criterion 4. Best realisable outcome for the failed company and its creditors

Providing the best possible outcome for shareholders/investors and its creditors will ensure that investment in retail supply is not undermined. This means that the option would allow the best outcome to be determined in terms of rescuing the failing retailer or transferring the consumers to one or more retailers. This outcome would also ultimately align with the best interests of consumers. However, moral hazard also needs to be avoided or minimised.

Criterion 5. Optimal allocation of risk

There are a number of principles for optimal allocation of risk e.g. risk should be borne by parties who are best able to manage the risk, are the least risk averse in the sense that they place the lowest cost on bearing risk, are in the best position to pool risk in order to lower the total variance of risk faced, etc. The options to mitigate the risk of financial contagion will need to be assessed in terms of the allocation of risk.

DPI recognises that Government intervention may in some instances most efficiently manage risk. However, any role for government should be short term and a last resort and avoid unnecessary government assumption of risk. Also, the risk allocation should avoid moral hazard by maintaining the businesses' incentives for sound risk and businesses management.

Criterion 6. Cost allocation

Costs should be allocated to achieve efficient and equitable outcomes e.g. the beneficiaries of risk mitigation measures should pay for those measures.

Criterion 7. Simple, practical, timely

Ensure that the arrangements are as simple and practical as possible, which should also support their timeliness.

Balancing the criteria

Ultimately the criteria should support outcomes that are in the best interests of consumers. In some cases the interests of consumers are met indirectly and are focused primarily on benefits realised over the longer term. For example, ensuring that investment in retail supply or generation is not undermined and maintaining market integrity benefits market participants. Satisfying these objectives ensures the long term sustainability and viability of the NEM and aligns with long term customer interests.

In the context of a large retailer failure, there is significant tension between effectively managing material contagion risk while also maintaining strong commercial disciplines and incentives on the businesses to mitigate risks and avoiding moral hazard issues. This provides a bias towards limiting market interventions and recognising the ability of market participants and market instruments to effectively manage risk. A clear understanding of the incentives on the businesses with and without any proposed interventions is vital.

There is also tension between the significant impact of a large retailer failure but its low likelihood. While there is a valid desire to understand and best manage the impacts of a large retailer failure, the low likelihood means that mechanisms with significant costs that are realised in advance of the event should generally be avoided and instead a stronger emphasis placed on low cost preparations and greater action should an event occur.

2.2 Assessment of AEMC options

DPI's assessment of the AEMC's risk mitigation options against the objectives and criteria follows.

1. Options that involve amendments to the ROLR regimes

(with the objective of improving their ability to manage a large retailer failure)

a. Revised cost recovery arrangements

Well-designed cost recovery arrangements will be an important part of any administered arrangements. This option meets the objectives and criteria and hence would be supported. DPI notes the barrier to effective cost recovery that is posed by continuing retail price regulation in many NEM jurisdictions.

However, it is likely that improved cost recovery arrangements will need to be combined with other actions that more directly address the risk of financial contagion associated with a large retailer failure e.g. the risks that arise from unhedged energy purchases associated with the failed retailers' load and the need to meet increased prudential obligations within very short timeframes.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. Proportionate: Yes and does assist retailers to manage contagion risks.

2. Interest of consumers: Depending on its implementation, this option could result in large costs being imposed on consumers e.g. significant energy costs associated with unhedged load. Therefore, it may need to be combined with other mechanisms that can help to reduce costs. However, cost recovery supports continuity of supply and market integrity.

3. Integrity of market arrangements: Improved cost recovery arrangements would improve the ability of ROLRs to successfully take on new customers including by improving their ability to gain financial backing and providing greater confidence to ROLR counterparties and hence improve their ability to negotiate new hedging arrangements.

4. Best outcome for failed company and creditors: This criterion is not applicable when a ROLR event is triggered.

5. Risk allocation: Retailers will be better placed to manage the risk of being a ROLR.

6. Cost allocation: There are benefits to the entire market from containing contagion risk. Therefore there could be an argument on "beneficiaries pay" grounds for recovering costs across a broad customer base. Costs could be onerous if only recovered from the customers of the failed retailer.

7. Simple, practical and timely: Yes and the AER are well placed to manage the cost recovery arrangements.

b. Enhanced preparation arrangements for a ROLR event

This option seeks to augment the NECF to allow the AER to better prepare for a ROLR event involving a large retailer failure, including through preparation of a "large retailer failure contingency plan" and to allow for the designation of multiple ROLRs. While this option does not directly address individual sources of contagion risk (e.g. unhedged energy purchases and the need to meet increased prudential obligations in short time frames) it would reduce the level of risk borne by individual ROLRs and hence reduce contagion risk. The expanded planning process could also lead to improved operation and hence success of the ROLR arrangements.

In principle, DPI supports allowing for multiple ROLRs when any ROLR event is triggered as it supports a number of the desired criteria including maintaining continuity of supply, supporting the integrity of the market arrangements, improving the allocation of risk, maintaining competitive market structures and could be relatively low cost. However, further changes to the ROLR arrangements or alternative arrangements are likely to be needed that more directly mitigate the sources of financial contagion risk in the event of the failure of a large retailer.

The effectiveness of this option is also reliant on the ability to allocate only a "manageable" customer transfer and resulting obligation on any one retailer to minimise contagion risk. It is difficult to be certain in advance that this could be achieved and the arrangements for appointing ROLRs do not guarantee that the transferred customer base will be manageable. Hence, there would always be a degree of uncertainty about the effectiveness of this option and the remaining possibility of financial contagion.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. Proportionate: Yes this option could reduce contagion risks at a relatively modest cost (noting that some care would be needed to ensure that the additional costs to the ROLRs and AER resulting from the changes are not onerous). The NECF ROLR arrangements already provide for multiple ROLRs and these arrangements could be readily improved. The arrangements for this option appear to envisage a significant role for the AER in establishing the viability of the multiple ROLRs and potentially to determine the optimal allocation of a failed retailer's load among the ROLRs. Further consideration should be given to whether this is necessary. The onus could be on the ROLRs themselves to demonstrate their ability to meet the requirements of the role. As ROLRs will face severe consequences if their business subsequently fails they may be best placed to make the judgement about their ability to perform as a ROLR.

2. Interest of consumers: This option lowers costs by sharing the burden and risks of being a ROLR among multiple retailers. This option would also better preserve competitive market structure.

3. Integrity of market arrangements: Yes. This option strengthens market integrity by sharing the burden and risks of being a ROLR among multiple retailers and through improved planning and preparation.

4. Best outcome for failed company and creditors: This criterion is not applicable when a ROLR event is triggered.

5. Risk allocation: Risks are shared among a greater number of retailers. As acknowledged by the AEMC, residual risks remain that ROLRs could fail.

6. Cost allocation: Costs are shared among a greater number of market participants.

7. Simple, practical and timely: Yes. To simplify the arrangements further, consideration could be given to whether the AER allows the retailers to nominate their ability to act as a ROLR rather than incurring significant time and effort to determine this themselves through information gathering and analysis.

c. Transfer of hedge contracts to the designated ROLR

This option transfers existing contracts to the ROLR via a legislated novation. It addresses a key source of financial contagion risk, namely that the energy cost of the receiving ROLR(s) is no longer adequately hedged. However, DPI agrees with the AEMC's conclusion that there are significant commercial and legal impediments to the workability of this option. Hence, this option does not meet the criteria that the option should be simple and practical.

In terms of the other criteria outlined above, on the positive side this option is aligned with the interests of consumer (particularly by minimising supply costs). On the downside it could impose unacceptable risks and costs on generators including unforeseen counterparty risk. In addition, the contracts may have been relatively unfavourable to the original retailer in which case they may have been a contributing factor to its failure and should not be transferred.

On balance this option is not supported. DPI considers that there is value in further investigating an option to provide hedging cover (at least on a transitional basis) for some or all of the failed retailer's load. However, DPI recommends that the AEMC consider an alternative mechanism.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. Proportionate: This option addresses a key source of financial contagion risk, namely that the energy costs of the receiving ROLR(s) is no longer adequately hedged. However, this option would involve a significant intervention into the operation of hedging markets and the activities of market participants. This would have implications for the current financial contracting decisions and activities in the NEM. Hence, this option fails the test of avoiding significant *ex ante* market effects and hence is not proportionate or well-targeted.

2. Interest of consumers: The option lowers energy and prudential costs but could undermine the integrity of the market, which would ultimately be against the best interests of consumers.

3. Integrity of market arrangements: By over-riding the contractual rights of market participants this option undermines the integrity of the market arrangements.

4. Best outcome for failed company and creditors: As noted by the AEMC, this option may take property without compensation and may be incompatible with insolvency or other corporations law.

5. Risk allocation: This option would raise risks for generators and ROLRs and could perpetuate the operation of poor hedging arrangements.

6. Cost allocation: While overall ROLR cost could be reduced the option is unworkable.

7. Simple, practical and timely: This option is not workable or practical and would face significant commercial and legal impediments to implement.

d. Amending the ROLR event triggers (to delay ROLR event)

This option is designed to delay the triggering of a ROLR event when a large retailer fails to provide the time needed to find the best outcome for investors and customers e.g. via a sale process or a more ordered ROLR process. Significant time is likely to be required for this process and large financial obligations to the market and generators will accrue during this period.

DPI considers that this option on its own would not be workable. DPI agrees with the AEMC's analysis that this option could substantially increase risk for other market participants. Action would be needed to support market integrity and payments to generators and network service providers e.g. through new credit support guarantees by a solvent entity associated with the failed retailer, the receiver or government as part of specific support or administered management of the failed retailer.

In summary, while this option could work for a more modest retailer failure, this option is not well suited to a large retailer failure and hence is not supported.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. Proportionate: The AEMC indicates this is a significant market change and could have broad market impacts. Hence, it is unlikely to be proportionate.

2. Interest of consumers: This option could result in more orderly transition in the event of a large retailer failure that benefits consumers. But to the extent it requires higher prudential standards and significantly raises risks for market participants including generators it could raise costs in the short and long term.

3. Integrity of market arrangements: This option could reduce contagion risk but significantly increases risks to market integrity. There is a greater risk of delayed or short payments to generators and network service providers under this option.

4. Best outcome for failed company and creditors: This option offers more time for the retailer to find the best solution, but involves significant costs and risk.

5. Risk allocation: This option creates new risks to generators and network service providers that impose greater costs.

6. Cost allocation: Raises costs that would ultimately be recovered from consumers.

7. Simple, practical and timely: This option is likely to be complex and costly to implement.

e. Delayed designation of ROLRs

This option envisages providing additional time to allow regulators to determine which retailer to appoint as a designated ROLR. It is not clear that this additional time will add sufficient value. As noted above better outcomes may be achieved and unnecessary time and effort avoided if regulators rely on the judgement of potential ROLRs of their own capacity, rather than trying to make this judgement themselves based on what is likely to be imperfect information.

While supporting processes that allow for the appointment of multiple ROLR and improvements to NECF may be warranted to allow for this, the idea of auctioning the allocation of customers in the face of the failure of a large retailer is not supported. This process will be complex, time consuming and will have highly uncertain and possibly unhelpful outcomes. The primarily objective must be to manage the large and extreme event at hand in a timely manner. Undertaking complex competitive processes to achieve cost savings, while valuable in situations when there is no emergency and when time is available, is unlikely to be appropriate for the circumstance of managing a large retailer failure.

Overall, this option appears to offer marginal value, is likely to add considerably to the complexity of managing a large retailer failure and to have highly uncertain outcomes. As such, while supporting improvements to allow for multiple ROLRs, DPI does not support this option.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. Proportionate: It is not clear that this option addresses financial contagion risk, rather it could exacerbate contagion risk. The option is not well designed for the circumstance of managing an extreme event where certainty of outcomes and timeliness are crucial. This option would instead add to risks and uncertainty. Hence it is not proportionate.

2. Interest of consumers: This option raises risks and uncertainty and potentially costs. The extra time made available does not necessarily deliver a better outcome.

3. Integrity of market arrangements: This option does not support market integrity. It adds to the risk of delayed or short payments to generators and network service providers.

4. Best outcome for failed company and creditors: It is not clear that the arrangements would benefit any parties.

5. Risk allocation: The option creates greater risks for generators and network service providers.

6. Cost allocation: The option would be costly, complex and it is uncertain where the costs would fall.

7. Simple, practical and timely: The option would be complex and costly to implement. It is also unworkable and raises significant uncertainties.

2. Options that seek to address financial contagion risks
(related to the designated ROLR's credit support obligations to AEMO and distribution businesses)

a. Amendments to AEMO credit support provisions (waived or reduced for transitional period)
b. Amendments to DNSP credit support provisions (waived or reduced for transitional period)

These options more directly target a key source of contagion risk i.e. the ROLR's need to provide increased credit support in short time frames. However, they are not proportionate. As acknowledged by the AEMC, generators are likely to seek to price the risk of reduced prudential quality (with difficulty), resulting in cost impacts in the normal operation of the NEM and associated financial markets. Hence, these options are likely to have wider market impacts rather than being well targeted to the event.

On balance, these options are not supported.

A summary of DPI's assessment of the options against the desired criteria is as follows:

1. Proportionate: The options more directly target a key source of contagion risk i.e. the ROLR's requirement to provide increased credit support in short time frame. However, they are not proportionate due to the wider market impacts.

2. Interest of consumers: The options could reduce retailer financing costs, but increase costs due to greater risks on generators and network service providers which they are not well placed to manage.

3. Integrity of market arrangements: The options do not support market integrity. They create greater risk of short payments due to lower credit support.

4. Best outcome for failed company and creditors: This criterion does not apply. The options do not change the triggering of a ROLR event.

5. Risk allocation: Greater risks are allocated to generators and network service providers and the options may raise overall risk management costs for the NEM.

6. Cost allocation: The options impose greater costs on generators and network service providers and there may be limits on their ability to recover these costs.

7. Simple, practical and timely: The options would be simple to implement but trigger significant risks and costs.

3. Options that seek to address financial contagion risks in the period immediately following a ROLR event

(addressing the increased costs and liquidity challenges that the designated ROLR is likely to face)

a. Spot market price cap

The AEMC presents two key sub-options for a spot market price cap:

1. Administered pricing provisions (APPs) that would cap pool prices for a defined period
2. Price cap applied only to the designated ROLR load.

DPI does not support the first option of capping pool prices. This would represent a significant distortion of the wholesale market and hence is poorly targeted to addressing a large retailer failure and associated contagion risks.

Sub-option 2 is superior but also raises significant concerns. This option should not apply to all ROLR events, only to those involving a large retailer. However, an assessment of this option against the desired criteria demonstrates that it also imposes costs widely across the NEM (all generators). Hence, this option is also not supported. DPI considers that the AEMC should consider alternative options for gaining transitional hedging cover for the failed retailer load.

A summary of DPI's assessment of sub-option 2 against the desired criteria is as follows:

1. Proportionate: The option addresses a key source of contagion risk i.e. unhedged load.

2. Interest of consumers: The option could undermine efficient investment in generation in the NEM and hence is not in the interests of consumers.

3. Integrity of market arrangements: This option distorts the market and undermines the integrity of the market.

4. Best outcome for failed company and creditors: Not applicable.

5. Risk allocation: All generators will bear new risks and costs that they cannot manage.

6. Cost allocation: Allocates costs to all generators.

7. Simple, practical and timely: This option is not overly complex but its distortionary nature makes it impractical.

b. Initial period where designated ROLR passes through retail prices

This option consists of two quite different sub-options:

1. An administered wholesale price
2. Recover difference between transitional ROLR tariff and spot price from all retailers.

The first sub-option has the same problems as the option of a spot market cap. This is an administered price which is imposed on the entire wholesale market and is more onerous than the cap as the effective cap is lower. This is a highly interventionist and complex mechanism that is not proportionate. This option is not supported.

Sub-option 2 is very different in that it shares the energy costs across all retailers. This option imposes costs and risks on third party retailers that they cannot manage. This option is not supported. DPI consider that the AEMC should explore potentially superior and better targeted options to hedge the failed retailer's load that does not distort market prices or create unmanageable risk for third party market participants.

A summary of DPI's assessment of sub-option 2 against the desired criteria is as follows:

*1. **Proportionate:*** No, as costs and risks extend across all retailers.

*2. **Interest of consumers:*** Could undermine a broader set of retailers.

*3. **Integrity of market arrangements:*** Less impact on the integrity of the market arrangements but at a cost to the retail sector.

*4. **Best outcome for failed company and creditors:*** Not applicable.

*5. **Risk allocation:*** Raises risks for all retailers.

*6. **Cost allocation:*** Allocates costs to all retailers.

*7. **Simple, practical and timely:*** Simple to implement but undesirable.

c. Delayed settlement period for designated ROLR to pay AEMO
d. Delayed settlement period for designated ROLR to pay DNSPs

Generators and DNSPs effectively act as financiers under these options, and these options therefore involve a transfer of risk to third parties. The options are likely to be of only very marginal benefit in terms of addressing contagion risk but are complex. The options are not supported.

A summary of DPI's assessment of the options against the desired criteria is as follows:

*1. **Proportionate:*** The options do not materially change the level of risk and hence do not meet this criterion. This incremental change could be better achieved through commercial market arrangements put in place by ROLRs.

*2. **Interest of consumers:*** The options transfers risk away from the parties that are best placed to manage it (ROLRs) and hence are likely to raise costs.

*3. **Integrity of market arrangements:*** The options reduce prudential quality and hence undermine market integrity.

*4. **Best outcome for failed company and creditors:*** Not applicable.

*5. **Risk allocation:*** Transfers risk to generators and DNSPs.

6. Cost allocation: The options allocate additional costs to generators and DNSPs.

7. Simple, practical and timely: The options are complex and of limited value.

e. Industry co-insurance fund

As argued at various points in this submission it is generally unwise from both a policy and economic perspective to crystallise substantial upfront costs in order to fund the adverse consequences of a low probability and highly uncertain event. In addition to the general proposition that it is costly to attempt to make funding provision for unpredictable, low probability events, there are some practical challenges that arise.

From an economic perspective there are difficult questions about who should contribute to the fund, how widely the risks should be pooled, the magnitude of the fund and the structure of the levies, and the rules for allowing distributions from the fund.

By the nature of the risks we are seeking to insure against, the past is not a reliable indicator of future risks, or the magnitude of future losses. The normal actuarial calculations cannot be undertaken, with the consequence that there will be considerable uncertainty as to whether the fund is insufficient, leading to funding shortfalls, or excessive, imposing unwarranted costs on funders. The accrual of an insurance fund also raises equity issues, for example, contributors to the fund may exit the industry, but recent entrants draw on the fund. The fund may also be perceived as supporting the entry of high risk businesses.

The existence of a fund may also distort the behaviour of market participants. If participants, observing a large accruing fund, expect the fund to bail them out, then it will be rational for them to invest less in their own risk management strategies.

The latter issue raises the possibility that the fund could generally be quite divisive. Firms who have contributed to the fund may believe that a failed retailer does not deserve support either because the failed retailer made a series of poor decisions that should not be rewarded by access to the fund, or took actions to enter into default in order to obtain financial support.

For the reasons outlined above the option of an industry co-insurance fund is not supported.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. Proportionate: This option is not proportionate. It imposes significant up-front costs to manage an event that may never occur. The costs and hence funds needed to manage a large retailer failure event are highly uncertain.

2. Interest of consumers: Imposes potentially unnecessary costs, with costs of insurance borne by consumers for an event that may not eventuate.

3. Integrity of market arrangements: The co-insurance fund creates a moral hazard – ROLRs have reduced incentives to manage their obligations. Hence, the integrity of market arrangements is undermined.

4. Best outcome for failed company and creditors: Not applicable

5. Risk allocation: The fund undermines incentives for sound risk management.

6. Cost allocation: The fund would impose significant costs for an eventuality that may never be realised. These significant costs will be imposed on consumers.

7. Simple, practical and timely: This option would be complex and expensive to establish and administer.

4. Options for a last resort government response

a. Government posts credit support for the designated ROLR (for initial period)

On balance, DPI supports this option on the basis that the government support is provided by the Commonwealth Government.

A summary of DPI's assessment of this option against the desired criteria is as follows:

1. ***Proportionate:*** Yes, targeted to ROLR event. As long as very much last resort.

2. ***Interest of consumers:*** Does not manage the ROLR costs including energy costs.

3. ***Integrity of market arrangements:*** Yes supports market integrity.

4. ***Best outcome for failed company and creditors:*** Not applicable.

5. ***Risk allocation:*** Risks are pooled rather than being on the ROLR.

6. ***Cost allocation:*** Could be met by taxpayers or levy on electricity consumers which is appropriate for a low probability, high impact event.

7. ***Simple, practical and timely:*** This option would require significant negotiation between governments e.g. Commonwealth may be concerned by actions of jurisdictions that exacerbate risks e.g. through retail price regulation or that are likely to receive windfall gains through dividend payments. AEMC indicates a rule change would be required to implement.

b. Enhanced administration arrangements coupled with interim government funding

This option is outside the ROLR process.

If it is considered that a single or multiple ROLR response is not capable of managing a large retailer failure (either on practical/operational or market competition grounds) then all of the above ROLR mechanisms would not present feasible options. This was the conclusion that appears to have been reached by the UK Department of Energy and Climate Change. In this case, a government-supported, administered arrangement is likely to need to apply and hence should be further investigated by the AEMC.

As indicated above, the AEMC should undertake deeper analysis into this fundamental question.

The design would also need to address the moral hazard issue that it raises i.e. the reduced incentives on the failing retailer and its investors to manage their business and prevent failure. It is likely to be necessary to quarantine some of the realised value of the sale of the business for the government/taxpayers rather than for the benefit of the failed firm and its creditors.

c. **Government funding, loans or guarantees**

Some of the options put forward by the AEMC for government intervention involve use of government funding to support the AEMC's other options outlined above. If a mechanism is poorly designed and DPI has therefore indicated that it does not support the option, DPI would as a consequence also not support any use of government funding as part of the mechanism.

2.3 Additional option

As noted above, the AEMC should consider alternative options for short-term arrangements to maintain hedging cover for the failed retailer load that would replace the discontinued hedging cover e.g. time limited, administered or default hedge agreements for some or all of the failed retailer load. The hedges could operate in the context of a special administration arrangement or in the context of an amended ROLR arrangement for a large retailer failure.

DPI notes that this option has also previously been suggested by the AER (emergency arrangements to support hedging following a large retailer failure as reported on p.19 of the Options Paper) and could be a more workable alternative to the AEMC's option of transferring existing hedge contracts to the designated ROLR.

DPI suggests investigation into:

- Simple, standard form administered OTC contracts between the generators that had OTC contracts with the failed retailer. The counterparty to this contract would be the ROLR or the government supported retailer under the administration option. With appropriate terms and backing, it is feasible that generators may be willing to enter into such hedging contracts.
- Exchange traded contracts, to the extent that these are available.

The use of financial hedging instruments for the failed retailer load could significantly reduce contagion risks and hence the requirement for government support may become a more remote requirement. This option when combined with government supported arrangements would also ensure that government funds (and ultimately taxpayer's funds) are not used to provide windfall gains to generators that are possible in the event of a large retailer failure.

2.4 Summary of assessment outcomes

In summary, DPI supports well designed cost recovery arrangements for any mechanisms utilised to manage a large retailer failure and associated contagion risk.

Where a ROLR event is triggered, DPI supports the utilisation of multiple ROLRs. This would reduce risks for any individual retailer and hence the potential for contagion. The proposal for an expanded planning process could also lead to improved operation and hence success of the ROLR arrangements. As explained within our submission, the other proposals for ROLR amendments are not supported.

DPI considers that additional significant analysis is needed to determine whether any form of ROLR response is likely to be feasible in the event of a large retailer failure. The operational challenges for the new ROLRs and the potential for a retail market structure that is substantially less competitive from triggering a ROLR event are serious threshold issues that have not been answered. DPI recommends that the AEMC undertake this analysis, including an appraisal of the possible role of the ACCC in approving a reallocation of customers.

The only other RORL option supported is for the Commonwealth Government to post credit support to the designated ROLR for an initial period.

DPI does not support those options that are clearly a disproportionate response in that they impose large, unnecessary up-front costs or substantially intervene and distort normal market functioning. These options would include the option of an industry co-insurance fund and any options that cap or modify the wholesale market prices.

An option that appears to have merit is a (last resort) government-supported, administered arrangement. However, further analysis is needed to develop the government intervention option. As noted above, a key concern with this approach is the moral hazard problem it can raise if retailers and their investors know that their business may receive government support. Options to minimise or address the moral hazard problem are needed e.g. limiting the distribution of sale proceeds to the failed business where the government has intervened to provide support. Any option involving government intervention would need to be at the national level via the Commonwealth Government and national market institutions.

Finally, DPI requests that the AEMC explore further options for short-term arrangements to maintain hedging cover for the failed retailer load. The hedges could operate in the context of a special administration arrangement or in the context of an amended ROLR arrangement for a large retailer failure. This could substantially reduce contagion risks and the requirement for government support and would limit the energy costs associated with meeting the failed retailer's load.