AUSTRALIAN ENERGY REGULATOR

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19 December 2012

John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

Submission on NEM Financial Market Resilience Options Paper

Please find attached the Australian Energy Regulator's (AER) submission regarding the Australian Energy Market Commission's (AEMC) NEM Financial Market Resilience Options Paper.

The AER welcomes the opportunity to comment on the options set out in the paper for mitigating the risks arising from the financial failure or distress of a large electricity retailer.

The AER would be pleased to provide further assistance to the Commission on this important area of work. If you would like to discuss any aspect of this submission please contact Tom Leuner, General Manager, Wholesale Markets, on (03) 9290 1890.

Yours sincerely

Andrew Reeves
Chairman
Australian Energy Regulator

AER Submission

NEM Financial Market Resilience Options Paper

December 2012

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Summary

The AER welcomes the opportunity to respond to the AEMC's NEM financial market resilience options paper.

The AER considers that retailer of last resort (ROLR) regimes are not appropriate for addressing large retailer failures. While the AER welcomes several of the options proposed for refining the National Energy Retail Law (NERL) ROLR regime, such as delaying designation of ROLRs, these refinements, though potentially useful for small retailer failures, will not assist significantly with large retailer failures. Large retailer failures need to be addressed outside the ROLR regime.

The AER is concerned that addressing large retailer failures through the ROLR regime creates a risk of cascading failure and would result in unacceptably high market concentration, as the majority of customers are likely to be transferred to the remaining large retailers. The AER supports options that would assist in avoiding a ROLR event for large retailers, such as special administration regimes. The AER agrees that a comprehensive response to the financial distress of a large retailer may require a combination of options, and that the mechanisms may need to include some last resort role for government where market-based mechanisms are not adequate.

The AER has set out its considerations on the options outlined in Chapters 5 to 8 of the AEMC's options paper below. The AER's submission only comments on the options insofar as they affect the ROLR regime under the NERL. The AER has not commented on the recommendations insofar as they affect existing jurisdictional ROLR regimes. While the AER's comments only relate to the National Electricity Market (NEM), the AER considers that similar issues would arise from the failure of a large gas retailer.

Comments on options involving amendments to the ROLR regime

The AER considers that while some changes to the NERL ROLR regime may possibly assist in managing the failure of a large retailer, there are significant limitations in the ability of any ROLR regime to respond to and manage the failure of large retailers. There are practical and systems problems associated with transferring large numbers of customers to a new retailer and there is a significant risk of cascading retailer failure. Furthermore, the AER is highly concerned about the long-term impact on competition of transferring a large retailer's customers to the other retailers. While the NERL ROLR regime in its current form is, in terms of the legislative powers available, theoretically capable of managing the failure of a large retailer, in practical terms the regime will often not be able to handle a large retailer failure.

The AER supports the development of alternative measures to displace the ROLR regime where it is likely that the regime could not manage the failure of a large retailer. The regime needs supplementing through both additional measures to manage the financial distress of a large retailer such as special administration and arrangements for intergovernmental co-ordination.

Section 5.1 of Options paper – Revised cost recovery arrangements

The AER notes the option considered in section 5.1 of the options paper, to expand and clarify the existing ROLR cost recovery provisions to give the designated ROLR greater certainty that it can quickly recover all reasonable costs associated with a ROLR event.

The AER notes that there is an inherent tension in the proposal to provide greater certainty to the designated ROLRs that they will recover all of their efficient costs following a large retailer failure. In practice, there is a tension between providing certainty of cost recovery, and limiting cost recovery to only efficient costs. Where cost recovery is limited to efficient costs, some regulatory assessment will need to be made and this will introduce an element of regulatory judgement. Notwithstanding this, the AER supports the principle that only efficient costs should be recoverable.

Section 5.2 of the options paper – Enhanced preparation arrangements for a ROLR event

The AEMC's options paper puts forward a proposal to augment the existing ROLR provisions under the NERL to assist the AER to better prepare for a large retailer failure event and develop a plan for how it would designate multiple ROLRS.

The AER recognises the need for a "large retailer failure contingency plan", but considers that any contingency plan should not be in the form of an instrument under the NERL overseen by the AER. The range of issues that need to be addressed in a large retailer failure, and the limitations of any form of ROLR regime to respond to and manage the failure of large retailers, necessitate intergovernmental involvement. Any contingency plan for large retailer failure should be co-ordinated at that level to ensure that all aspects of large retailer failure can be considered, and the plan is not limited by the scope of the ROLR regime.

In relation to any large retailer failure contingency plan, the AER notes the following:

- A large retailer failure contingency plan would not necessarily better enable the AER to spread customers of the retailer around a number of different designated ROLRS, and there would still be a high likelihood that all the customers of the failed retailer could not be readily absorbed by designated ROLRs.

- The AER has prepared a detailed internal procedures manual for ROLR events, which is designed for use in both small and larger retailer failures. The AER will review this manual at regular intervals.

- Incorporating detailed plans of how the AER should allocate customers of a large failed retailer into any contingency plan is unlikely to be particularly helpful, given that there are many different scenarios that could arise.

The AER has concerns about the practicality of appointing backup ROLRs, and has decided not to appoint them at this stage. However, from a purely procedural perspective, if a default ROLR was failing or had failed and the AER needed to appoint backup ROLRs, the process that the AER would follow does not differ substantially from the process that applies when designating ROLRs with non firm offers. The AER would need to:

- Consult with the remaining retailers
- Determine which retailers most nearly satisfy the NERL's "financial resources" criterion
- Determine customer allocation as between the retailers
- Appoint and register the retailers as default ROLRs
- Prepare instructions to AEMO on the allocation of customers to the ROLRs. If a ROLR event had not yet occurred, this would involve changes to the standing instructions, or could be done through an appointment notice under s. 132 of the NERL. Revised standing instructions can be prepared relatively quickly using the AER's template. The customer allocation arrangements would also be set out in the AER's ROLR notice.

The AER considers that the above approach is appropriate from a process perspective and could be implemented within an appropriate timeframe, however, it does little to address the more fundamental problems of any ROLR regime for large retailer failures—risk of cascading failure, practical difficulties in terms of the ROLRs taking on the failed retailer's customers, and long-term impacts on competition.

Section 5.4 of the options paper – Amending the ROLR event triggers

The AER notes the option to amend the NEM suspension provisions, to delay the triggering of a ROLR event. The AER considers that, if AEMO advises it is feasible to implement such an option, it would be useful to explore this option further. While amendments may shift some risks onto generators, the AER considers that in the event of a large retailer failure situation, all industry participants will need to bear some risk. Such an event will have serious repercussions across the industry and place the prudential system under strain. There is already a risk for generators that a large retailer failure could lead to cascading retailer failures and hence adverse impacts on the prudential system, so, in the AER's view, adopting this approach is unlikely to significantly change the risk profile of generators.

Section 5.5 of the options paper – Delayed designation of ROLRs

The AER notes the option proposed in section 5.5 of the paper to amend the ROLR regime to delay the time at which the designated ROLR is appointed, with backdating of the designated ROLR's appointment to the time of the original ROLR event and financial responsibility for the customers from that date.

It would be worthwhile to explore this option further, in consultation with AEMO. If this option proves feasible, it may be useful to enable delayed designation of ROLRs not only for larger retailer failures, but also for small and medium retailer failures.

While the AER considers that longer timeframes for designating ROLRs would be useful, and supports exploring this option further, it notes that having a longer period of time in which to appoint designated ROLRs will not necessarily enable them to absorb large numbers of new customers. Even with the delay, it is likely that there may not be any interest from remaining retailers to take on the customers of the failed retailer. However, in some circumstances it may reduce the likelihood of having to rely on default ROLR arrangements.

Section 7.1 of the options paper – Spot market price cap

The AER considers that emergency administered spot pricing arrangements should be considered further.

The AEMC notes that such a mechanism could prove distortionary and could harm the long-term incentives for generators to invest in the NEM. In particular, the AEMC notes that it may discourage investment in peakers because they rely on the expectation of a small number of peak prices.

The AER considers that, if the mechanism were properly formulated, it would have negligible distortionary impacts and would not affect incentives to invest. This is because the mechanism would only be triggered by the most extreme instances of retailer failure. Such "black swan" events are unlikely to alter incentives to a significant degree.

To remove uncertainty around the mechanism, a fixed rule could be established. For example, it might be that the mechanism only takes effect for a ROLR event where the failed retailer has more than X percent of the load in a jurisdiction and it remains in place for only Y weeks. Given the focus is on large retailers, the X figure could potentially be set quite high.

In terms of the actual mechanism, there are a range of possible options, including applying an administered price (adopting the current approach to administered price periods). Alternatively, the cumulative price threshold could be lowered to a half or a third of its normal level during the period.

The AER believes that such a mechanism, in conjunction with other mechanisms, will significantly increase the likelihood of an orderly response mechanism being implemented after a major retailer failure (whatever form that mechanism takes, be it government support, sale of the business, special administration, ROLR or other). It will have the impact of significantly moderating margin payments associated with the load of the failed retailer and potentially facilitate a lessening of AEMO prudential requirements. Such a mechanism will assist in ensuring that the scale of the problem does not rapidly escalate out of control in situations where it is uncertain how and when the response mechanism will be implemented. It places a limit on the rapid escalation of the financial obligations of whoever is responsible for the energy consumed by the customers of the failed retailer, be that the ROLR, Government, purchaser or some form of special administrator. This will be likely to increase the number of response mechanisms that are available to choose from. For example, a limit on the rapid escalation of the financial obligations associated with the customers of the failed retailer may make it more likely that a trade sale can be negotiated with limited government financial support.

Section 8.1 of the options paper – The role of governments in mitigating contagion risk

The AER agrees with the AEMC that there is benefit in considering in advance how governments would respond to the financial difficulties of a large retailer, as any response will need to occur rapidly.

The AER supports ensuring that there is an in-principle agreement between governments in relation to both any government response aimed at protecting the large retailer's operations (by this the AER means protecting the operations of the retailer, rather than protecting equity or debt holders in the failed retailer), and any government assistance that might be directed to designated ROLRS to address contagion issues and prevent cascading retailer failure. The AER considers that any governmental assistance should occur in a pre-determined and co-ordinated fashion, as is the case with existing emergency powers designed for physical emergencies. The AER considers that pre-determined arrangements to address the respective responsibilities of jurisdictions should be developed. These arrangements could be considered in conjunction with special cost recovery provisions that provide greater comfort to governments regarding their ability to later recoup any assistance they have provided.

The AER does not agree that the target of government assistance should necessarily be the designated ROLRS. As noted elsewhere in this submission, there are limitations in the ability of any ROLR regime to manage large retailer failures. Even if contagion risks could be removed, there are a range of practical and system limitations for bulk transfers of customers (particularly for the ROLR). This suggests that where large numbers of customers are affected, there is a role for assistance or mechanisms targeted at protecting the operations of the failing retailer (without protecting the equity or debt holders of the failing retailer).

Section 8.8 of the options paper – Enhanced administration arrangements coupled with interim government funding

The AER considers that the options canvassed in chapter 5 of the paper for changing the NERL ROLR regime, and the options in chapters 6 and 7 of the paper, are not likely to be sufficient to enable the management of a large retailer failure, and that an alternative to ROLR needs to be available for larger retailer failures.

The AER supports further consideration of the United Kingdom's "special administration" arrangements to determine if they may be useful in the NEM context. The AER agrees with the AEMC on the key features that might be part of any such regime, and that the NEM suspension arrangements may need to be changed to accommodate the functioning of a special administration regime. As with other government interventions, there would be benefit in determining in advance how the respective governments would respond in a "special administration" situation.

Other comments

The AER supports further consideration of options involving an industry co-insurance fund, as well as options involving the deferral of credit support to distributors and deferring the payment of network charges to distributors. The AER recognises that there are various advantages and disadvantages to each of these options, but considers that they are worth considering further.