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Australian Energy Market Commission

Lodged electronically: www.aemc.gov.au (EMO0024)

Dear Commissioners

NEM Financial Market Resilience – Options Paper

EnergyAustralia welcomes the opportunity to make a submission on the 'Power NEM Financial Market Resilience Options Paper' (the options paper).

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.7 million household and business customers. We own and operate an integrated portfolio of energy generation and storage facilities across Australia.

The financial markets that support the efficient and stable operation of the National Electricity Market (NEM) are generally deep, liquid and robust. The risks and issues associated with the failure of a large retailer identified in the options paper primarily result from the design and operation of the Retailer of Last Resort (RoLR) schemes that essentially act to maximise the risk of financial contagion.

The AEMC should further explore options to utilise insolvency laws and administration to manage retailer default in a more orderly and sustainable manner.

The policy objectives in responding to the failure of a retailer should be to ensure an orderly market driven response and to enable consumers of the failed retailer to enjoy continuity of supply at competitive, cost reflective tariffs. Government should not seek to prevent the failure, or directly impose costs and risks on other market participants (retailers or generators). Direct Government intervention should generally be avoided, as it is likely to be too slow and may complicate negotiations with creditors.

Most importantly, Government must avoid creating a systemically unsustainable market through inefficient regulation of retail prices or distorting investment signals in wholesale markets. A competitive and sustainable NEM will then be in a strong position to accommodate and adjust to the failure of individual market participants and/or exogenous shocks.

To reduce the risk that RoLR arrangements cause financial contagion and systemic instability, the key issues that need to be addressed are: cash flow, working capital, and secure, timely recovery of costs.

Contagion risk is exacerbated by transferring costs and risks to other retailers or generators. It may be possible for Distribution Network Service Providers (DNSPs) to temporarily absorb some costs and reduce contagion risk, provided they have access to secure and timely cost recovery under the National Electricity Rules (NER). Indeed, this may reflect the original logic when RoLR arrangements were established in a market dominated by stapled retail-distribution businesses.

The RoLR arrangements under the National Electricity Consumer Framework (NECF) are generally superior to the jurisdictional schemes that they are intended to replace. Jurisdictions should seek to adopt and reform the NECF arrangements in preference to reforming their own schemes.

The options paper is comprehensive and identifies most of the options to amend the RoLR schemes. One additional option to reduce the scale and risks associated with the RoLR schemes would be to restrict coverage to small and medium consumers. Large industrial and corporate consumers could reasonably be excluded as they have the resources and purchasing power to manage the risk of retail failure through procurement and contracting strategies, insurance, and back up generation for critical loads. Excluding large loads from RoLR would also provide efficient incentives for large consumers to consider supply chain viability and for generators to offer competitive contracts in the event of a retail failure.

In respect to the proposals in the options paper we support further investigation of the following options to improve existing RoLR arrangements:

- **Option 1: Revised cost recovery arrangements (section 5.1)**

  The RoLR needs certainty that they will be able to recover all costs in a timely manner. This is critical to support short term funding to cover the step change increase in settlement and prudential costs well in advance of receiving additional revenue from consumers. RoLR tariffs should allow for full cost pass through (including time of use components where interval metering is in place).

  If RoLR arrangements impose costs or risks on DNSPs or generators, then they should also be entitled to secure and timely recovery of all costs. NECF cost recovery arrangements are generally superior to the jurisdictional schemes.

  RoLR costs should be recovered directly from RoLR customers as far as practical, through cost reflective tariffs (reflective of actual market circumstances at the time of the RoLR event).

  Costs incurred by the RoLR that are not recovered directly through RoLR tariffs at the time of the RoLR event should be recoverable through fees on network charges and recovered from all customers. Costs should be recovered within the jurisdiction they occur to ensure that consumers in other jurisdictions do not pay for inefficient jurisdictional regulation that may exacerbate the costs.

- **Option 2: Enhanced preparation arrangements for a RoLR event. (Section 5.2)**

  The NECF arrangements are superior to the pre-existing jurisdictional arrangements; however they are still fundamentally misaligned to the structure of the competitive market.

  RoLR arrangements may have been appropriate in the context of a market dominated by stapled retailer-distribution businesses with the scale and regulated asset base to be able to absorb the return of customers in their area. However, RoLR appears to be an entirely inappropriate intervention in the context of a competitive market where the very concept of a host retailer increasingly anachronistic, particularly for large customers. If a large retailer fails it is also likely to be the designated host retailer in some areas.

  RoLR arrangements should be structured so that the primary method of determining RoLRs is voluntary, market led and based on expressions of interest from retailers. Retailers should essentially bid for customers and load (including bidding negative values and annual fees where appropriate). The market would then transparently determine the efficient cost of RoLR arrangements, which are likely to vary from year to year with market circumstances. An income stream may be required to allow RoLRs to meet the cost of maintaining contingency access to working capital to meet their agreed RoLR load. To cover a reasonable contingency, RoLR arrangements may need to allow for the failure of the single largest retailer.

  Regulatory failures associated with the design of RoLR arrangements should not be used to justify intrusive new regulatory powers or impositions on retailers. In particular, there is no justification for the AER, or any other body, to be provided with new and intrusive powers to examine the specific commercial circumstances of individual retailers on an ongoing basis.

- **Option 4: Amending the RoLR event triggers (Section 5.4)**
- **Option 5: Delayed designation of RoLRs. (Section 5.5)**

These options may have some potential benefit if they allow a more market driven response by providing time for the regulator to engage with receivers, undertake an orderly process to appoint RoLRs, or coordinate transfer of customers. However, this needs to be balanced against the potential costs associated with the impact on prudential quality.

If the period between participant default and suspension was increased, AEMO may to need to increase the 'reaction period' used to calculate credit limits to meet the NEM prudential standard (2% probability of loss given default). If the reaction period is extended then every day of additional time would increase the total prudential costs for retailers, and ultimately customers. This option may be more beneficial if combined with options that provide for enhanced use of administration and guarantees.

- **Option 7: Amendments to DNSP credit support provisions (Section 6.2)**
- **Option 11: Delayed settlement period for designated RoLR to pay network charges (Section 7.4)**

It may be possible for DNSPs to temporarily absorb costs and reduce contagion risk, provided they have access to secure and timely cost recovery under the NER. The RoLR should not be required to post credit support for network charges or pay DNSPs for RoLR load before they receive revenue from the customers.

We do not support the following options:

- **Option 5: Transfer of the failed retailer's hedge contracts to the designated RoLR (Section 5.3)**

This option would be highly complex and impractical to implement, increase uncertainty and deliver little or no benefit.

- **Option 6: Amendments to AEMO credit support provisions (Section 6.1)**
- **Option 8: Spot market price cap (Section 7.1)**
- **Option 9: Initial period where the designated RoLR passes through retail prices instead of paying the spot price (Section 7.2)**
- **Option 10: Delayed settlement period for designated RoLR to pay AEMO for energy (Section 7.3)**

These options essentially transfer cost and risk to generators and would be complex to administer where restricted to RoLR customer load in a competitive market.

If a large retailer fails it would directly impact on generators (through ownership and/or contracts). RoLR options that involve short payment of generators, or reduced credit quality in the wholesale market, would exacerbate the risk of contagion.

RoLR consumers should not be shielded from cost reflective prices (energy and network) as this would impede efficient demand response and reduce incentives for generators to contract in a tight market. Regulated retail prices should allow for flexible, cost reflective prices.

RoLR schemes do not provide a significant price protection mechanism for residential users who have access to standing offers and/or regulated tariffs in the event their retailer fails. There are extensive consumer protections under energy retail laws and the quality of supply experienced by consumers is primarily determined by DNSP performance. RoLR arrangements are primarily designed to secure payment to network businesses and generators.

Amending AEMO credit support provisions could be useful if AEMO absorbed the credit risk on behalf of the pool instead of transferring it to generators. However, AEMO would need to maintain a line of credit to pay any default, and be able to recover costs from consumers.

- **Option 13: A Government entity posts credit support for the designated RoLR (Section 8.2)**

  As noted in the options paper, Government is unlikely to be able to effectively provide this service in a timely manner. Support is likely to be 'last resort', expensive and impractical to access.

  The existence of potential Government support is also likely to complicate negotiations with potential commercial credit providers who are likely to want to spread their risk.

The AEMC should further explore the options to utilise existing or modified insolvency laws to manage retailer default, potentially combining aspects of options 12 and 14:

- **Option 12: Industry co-insurance fund (Section 7.5)**

  We do not support the proposed model for an industry co-insurance fund. We believe that it is likely to be costly, inefficient and complex to implement. However, the key functions may have some merit: providing loans; providing credit support; and providing funding for cost recovery.

  Given the contingent nature of the risk, it would be inefficient to maintain a fund able to address risks associated with the failure of a very large retailer. It may be more efficient to establish a smaller fund in a structure that would be able to borrow if necessary and recover costs over time. This option could be used in combination with enhanced administration arrangements (option 14) to eliminate the need for RoLR schemes and their associated unintended consequences.

- **Option 14: Enhanced administration arrangements coupled with interim government funding (section 8.3)**

  The use of existing or enhanced administration arrangements in preference to RoLR has potential merit. This is the only option that fundamentally reduces the risk of contagion by removing the mandated and perverse transfer of risk and cost under RoLR.

  Administration arrangements designed to cope with the failure of very large retailers should also be capable of effectively dealing with the failure of small retailers. There is no need to discriminate based on size.

  In the event that a retailer (or other market participant) defaults on its obligations to AEMO then AEMO could be specifically empowered and required to immediately appoint an administrator.

  There are good prospects that commercial imperatives would provide sufficient incentives for an administrator to protect consumer interests. In a sustainable market, customers are inherently valuable. There are also extensive consumer protections under energy retail laws and the quality of supply experienced by consumers is primarily determined by DNSP performance.

  In the event of the failure of a large integrated retailer, an orderly restructure or liquidation is even more likely to be in the interests of creditors who are likely to have significant value at risk.

  There may be merit in Government, or an industry fund, providing a short term guarantee to the administrator to allow them time to determine whether to liquidate customers directly, or continue to operate the business for a period (at their own risk) to maximise returns to creditors.

  Appropriate administration arrangements could have several potential benefits including:

  - allowing a whole of business review of options to restructure, refinance and/or liquidate;
  - facilitating an orderly market lead transfer of customers to other retailers; and
  - allowing transitional arrangements to be agreed to maintain continuity of billing and other services while customers are transferred and absorbed by new retailers.

Conclusion

The risks associated with the failure of a large retailer that are identified in the options paper primarily result from the design and operation of the Retailer of Last Resort (RoLR) schemes that essentially act to maximize the risk of financial contagion.

The AEMC should further explore the policy rationale for RoLR and the options to utilise existing or modified insolvency laws to manage retailer default in a more orderly and sustainable manner.

The risk of financial contagion is exacerbated by options that transfer costs and risks to other retailers or to generators. However, it may be possible for DNSPs to temporarily absorb some costs and reduce contagion risk, provided they have access to secure and timely cost recovery under the National Electricity Rules (NER).

We thank the AEMC for the opportunity to respond to the draft report. For any questions regarding this submission, please contact me by email ralph.griffiths@energyaustralia.com.au or by phone on (03) 86281034.

Regards

[signed for email]

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