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John Pierce
Chairman
Australian Energy Market Commission
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SYDNEY SOUTH NSW 1235

Dear Mr Pierce

NEM FINANCIAL MARKET RESILIENCE ISSUES PAPER

The Australian Energy Regulator (**AER**) welcomes this opportunity to comment on the AEMC's issues paper in regard to potential risks arising from financial interdependencies between participants in the National Electricity Market (**NEM**).

This submission focuses on existing retailer of last resort (**ROLR**) arrangements and issues in relation to potential cascading retailer failure caused by a large retailer failure.

ROLR arrangements

Under the National Energy Retail Law (**Retail Law**), commencing from 1 July 2012, the AER administers a ROLR scheme in those jurisdictions that apply the Retail Law. The ROLR scheme is designed to ensure that, in the event of a retailer failing, customers continue to receive electricity and/or gas supply.¹ The AER has a number of responsibilities under the ROLR scheme which include:

- publishing the ROLR guidelines
- publishing the ROLR plan
- appointing default ROLRs
- appointing additional ROLRs
- maintaining and publishing a register of ROLRs
- appointing designated ROLRs immediately prior to a ROLR event and

¹ s.130 Retail Law

- making ROLR cost recovery scheme determinations.

In addition, the Australian Energy Market Operator (**AEMO**) has a range of functions including the transfer of customers, which are set out in various NEM procedures and gas market procedures.

The ROLR scheme under the Retail Law has applied from 1 July 2012 in the Australian Capital Territory (ACT) and Tasmania. Jurisdictional retailer of last resort schemes still apply in the states where the implementation of the Retail Law has been delayed. The delays in implementing the Retail Law across the NEM have resulted in differing ROLR processes across jurisdictions. However, in the event of a retailer failing, ROLRs have been appointed to all distribution networks across the NEM, such that every customer of the failed retailer connected to a particular distribution network or system will be transferred to a ROLR.

Across the NEM, there are currently five retailers that are deemed, or have been appointed as ‘default’² ROLRs: ActewAGL, Aurora, TRUenergy, Origin Energy (and its subsidiary, Sun Retail) and AGL. Origin Energy is default ROLR for the largest number of customers, being the default ROLR for six distribution networks in Queensland, NSW and Victoria. The current ROLR for South Australia is the distributor, ETSA Utilities. The AER understands that ETSA Utilities has contracted out its ROLR responsibilities for the majority of its small customer connection points to AGL. Most of the jurisdictional default ROLR appointments will be transitioned under the Retail Law, with the exception of ETSA Utilities, which will not be transitioned as the default ROLR for South Australia. In anticipation of its responsibilities under the Retail Law, the AER appointed AGL (South Australia) as the default ROLR for gas and electricity in South Australia. This appointment will take effect when the Retail Law commences in South Australia.

The AER can also appoint ‘additional ROLRs’ in a ROLR event. Additional ROLRs may be appointed at the time of a ROLR event to take on customers in addition to, or instead of, the default ROLR. There are two types of additional ROLRs—those that are appointed on the basis of ‘firm’ offers and those that are appointed on the basis of ‘non-firm’ offers. A firm offer by a retailer is effectively a commitment to take on a certain number of customers if a ROLR event occurs and the AER decides the customers should be transferred to that retailer. Non-firm offers are effectively an expression of interest by the retailer to take on customers in the event a ROLR event occurs. The AER would seek the permission of a retailer with a non-firm offer prior to designating it as a ROLR. To date, the AER has registered two additional ROLRs, one with a firm offer and one with a non-firm offer. However, these registrations are only in jurisdictions where the Retail Law has not yet commenced. Every 3 months the AER will call for firm and non-firm offers from retailers who are interested in being registered as additional ROLRs.

Such provisions for default and additional ROLRs provide the market with some level of surety that in the event of retailer failure there are arrangements in place that will facilitate the supply of energy to consumers.

When the AER registers additional ROLRs or appoints default ROLRs, it is compelled to have regard to the ROLR criteria set out at s. 123 of the Retail Law. These criteria are the financial capacity criterion, the organisational capacity criterion, and the suitable person criterion. The AER must be satisfied that a retailer has met all three criteria before appointing it as a default ROLR or registering it as an additional ROLR. This process provides a degree of surety that a retailer has adequate systems and procedures in place, and the requisite financial capacity, to act as a ROLR in the case of a ROLR event. At the time a ROLR event occurs, the AER may also have regard to a ROLR’s prudential status to ensure that it is financially capable of taking on

² The term ‘default ROLR’ is only used in the Retail Law, but for ease of discussion, the term is used for all jurisdictions in this submission.

additional customers. It is however important to note that the AER has a limited role in assessing the financial status of applicant businesses. The AER does not look to provide a comprehensive review of the financial capabilities of the retailers in assessing their applications for retail authorisation or ROLR applications nor do we undertake a prudential supervisory or ongoing financial viability assessment role.

There are information sharing arrangements in place with AEMO and the AER to access real-time data to ensure the AER has access to data to make appropriate decisions in relation to the appointment of ROLRs.

As noted in the AEMC's issues paper, the ROLR provisions in the Retail Law are currently untested. However, the ROLR scheme under the Retail Law contains many features of the jurisdictional ROLR schemes which have generally appeared to function effectively on the two occasions that there has been a ROLR event (although concerns still exist around moral hazard issues and ensuring accurate customer data is provided to the ROLR). Further, the ability for the AER to appoint additional ROLRs (i.e. non-default ROLRs) is an additional feature of the Retail Law scheme that may reduce the financial liabilities taken on by any one retailer and therefore may diffuse the risk of cascading retailer failure. These features of the Retail Law ROLR provisions were not present in previous jurisdictional ROLR schemes.

Large retailer failure

While the AER considers that the ROLR arrangements would likely suffice in the failure of a small to medium retailer, without causing cascading retailer failure, the AER shares the AEMC's concerns this may not be the case in the event of a large retailer failure. In particular, concerns arise where a default ROLR itself fails.

In the ROLR scheme under the Retail Law, the AER may appoint a 'back-up' ROLR in circumstances where the default is unable to perform its role.³ The AER has included provision for back-up ROLRs in its guidelines. Some jurisdictions also have back-up ROLR plans should a default ROLR fail. However, 'back-up' ROLR arrangements do not solve the risks of large retailer failure, as the customers are still transferred to other retailers.

The AEMC has explored the risks of large retailer failure in its issues paper. From the AER's perspective, the two key risks arising from a large retailer's customers being transferred to other retailers are cascading retailer failure and the effect on longer-term competition through changes in market structure (i.e. the effect on market shares of moving a large retailer's customers to other large retailers). Although the chances of a large retailer failing may be low, the consequences in terms of cascading retailer failure and market structure are very serious.

The AER sees merit in exploring arrangements to support or supplant the ROLR processes in the event of a large retailer failure.

Next steps and possible solutions

Although a failure of a major retailer might be unlikely, there are a vast array of possible triggers for financial concern. NEM participant financial arrangements are inherently complex. Retailers and generators use an array of hedge contracts and insurance-style contracts to manage risk. They have large numbers of traders and complicated risk management strategies. Most of the major retailers also engage in extensive activities outside of the NEM, including in gas markets and overseas markets. All of the major retailers also have exposure to the potential failure of their generation assets.

³ Retailer of Last Resort Guideline, November 2011, page 3.
<http://www.aer.gov.au/sites/www.aer.gov.au/files/ROLR%20guidelines.pdf>

Given the complexity of each participant's business, the AER considers that it is generally very difficult to attempt to monitor or predict retailer failure, and it is also impossible to forecast the precise outcomes of a retailer failure. The AER therefore considers that the AEMC's review should be targeted at contingency measures for major retailer failure, rather than preventative or monitoring measures. However, there may be merit in exploring possible processes or frameworks for monitoring the adequacy of whether market participants' governance structures and risk management strategies are adequate and whether there is a role for some limited form of prudential supervision. The AEMC may wish to consider the experience of financial and market regulators such as APRA in industries such as superannuation and financial markets in this regard.

In terms of emergency contingency measures, the AER considers that the AEMC should look at a range of possible options, including:

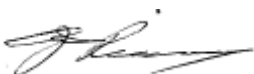
- the development of further emergency powers for federal or state government and the role of the Energy Security Council and how this might operate in the context of existing ROLR regimes
- emergency price caps
- emergency arrangements to support hedging when there is a major retailer failure
- whether the ROLR process, as prescribed under the Retail Law, is the appropriate mechanism through which to respond to the failure of a major retailer and
- industry funded insurance schemes.

Measures such as a short-term emergency price cap, which only takes effect in the most extreme circumstances, may assist by allowing sufficient time for government, industry and relevant businesses to ensure that other mechanisms operate more effectively and minimise the risk of cascading retailer. The concern with current arrangements is that, due to AEMO's need to protect the prudential system and ensure generators continue to be paid, the customers of the failed retailer will *have to be transferred*, regardless of the cascading failure consequences. The risk of cascading failure is amplified because the high-price cap means prudential requirements and spot market exposure rise extremely quickly for the retailer taking on customers.

The AER wishes to emphasise that the emergency contingency measures should be designed in a way that they only apply in circumstances where there is a serious threat of cascading retailer failure. Further, when considering possible contingency measures, it is important to ensure that incentives for businesses to manage risk prudently and investment signals are not distorted. It will also be important for the AEMC to consider interactions with gas markets, given all of the major retailers have a significant gas market presence.

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
AER Chairman