AEMC

REVIEW

Australian Energy Market Commission

CONSULTATION PAPER

REVIEW INTO THE ARRANGEMENTS FOR FAILED RETAILERS' ELECTRICITY AND GAS CONTRACTS

13 OCTOBER 2022

INQUIRIES

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ABOUT THE AEMC

The AEMC reports to the Energy Ministers' Meeting (formerly the Council of Australian Governments Energy Council). We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the Energy Ministers' Meeting.

SUMMARY

1 The Australian Energy Market Commission (AEMC or Commission) has self-initiated a review into contracting arrangements for failed energy retailers (the Review).

2 The AEMC self-initiated Review seeks to:

- Determine if changes can and should be made to energy laws and rules to minimise the risks that retailers of last resort (RoLRs) face and the costs that customers incur following retailer failures. This may include enabling the designated RoLR to access the hedging instruments of the failed retailer.
- Analyse the recent conduct of retailers encouraging their customers to change retailer during this period of volatile market conditions to determine if this behaviour harmed consumers or the market and, if so, what regulatory changes are needed.

Context

3 Prior to 2022, we had seen very few retailer failures in Australia's east coast electricity and gas markets. However, in the past five months, seven electricity retailers, one gas retailer and one embedded network operator have failed. Overseas, energy retail markets with similar characteristics have also seen significant retailer failures. In particular, in the United Kingdom, more than fifty retailers have failed since 2019 and this has included large retailers whose failure could threaten the financial stability of the retail market.

4 Retail competition has progressively been developing over the past 15 years through the entry of new retailers and privatisation of the electricity and gas retail sector. As market entry continues we should also expect to see market exit. Furthermore, as the overseas experience shows, this may not be limited to small retailer failures.

5 Exit is an important feature of efficient competitive markets. In and of itself, market exit should not be a concern. However, in the provision of essential services like electricity and gas, it necessitates that well-functioning exit arrangements are in place to ensure continued energy supply to customers.

6 The RoLR scheme is the primary regulatory mechanism to deal with market exit. In the event of a retailer failure, to prevent the disruption of electricity or gas supply, customers of the failed retailer are quickly transferred to another retailer – the designated RoLR.

The problem for failed retailers' electricity and gas contracts

7 The RoLR scheme is an important mechanism to ensure the continued supply of an essential service to customers in the event of a retailer failure. However, the rapid transfer of a (potentially) large number of customers without significant notice represents a material risk and cost for the designated RoLRs. In particular, these retailers will not have the appropriate electricity and gas contracts to insure them against high electricity spot prices or to supply gas to supply customers. This is because any electricity or gas contracts that the failed retailer relied upon to manage those customers remain with the failed retailer following the RoLR event.

8 The supply of customers without hedging cover represents a potentially significant risk to the designated RoLRs if a medium or large retailer was to fail. Retailer failures tend to occur most often during periods of volatile market conditions. In these instances, the designated RoLR may have difficulty sourcing contracts or be exposed to elevated market prices to manage its increased customer numbers.

9 The transfer of a large number of customers due to a retailer failure presents two potential risks:

- Systemic risk: the risk of cascading retailer failures may occur if the retailer failure is too large for the designated RoLR to manage.
- Increased costs to the designated RoLR and customers: the costs to the designated RoLR to secure contracts or buy energy from the spot market to service customers on short notice may be high. These costs will be passed through to consumers under the RoLR cost recovery scheme.

Solutions — gas

10 When a gas retailer fails, the Australian Energy Regulator (AER) has existing powers to direct contracts for gas supply and pipeline capacity to the designated RoLR under section 137 of the NERL. These directions only apply to contracts that were held by the failed retailer at the time of the RoLR event and may be triggered if there is no declared wholesale gas market or short term trading market or where, in the opinion of the AER, sufficient capacity or gas is not available in a short term trading market. The Commission considers it is worth analysing potential improvements to the current RoLR gas directions framework. The Commission's initial analysis of improvements that could be made is split into:

1. expanding the directions power to include other contracts typically used by gas retailers such as storage contracts
2. improvements to the existing RoLR gas directions framework to provide greater clarity, certainty and powers to the AER.

Solutions — electricity

11 Unlike in gas, there is currently no regime for the RoLR to access the contracts of a failed electricity retailer. Access to the failed retailer's contracts, by the designated RoLR, would be of benefit to minimise financial risk. This is distinct from gas where a lack of access to the failed retailer's contracts could inhibit the RoLR being able to meet a customer's physical supply requirements. The Commission has set out a range of potential solutions for consultation to reduce the risks and costs associated with a retailer failure for the designated RoLR and affected customers.

12 The Commission notes that we are not seeking fully developed solutions in Stage 1 of the Review. Rather, we are exploring and seeking stakeholder views on the feasibility and merits of potential solutions to address the identified problems. Furthermore, some proposed solutions are highly complex and have potential legal issues that are still being explored. As such, the Commission's analysis of potential options is preliminary, and we welcome

stakeholder submissions or discussions on these or alternative potential solutions.

13 The initial options the Commission has considered include:

- **Cost recovery clarity**: Clarify that RoLR cost recovery available to the designated RoLR includes wholesale and hedging costs
- **Matchmaking service**: Introduce an automatic information gathering provision by the AER allowing it to obtain from the failed retailer all contracts it holds and to allow the AER to share that information with the designated RoLR
- **Introduce a directions framework**: Similar to what currently exists for gas, where directions are issued to the failed retailer and counterparty to the contract, requiring them to negotiate a new contract with the designated RoLR. Two proposed options for consultation are that:
  - contracts should be negotiated with reference to the current market price
  - contracts should be negotiated with reference to the contracted price.
- **Use the failed retailer's 'in the money' electricity contracts to minimise RoLR cost recovery**: Introduce a new RoLR cost recovery mechanism where the wholesale and contracting costs the designated RoLR incurs to manage taking on the failed retailer's customers are paid for by the failed retailer through the sale of its electricity contracts following a RoLR event. If some or all of the value of the failed retailer's contracts can be accessed and used for this purpose, amend the RoLR cost recovery to only include any net costs incurred by the RoLR in taking on the failed retailer's customers.

Retailer behaviour during volatile market conditions

14 Distinct from the issue of retailer failures, the Commission has also noted that in the recent volatile market conditions, some unusual retailer behaviour took place. In particular, one retailer employed strategies to reduce their exposure to high spot prices by more than doubling its retail offers, instructing its customers to switch retailers and allegedly then selling its in-the-money hedges. The Commission will analyse and seek stakeholder views on whether this behaviour harmed customers or the market and, if so, whether regulatory changes are needed.

Process for this review

15 The Commission notes that because of the interrelationship between the RoLR scheme and insolvency laws, the Review may identify policy solutions that require implementation through legislation other than the energy laws and rules. Furthermore, some solutions may be legally complex to implement in areas where the AEMC does not have law or rule making powers. Therefore, the Review is being undertaken in two parts:

- **Stage 1**: is a feasibility study to identify what policy options are available to address the matters within the scope of the Review and the relevant law and/or rule changes that may be required to achieve them. At a minimum, the AEMC will publish two reports during this stage:
  - consultation paper 13 October 2022 with **submissions due 10 November 2022**

  - final report February 2023.
- **Stage 2**: will address the implementation of feasible policy options identified in stage one.

16 Details on how to lodge a submission are contained in chapter 7 of this consultation paper. A template is available to help stakeholders provide their views on the issues raised in this paper.

Related reforms

17 This Review is one of a suite of recommendations made by the AEMC to Energy Ministers in August 2022 following a request to analyse previous reviews related to financial resilience in the retail sector. These recommendations address process improvements to the RoLR scheme, improve credit support for RoLRs immediately following a RoLR event, examine improvements to the number of registered RoLRs and provide enhancements to the equivalent arrangements for embedded network customers.

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1 INTRODUCTION

This chapter outlines the context, purpose and approach for the Review.

1.1 Australian context for the Review

In the event of a retailer failure, the RoLR scheme is the mechanism that facilitates the orderly transfer of customers from the failed retailer to a new retailer (a designated RoLR) to prevent disruption of electricity or gas supply to those customers. A RoLR event may be triggered by a number of events or circumstances including a retailer going into receivership or becoming insolvent, failing to meet its prudential requirements, or ceasing to be a market participant.

When a retailer fails, its customers are transferred to a designated RoLR. However, the contracts that the failed retailer used to manage wholesale price risks are not transferred to the designated RoLR. If the retailer failure occurs in volatile market conditions with high wholesale prices, the designated RoLR may face financial distress from being exposed to these prices. In extreme circumstances this may trigger cascading retailer failures. Even if it does not lead to cascading retailer failures, this may result in higher costs to customers because the RoLR arrangements allow the RoLR to pass on costs from a RoLR event to customers.

1.1.1 Current pressures in the NEM

Until recently, the RoLR provisions were rarely relied upon. However, in the period from 24 May to 1 September 2022:

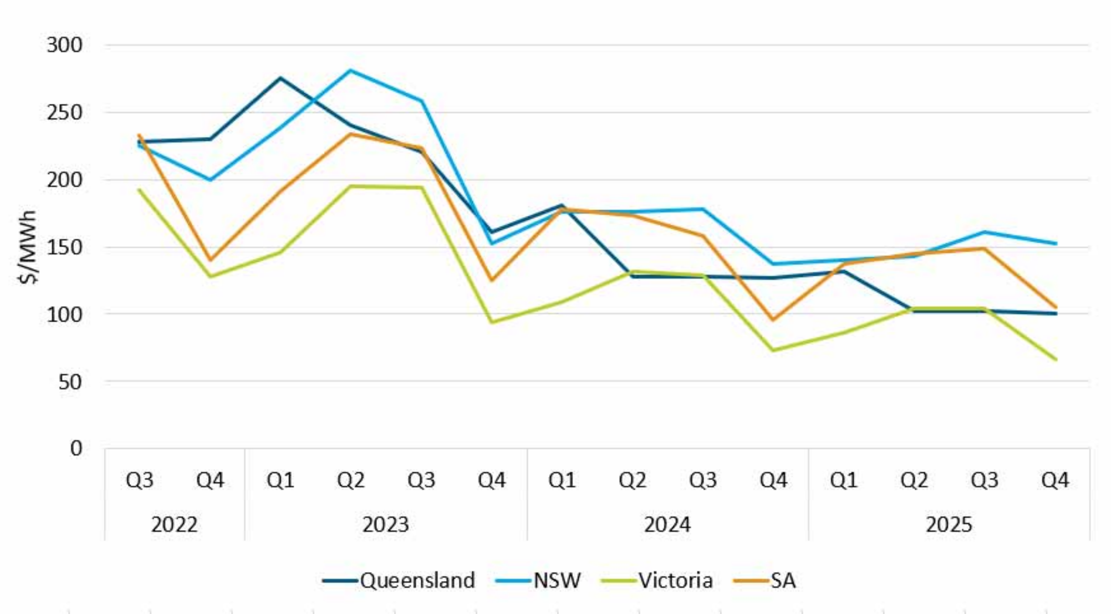
- seven authorised retailers have failed and triggered RoLR events – Weston Energy in gas, and Pooled Energy, Enova Energy, Powerclub, Mojo Power East (also trading as People Energy), Social Energy and Elysian in electricity
- Apex Energy (an exempt seller within embedded networks) recently entered administration.

In this period, the Commission also observed some retailers actively encouraging customers to move to other retailers, and have been informed that some designated RoLRs have experienced difficulty accessing contracts to service their new customers.

Record high wholesale prices have put pressure on retailers and this is likely to continue with electricity forward prices above $100/MWh for at least the next two years (Figure 1.1). Continued high prices are likely to put ongoing pressure on retailers, including those who may receive customers via a RoLR event for which they had not planned.

In recent years, retail electricity and gas markets have seen growth in the number of retailers in the market and increased retail competition. In competitive markets with low barriers to entry retailer exits are expected, as less successful business models are tested. This suggests further market exits may occur, particularly given the current market outlook. As a point of reference more than 50 retailers have exited the Great Britain market since 2019.

Figure 1.1: **Forward quarterly base futures prices**



Source: ASX Energy
Note: ASX quarterly base futures prices as at 30 September 2022.

1.1.2 AEMC advice to Energy Ministers in August 2022

On 12 August 2022, the AEMC put forward a suite of recommendations to Energy Ministers to strengthen the RoLR scheme and last resort measures to plan for and manage crises and the risk of significant market participant failure. The recommendations were informed by the AEMC's previous reviews into financial resilience (2015), retail competition (2020), and the ROLR (2021), and the recent retailer failure experiences of the AER.[1] All recommendations were endorsed for immediate action or further work, which is now underway. The Review is one of the recommendations the AEMC put forward to Energy Ministers for further work to address observed issues in electricity and gas markets.

The recommendations were as follows:

1. Immediate reforms to improve the RoLR scheme through a package of law and rule changes, most of which came from the AEMC's 2021 RoLR review that aim to improve the functioning of the current RoLR scheme.
2. Immediate actions for further work to enhance customer protections and improve the RoLR scheme including looking at how to improve compliance of exempt sellers and for the AEMC to commence a self-initiated review into whether and how underlying capacity

1 AEMC, NEM financial market resilience, Final report, 6 March 2015.
AEMC, 2020 Retail energy competition review, Final report, 30 June 2020.
AEMC, Review of the Retailer of Last Resort scheme, Final report, 25 February 2021.

and hedge contracts can be accessed by the designated RoLR for both gas and electricity (this Review).

3. Longer term work for last-resort planning including scenario planning with jurisdictions and market bodies to develop coordinated and clear approaches to managing crises and examining improvements to the number of registered RoLRs.
4. Longer term work to improve the RoLR scheme including the AEMC to begin a review in 2023 to move aspects of the RoLR regime from the National Energy Retail Law (NERL) into the National Energy Retail Rules (NERR).

1.2 International market pressures and policy responses

There are a range of schemes internationally that try to preserve the continuity of energy supply for customers by automatically transferring them to another retailer if their existing retailer fails. In Europe, these are often called a Supplier of Last Resort (SoLR) and are analogous to the RoLR scheme.

Recently, Europe has been severely impacted by high gas prices and shortages in supply. These have been reflected in sustained high prices in wholesale gas and electricity markets since mid-2021. Sustained high prices have resulted in significant financial stress on retailers and has led to many retailer failures. A detailed explanation of these issues is set out in appendix B, but the most important conclusions are:

- In Great Britain, 26 retailers exited the market in the 9-month period from July 2021 to March 2022.[2] One of these retailer failures was considered too big to transfer customers to another retailer. The UK's Office of Gas and Electricity Markets (Ofgem) was therefore forced to use its Special Administrator Scheme instead of the SoLR. Ofgem has been considering how to enhance retail financial market resilience and improve the operation of its SoLR scheme with particular focus on exploring ways in which the value of the contracts held by the failed retailer may be transferred to the SoLR. This is designed to minimise the costs that consumers must pay to the SoLR from the SoLR being exposed to very high wholesale prices in serving the new customers for which it could not hedge.
- Germany, Austria and Great Britain governments have sought to support struggling retailers with liquidity to manage margin calls. For example, in Germany, a scheme has been implemented which sees KfW, a government-owned bank, provide loans to retailers to cover large margin calls. The intention of this scheme is to bolster liquidity as large margin calls may discourage hedging or shift contracts to OTC.[3] This process has already been utilised by gas company Uniper, who have fully used a €9 billion credit facility, and the German government subsequently purchased a 99% stake in the company for a further €8 billion.

2 Ofgem 2022, Ofgem, London, viewed 13 September 2022, https://www.ofgem.gov.uk/energy-data-and-research/data-portal/retail-market-indicators.

3 Exchange-traded contracts typically have a margining process where the daily changes in the contract value must be paid for by the counterparties to the contracts. OTC traded contracts do not generally have a margining process.

In July 2022, Ofgem consulted on several options to preserve the value of hedge positions following a retailer failure so the benefit may be realised by the SoLR or special administrator and ultimately customers:[4]

- Option 1: a Licence change that requires that proceeds from liquidated 'in-the-money' hedges be paid directly by the counterparty (e.g. a generator or clearing house) to those positions into a separate trust. If a retailer fails, the money held in this trust can then be pad to the SoLR and therefore remain with the customers that it was originally intended to service.
- Option 2: a change to the contractual arrangement between customer and retailer that the retailer, in the event of insolvency, pays to the SoLR (acting on behalf of the customer) all costs incurred as a result of the retailer's insolvency, thus creating a debt owed to the customer, enforceable by the SoLR.
- Ofgem also considered transferring hedge positions from a failed retailer to a SoLR but decided against consulting on this approach, deeming it too difficult to implement.

1.3 Purpose of the Review

The objective of the Review is to determine if changes should be made to the regulatory framework to minimise the risks that designated RoLRs face and the costs that customers incur following RoLR events. In particular, because retailer failures are not necessarily able to be forecast, the RoLR cannot plan or hedge for the load of the new customers transferred to it from the failed retailer. The designated RoLR could be exposed to high energy spot or gas market prices which may cause financial stress and may pass this cost on to customers. The Review therefore seeks to:

1. identify ways in which the RoLR scheme may be improved, to potentially facilitate access to the failed retailer's electricity and gas contracts by a designated RoLR that is required to receive the failed retailer's customers, and
2. analyse the recent conduct of retailers encouraging their customers to change retailers during periods of volatile market conditions to determine if regulatory changes are needed to better protect customers.

1.4 Approach to the Review

The Review will consider National Energy Customer Framework (NECF) jurisdictions. Victoria has a separate RoLR scheme and is outside the scope of this review. However, the AEMC will consult and liaise with the relevant organisations in Victoria including the Victorian Department of Environment, Land, Water and Planning on the Review.

The AEMC notes that because of the interrelationship between the RoLR scheme and insolvency laws, the Review may identify policy solutions that require implementation through legislation other than the energy laws and rules. Furthermore, some solutions may be legally

4 The Special Administrator Regime (SAR) places a special administrator at the failing retailer to minimise costs to consumers and ensure security of supply. This mechanism is used when the SoLR regime is impractical, likely because it is a large retailer that has failed, and the customer base is too large to be realistically managed by a SoLR.
Ofgem, *Strengthening retail financial resilience*, Policy Consultation, 20 June 2022, London pp. 65-72.

complex to implement in areas where the AEMC does not have law or rule making powers. Therefore, the Review will be undertaken in two parts:

- **Stage 1**: is a feasibility study to identify what policy options are available to address the matters within the scope of the Review and the relevant law and/or rule changes that may be required to achieve them. At a minimum, the AEMC will publish two reports during this stage:
  - consultation paper in October 2022 and **submissions due 10 November 2022**
  - stage one final report published February 2023
- **Stage 2**: will address the implementation of any feasible policy options identified in stage one.

2 OVERVIEW OF EXISTING ARRANGEMENTS

The primary focus of the Review is to identify ways in which the RoLR scheme may be improved by facilitating designated RoLRs gaining access to contracts or equivalent hedging arrangements following a RoLR event. This section provides an overview of the existing RoLR arrangements to facilitate consultation. It is broken down in to:

- an overview and purpose of the RoLR scheme
- the circumstances that trigger RoLR events
- contracts typically used by electricity and gas retailers
- whether and how contracts may continue or be terminated depending on the type of contract and circumstances of the RoLR event
- an overview of current arrangements for designated RoLRs accessing contracts or equivalent hedging arrangements following a RoLR event.

The Commission is also analysing the recent conduct of retailers that encouraged their customers to change retailers, to determine whether regulatory changes are needed to better protect customers.

2.1 Purpose and overview of the RoLR scheme

In the event of a retailer failure, the RoLR scheme facilitates the orderly transfer of failed retailer customers to new retailers without disruption to their electricity or gas supply. A RoLR event may be triggered by a retailer going into receivership or becoming insolvent, failing to meet its prudential requirements, or ceasing to be a market participant. If the RoLR scheme is triggered, the customers of the failed retailer are immediately allocated to one or more other retailers that the AER determines. These retailers are referred to as designated RoLRs.

The designated RoLR(s) that customers are transferred to may include default RoLRs that are assigned by the AER for each electricity connection point and gas distribution system, or additional RoLRs that have volunteered and are approved by the AER. Customers are automatically transferred onto the standard retail contract of the designated RoLR(s).[5]

The RoLR scheme has been used several times since it was created, and has primarily involved shifting customers from small failed retailers to larger retailers. In recent months, there have been several RoLR events with the customers of these failed retailers all transferred to the three largest retailers (AGL, Origin and EnergyAustralia).

Given recent RoLR events have only involved small retailer failures, the impact on RoLRs from a sudden increase in customers and the subsequent prudential requirements and hedging strategies required to maintain profitability have been relatively small. However, in instances of multiple small/medium retailer failures or in the event of the failure of a large retailer, the sudden transfer of customers could be more material for the RoLR and, at the extreme, may cause cascading retailer failures and threaten the financial stability of the market.

5 One of the recommendations endorsed by Energy Ministers was for retailers to transfer customers to a market offer approved by the AER. This recommendation is now being drafted as part of a package of law and rule changes.

2.2 Circumstances that trigger RoLR events

The NERL defines a number of triggers for a "RoLR event", including:[6]

- revocation of retailer's authorisation;
- retailer market suspension (AEMO initiated) or retailer cessation as a registered participant;
- appointment of an insolvency official;
- an order to wind up the retailer is made or a resolution is passed to wind up the retailer;
- the retailer ceases selling energy for reasons other than transferring customers to another retailer or, selling or otherwise disposing of its business;
- any other event or circumstances prescribed in the National Regulations.

2.3 Contracts used by retailers in electricity and gas

The Review focuses on contracts typically used by electricity and gas retailers. Below is an overview of the contracts that are the subject of this review with further detail on these and other types of contracts in appendix C.

Electricity retailer contracts

The NEM is a gross-pool market where all electricity is sold by generators and purchased by retailers or energy users. Therefore, unlike the gas market which relies on bilateral contracts for physical supply, all physical supply is purchased through the NEM spot market. Prices in the NEM can vary between -$1,000/MWh and $15,500/MWh every five-minutes. As such, electricity retailers typically use derivatives contracts to hedge against spot price volatility. Derivatives contracts are typically either traded on an exchange or over-the-counter:

- Exchange-traded derivative contracts are standardised, anonymous, and all prices and quantities are publicly available. Electricity futures exchanges include the Australian Securities Exchange (ASX) and the Finance and Energy Exchange (FEX) with products available for Queensland, NSW, Victoria and South Australia.
- Over the counter (OTC) contracts are bi-lateral, bespoke and negotiated contracts between the seller (typically a generator but may also be a financial institution) and a buyer (typically a retailer). The terms of these contracts are often documented under the 2002 International Swaps and Derivatives Association (ISDA) Master Agreement published by the ISDA, as supplemented by an industry standard electricity addendum published by the Australian Financial Markets Association (AFMA).

Gas retailer contracts

Contracts used in east-coast gas markets by retailers are typically bilateral contracts for gas supply, pipeline capacity and storage. These contracts are for physical gas supply and to transport gas to the customers. The Commission is focusing on the following contracts as they are contracts used by a gas retailer to supply its customers:

6 NERL section 122.

- Bilateral contracts for physical gas supply — these are wholesale supply deals negotiated between sellers (typically producers or other persons contracted to sell gas) and buyers (typically retailers), with the terms for each contract being specific to the counterparties.
- Bilateral contracts for pipeline capacity – these contracts give the holder the right to transport gas from an injection point on the pipeline to an offtake point further along (that is, to transport the gas from where it is purchased to the customer).
- Bilateral contracts at storage facilities and line pack storage – these are used to deliver additional volumes of gas to meet demand peaks over short periods of high demand as well as over seasonal winter demand periods.

2.4 What happens to contracts following a RoLR event?

There is a complex interaction between the circumstances that trigger a RoLR event (section 2.2) and the contracts that are the focus of the Review (section 2.3). Table 2.1 sets out the Commission's preliminary analysis of that interaction, which is consistent across most contracts. However, given the analysis is preliminary, it does not account for the nuances that may exist on a case-by-case basis particularly for bespoke bilaterally traded contracts. Our preliminary understanding of the interaction between a RoLR trigger and bilaterally traded contracts is explained in more detail in appendix D.

Table 2.1: RoLR event triggers and contracts

WHAT HAPPENS TO CONTRACTS?	ROLR EVENT TRIGGER
Unlikely to trigger a right to terminate the contract and therefore remain in force	• Revocation of retailer authorisation • Suspension of wholesale trading rights • Cessation of sale of energy
Terminate as a result of the RoLR event	• Appointment of insolvency official • Order or resolution for winding up

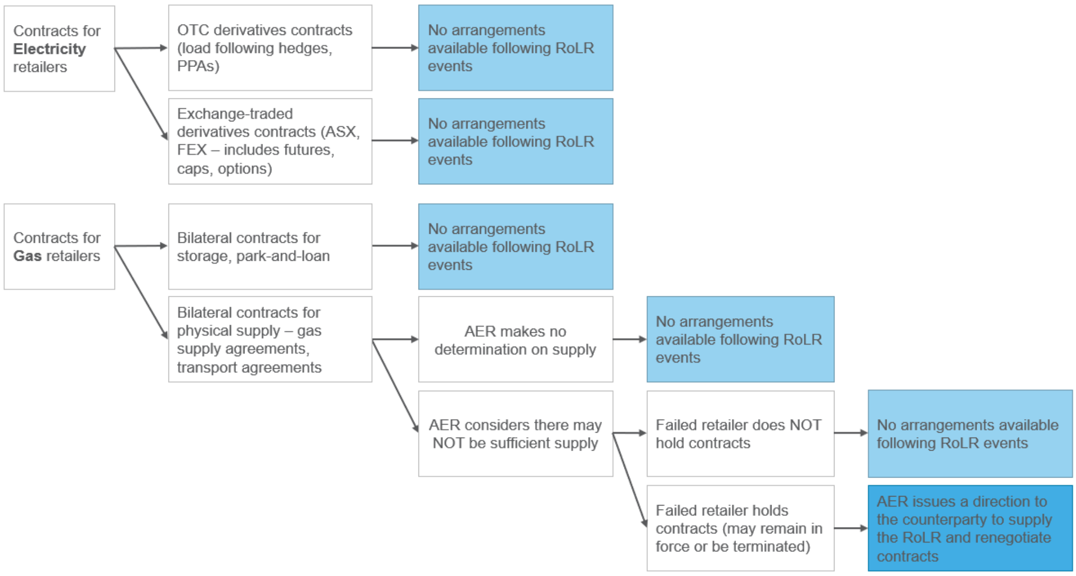
Source: AEMC

Furthermore, there are a range of specific laws that affect failing businesses such as the ipso-facto regime and specific obligations on insolvency officials. A high-level explanation of these is also set out in appendix D.3, appendix D.4 and appendix D.5.

2.5 Arrangements that facilitate designated RoLRs accessing electricity and gas contracts following RoLR events

Some arrangements are already in place under section 137 of the NERL to facilitate the continuity of supply of gas to customers following a RoLR event. However, the current provisions are limited and only apply in certain circumstances and for a relatively short period. The following figure outlines contracts considered in this Review and the arrangements for a designated RoLR to access these from the failed retailer or counterparty to the contract with the failed retailer, following a RoLR event.

Figure 2.1: Current arrangements for electricity contracts and gas contracts



Source: AEMC
Note: The figure includes all contracts in electricity and gas that are the subject of the Review.

2.5.1 RoLR directions for gas

Currently, section 137 of the NERL allows the AER to issue directions for gas supply and pipeline capacity. These directions only apply to contracts that were held by the failed retailer at the time of the RoLR event (regardless of whether those contracts were terminated as a result of the RoLR event or remain on foot).

A high level overview of the directions and subsequent negotiation processes are set out below.

- When is the direction issued – where there is no declared wholesale gas market or short term trading market or where, in the opinion of the AER, sufficient capacity or gas is not available in a short term trading market
- Who is it issued to – the distributor or transmission service provider (pipeline capacity); the producer or any person that has contracted to sell gas to the failed retailer (gas supply)
- What must the directed entity do – make gas supply or pipeline capacity available to the designated RoLR that was available to the failed retailer immediately before the transfer date on the same terms that were available to the failed retailer

- When must it be actioned – immediately upon receiving the direction[7]
- What follows the direction – as soon as practicable after the transfer date, negotiations should commence for a replacement contract with pipelines and/or the novation or replacement of a contract for gas supply (set out in Figure 2.2).

Figure 2.2: Current arrangements for the negotiation process following a direction for gas under section 137 of the NERL

Source: section 137 of the NERL.

7 This will be changed to "within 24 hours" following recent experience from the AER on the enforceability of "immediate" through a law and rule package to improve the RoLR scheme.

3 WHAT IS THE PROBLEM FOR FAILED RETAILERS' ELECTRICITY AND GAS CONTRACTS?

This section provides the Commission's initial view for stakeholder feedback on the nature and magnitude of the problem with the current arrangements. It is split into:

- risks to the designated RoLR and costs to customers associated with the sudden transfer of customers in a RoLR event
- customer and market impacts of retailers encouraging their customers to leave during volatile market conditions.

3.1 Risks and costs associated with the sudden transfer of customers in a RoLR event

Retailers can prudently manage their customer loads with contracts. This allows gas retailers to directly service customers and electricity retailer to reduce exposure to price volatility in the electricity spot market (for further information see section 2.3). The transfer of a large number of customers due to a retailer failure presents two potential risks:

- **Systemic risks** — This is the risk that the application of the RoLR scheme causes the designated retailer to fail and result in cascading failures in the retail market
- **Increased costs to the designated RoLR and customers** — The costs to the designated RoLR to secure contracts or buy energy from the spot market to service customers on short notice. These costs will be passed through to customers either through the RoLR cost recovery process or directly through higher prices.

3.2 Risks and costs for electricity retailers

There is no formal mechanism for the designated RoLR to obtain or negotiate to acquire the contracts of the failed retailer in electricity. Following a retailer failure, the designated RoLR could either be exposed to spot prices or the need to purchase hedging contracts at elevated prices upon receiving the customers, depending on market conditions. In periods of volatile market conditions, contract market liquidity may be low, creating a challenging environment for a retailer needing to purchase contracts in a short timeframe for relatively imminent supply periods. These circumstances could result in costs of servicing customers above the Default Market Offer (DMO).

BOX 1: SIMPLIFIED ILLUSTRATIVE EXAMPLE OF THE POTENTIAL MATERIALITY OF WHOLESALE COSTS OF A LARGER ROLR EVENT

The following simplified illustrative example seeks to highlight the potential materiality of this problem. Through consultation, we hope to gain a clearer understanding of the costs associated with recent RoLR events and potential impact of larger retailer failures.

Wholesale energy costs for the designated RoLR associated with a medium-sized retailer failure of around 250,000 residential customers in NSW for 70 days the period from 1 July to 8 September 2022 could equate to:

- $205 per customer or $227/MWh, resulting in $54,077,000 of total wholesale energy costs on the basis of NEM pricing over this period
- $110 per customer of this to be recovered from customer bills if applying the DMO wholesale cost component 2021-22
- $95 per customer in costs not covered.

This is a very simplified example of the potential materiality of the increase in wholesale costs associated with a larger RoLR event. While this assumes there are no additional costs to be recovered from the existing customer base, it does highlight the risks associated with a sudden and large increase in customer load where the RoLR does not have the capacity to quickly manage and mitigate the associated price risk.

In this example, the following risks and costs emerge following the RoLR event:

- There may be systemic risks associated with sudden increase in wholesale costs to service new customers and in prudential requirements with AEMO. If these are not able to be managed, the designated RoLR may risk failure and trigger cascading retailer failures.
- Increased costs to the designated RoLR and customers. The sudden increase in customers would force the designated RoLR to choose between purchasing contracts to cover load or being exposed to the wholesale spot price. In this example, purchasing contracts to cover customer load on 1 July would have resulted in higher costs than being exposed to spot as contract prices were elevated following the events in June. The designated RoLR may apply for cost recovery from the AER to cover temporary costs associated with a RoLR event.

Source: AEMC analysis using AER's Default Market Offer 2021-22 Final Determination.

Note: Customer numbers back-solved based on a smooth daily consumption based on DMO annual usage forecast of 4,700KWh and therefore doesn't account for seasonal variations in demand.

Note: Uses DMO forecast wholesale costs for the Ausgrid distribution area of $122.23/MWh.

Note: Retail costs determined using the NSW operational demand profile where 250,000 customers corresponded to around 0.05% of NSW demand.

Note: The period is 70 days from 1 July to 8 September 2022 chosen because it was sufficiently long after market suspension but in the period where more RoLR events began to occur.

QUESTION 1: NATURE OF THE PROBLEM

1. Do you agree with, or have feedback on, the problem statement regarding the need for retailers to access supply and/or hedging arrangements to manage increases in customer load following a RoLR event?
2. For default and/or designated RoLRs:
   a. Have you had trouble accessing contracts on a listed exchange or OTC? If yes, how have you managed sudden increases in customer load to date?
   b. Do you have evidence of the materiality of RoLR events on wholesale and contracting costs?
   c. Do you consider access to contracts would assist in managing the risks associated with RoLR events in the future?

3.3 Risks and costs for gas retailers

The current AER RoLR gas directions are set out in section 137 of the NERL and explained in section 2.5 of this paper. Directions enable the designated RoLR to access gas supply and pipeline capacity contracts purchased by the failed retailer to service its new customers on short notice. However, the Commission has observed three key issues with the framework through the recent use of the provision.

First, the threshold that the AER must meet to issue a direction is that there is no declared wholesale gas market or short term trading market or where, in the opinion of the AER, sufficient capacity or gas is not available in a short term trading market.[8] However, it is ambiguous on whether the AER may issue a direction for other reasons such as high prices, costs and associated risks, despite this representing a significant risk to RoLRs even where supply may be available.

Second, in relation to contracts that remain in place notwithstanding the RoLR event, the requirement provides for the RoLR and the supplier to negotiate a new contract with the designated RoLR and facilitates a three months period for negotiation. The Commission has identified two critical issues with this process:

- Complex negotiation processes may need longer than three months — The Commission understands that the transfer of customers from the failed retailer to the RoLR is not a simple process and requires the designated RoLR to assess the impact these customers may have on the retailer's contracted positions. Given the bespoke nature of gas supply contracts (set out in appendix C.2), this negotiation process may require more time than the existing directions powers offer.
- Adverse incentives from the ending of a gas supply direction — A direction is in place until a new contract is settled or, if no new contract is settled, following the three-month period, at which point the failed retailer or gas producer sells the contract. RoLR events

8 s.137(1) of the NERL.

are more likely to occur during times of tight supply in the market and in such scenarios the failed retailer may be incentivised to stall negotiations, so they retain ownership of the contracts at the end of the three-month term. This would allow the failed retailer to sell the contracts in the open market and stand to make greater gains than it could by selling to the designated RoLR.

Additionally, RoLR gas directions only apply to gas supply and pipeline capacity contracts despite other contracts such as storage being commonly used. Storage contracts facilitate retailers managing how much gas they use at certain times. Without access to such contracts, retailers may be unable to manage fluctuations in gas demand and need to pay for additional gas on the spot market.

QUESTION 2: RISKS AND COSTS FOR GAS RETAILERS

1. Do you agree with the issues identified with the current section 137 RoLR gas directions framework?
2. Are there other issues with section 137 directions not identified here? If yes, please explain and provide evidence.
3. How material do you consider the issues with section 137 directions are?
4. How material do you consider the problem with the scope of gas directions excluding storage contracts?

4 ASSESSMENT FRAMEWORK

To determine whether any policy recommendations identified in the Review promote the National Electricity Objective (NEO), National Gas Objective (NGO) and the National Energy Retail Objective (NERO), the Commission will assess policy solutions against an assessment framework. The assessment framework includes the following criteria:

1. Efficiency
2. Appropriate allocation of risk
3. Incentives
4. Predictability and stability
5. Simplicity and transparency
6. Timing and practicality.

The following sections describe how each criterion applies to the Review.

QUESTION 3: ASSESSMENT FRAMEWORK

1. Are there any other relevant considerations or principles that should be included in the assessment framework?

4.1 Criterion 1: Efficiency

Recommended changes to the regulatory framework should facilitate lower total system costs associated with RoLR events, thereby reducing prices for consumers. In particular, high costs associated with a retailer failure are likely to arise from the RoLR incurring high wholesale costs without appropriate contracts or equivalent hedging instruments to manage them.

4.2 Criterion 2: Appropriate allocation of risk

Risks should be allocated to those best-placed to manage them. However, the RoLR scheme involves the sudden shift of customers to retailers who are unable to account for this in advance. Therefore, recommended changes to the regulatory framework should seek to reduce the risks associated with a sudden increase in customers. The Commission will consider:

- the period of time immediately following the RoLR event that may be high-risk for the designated RoLR
- whether a materiality threshold or trigger (e.g. size of the failed retailer) is needed for any of the proposed options to be used
- whether and how cost savings may be passed through to customers and not contribute to additional profit for the RoLR.

The Commission's initial view for the high-risk period in both gas and electricity is that:

- the first 3-months following a RoLR event is a high-risk period where access to appropriate contracts may not be adequate and the load shape and risk profile of the new customers may not yet be known
- more than one year is lower risk and can be more easily accommodated through standard business practices particularly as the DMO changes each financial year and large loads are typically on 12-month contracts.

> QUESTION 4: APPROPRIATE ALLOCATION OF RISK CRITERION
>
> 1. Do you have views on the likely risk for designated RoLRs in the period following retailer failures?
> 2. Do you think the risk period is different for electricity and gas? If yes, please identify the proposed risk periods and explain.
> 3. Do you have views on whether a materiality threshold or trigger is needed for electricity or gas? If yes, please propose a minimum threshold, explain and provide evidence.

4.3 Criterion 3: Incentives

Recommended changes to facilitate designated RoLRs accessing contracts following a RoLR event should seek to avoid creating perverse operational incentives for the failing retailer such as those described in section 3.2. The Commission will have particular regard to the following potentially adverse incentives:

- the failing retailer shifting to another legal entity or selling contracts immediately before or in response to the RoLR event (as the case may be)
- the designated RoLR obtaining the benefit of underlying capacity or hedge positions and not subsequently passing these on to customers.

> QUESTION 5: INCENTIVES CRITERION
>
> 1. Do you see any other adverse incentives that may arise that the Commission should have regard to?

4.4 Criterion 4: Predictability and stability

Contracts of a similar nature should have a similar or consistent framework applied in a RoLR event. By way of example, a derivative contract used to manage price risk purchased on securities exchanges and OTC should have similar requirements to not create distortionary contracting incentives. The Commission is testing an approach in which the designated RoLR should, for all contracts, whether electricity or gas, exchange or bilaterally traded:

- be made aware of what contracts are held by the failed retailer
- have the option, but not an obligation, to take on some, all or none of the contracts or equivalent underlying hedge protection from the failed retailer.

QUESTION 6: PREDICTABILITY AND STABILITY CRITERION

1. Do you see any issues with the principles to support predictability and stability described above? Are they sufficient, or are additional or different principles required or preferable? If yes, please explain why.

4.5 Criterion 5: Simplicity and transparency

Recommended changes to the regulatory framework that facilitate access to contracts by the designated RoLR should be easily understood by all entities, must be capable of fast and effective use (given the context within which RoLR events and directions occur) and enforceable by the AER. Where appropriate, recommendations should enhance the clarity and enforceability of the current RoLR scheme.

4.6 Criterion 6: Timing and practicality

The laws and rules for the RoLR scheme and broader insolvency law are complex and may involve changes that require governments or other regulatory bodies to implement them. The Commission will therefore:

- consider how likely a practical policy solution will be developed and implemented
- consider how likely recommended changes to the regulatory framework will achieve the intended benefits in a timely proportionate and targeted way
- avoid changes to the regulatory framework that may affect retailers in non-NECF jurisdictions where possible
- seek to limit unintended consequences on competition within the retail electricity and gas markets, including any additional costs or risks for smaller retailers associated with changes to the RoLR scheme.

To further address this criterion, the Commission will engage Energy Ministers and other relevant market bodies throughout the Review.

QUESTION 7: TIMING AND PRACTICALITY CRITERION

1. Do you see any other issues that may influence the timing, practicality or uncertainty of any recommendations? If yes, please explain.

5 POTENTIAL SOLUTIONS FOR FAILED RETAILERS' ELECTRICITY AND GAS CONTRACTS

Chapter 3 sought views on the nature and materiality of potential problems with RoLRs not having access to failed retailers' contracts. This Chapter seeks stakeholders' views on potential solutions to those problems.

The Commission notes that the solutions provided in this chapter represent the Commission's initial analysis to facilitate consultation and stakeholder submissions. The Commission is continuing to assess these options and is open to others. We are exploring and seeking stakeholder views on whether the solutions are workable, the likelihood of them solving the problems highlighted in section 3.1 and their overall merit as policy solutions. The Commission welcomes comments on the preliminary potential solutions and alternatives in submissions.

A summary of the options explored in this chapter is set out in the tables below.

Table 5.1: **Potential solutions to for electricity retailer failures**

Option 1: Cost recovery clarity	Clarify that RoLR cost recovery available to the designated RoLR includes wholesale and hedging costs
Option 2: Matchmaking service	Introduce an automatic information gathering provision by the AER allowing it to obtain from the failed retailer all contracts it holds and to allow the AER to share that information with the designated RoLR.
Option 3a: Introduce a directions framework with reference to current market prices	Similar to what currently exists for gas, where directions are issued to the failed retailer and counterparty to the contract, requiring them to negotiate a new contract with the designated RoLR with with reference to the current market price.
Option 3b: Introduce a directions framework with reference to contracted prices	Similar to what currently exists for gas, where directions are issued to the failed retailer and counterparty to the contract, requiring them to negotiate a new contract with the designated RoLR with reference to the contracted price.
Option 4: Use the failed retailer's 'in the money' electricity contracts to minimise RoLR cost recovery	Introduce a new RoLR cost recovery mechanism where the wholesale and contracting costs the designated RoLR incurs to manage taking on the failed retailer's customers are paid for by the failed retailer through the sale of its electricity contracts following a RoLR event. If some or all of the value of the failed retailer's contracts can be accessed and used for this purpose, amend the RoLR cost recovery to only include any net costs incurred by the RoLR in taking on the failed retailer's customers.

Table 5.2: Potential improvements to the existing RoLR gas directions framework

Expanding the RoLR gas directions framework to include storage contracts
Broadening the trigger for the RoLR gas directions to make explicit that the AER may consider prevailing market conditions and pricing in the context of the NERO and NGO.
Increasing the directions powers for gas supply, pipeline capacity and transmission capacity from its current level of three months to a longer period.
Clarifying whether a direction should continue regardless of whether the contract expires or would have expired during the direction period.
Express requirement to negotiate in good faith or with best endeavours

5.1 Options for electricity retailers

Access to contracts by a designated RoLR would help minimise financial risk exposure. This includes access to the failed retailer's contracts. This is distinct from gas where a lack of access to the failed retailer's contracts could inhibit the RoLR being able to meet a customer's physical supply requirements.

For an electricity retailer, contracts are a key risk management tool because wholesale prices can fluctuate from -$1,000/MWh to $15,500/MWh in each five-minute period. This section explores whether and how a designated RoLR may access underlying hedge protection to minimise its risks and costs following a RoLR event. The Commission notes that a failed retailer may not have managed its customers in a way that results in useful hedging contracts for the designated RoLR. As a result, there may be limitations to the improvements that may be made to the financial resilience of retail markets to large retailer failures.

This section sets out a spectrum of potential options for consultation ranging from least to most interventionist. These solutions represent a snapshot of the Commission's initial analysis. In this section we are exploring and seeking stakeholder views on whether the proposed solutions are workable, the likelihood of them solving the problems highlighted in section 3.2, the merits and likely implementation costs and risks. While the Commission understands there are potentially significant issues involved in implementing various of these options, we are also open to alternatives that stakeholders have and would welcome suggested solutions being provided in submissions.

The initial options the Commission has developed include:

1. **Cost recovery clarity**: Clarify that RoLR cost recovery available to the designated RoLR includes wholesale and hedging costs
2. **Matchmaking service**: Introduce an automatic information gathering provision by the AER allowing it to obtain from the failed retailer all contracts it holds and to allow the AER to share that information with the designated RoLR
3. **Introduce a directions framework**: Similar to what currently exists for gas, where directions are issued to the failed retailer and counterparty to the contract, requiring them to negotiate a new contract with the designated RoLR. Two proposed options for consultation are that:

a. contracts should be negotiated with reference to the current market price

b. contracts should be negotiated with reference to the contracted price.

4. **Use the failed retailer's 'in the money' electricity contracts to minimise RoLR cost recovery**: Introduce a new RoLR cost recovery mechanism where the wholesale and contracting costs the designated RoLR incurs to manage taking on the failed retailer's customers are paid for by the failed retailer through the sale of its electricity contracts following a RoLR event. If some or all of the value of the failed retailer's contracts can be accessed and used for this purpose, amend the RoLR cost recovery to only include any net costs incurred by the RoLR in taking on the failed retailer's customers.

> QUESTION 8: OPTIONS FOR ELECTRICITY DERIVATIVES CONTRACTS
>
> 1. Do you prefer a particular option above others? If yes, please explain.
> 2. Are any other solutions not listed here that warrant consideration? Please explain and provide evidence.

5.1.1 Option 1: Cost recovery clarity

The NERL incorporates a process through which a designated RoLR can apply to the AER to recover the costs that it incurs on or after a RoLR event (see appendix A.4).[9] A default RoLR may also apply to recover costs incurred in preparing for RoLR events.[10] The designated RoLR does not take on any of the liabilities or obligations of the failed retailer.[11]

Following receipt of the application, the AER determines a cost recovery scheme informed by the following principles set out in its RoLR guideline.[12] In summary, the AER's guidance on applying the principles for cost recovery are:

- actions of the designated RoLR in performing its obligations should be prudent and minimise the costs incurred in the circumstances
- limits will not be imposed on the classes or magnitude of costs as the RoLR should be provided with reasonable opportunity to recover its reasonable costs incurred
- cost recovery should not result in onerous price shocks for small customers, as this may present hardship issues for some customers
- cost recovery should occur over the largest customer base which is appropriate to the RoLR event.[13]

Option 1 would seek to make explicit that RoLR cost recovery includes the wholesale and/or hedging costs incurred to serve the new customers in a defined period after the RoLR event. Consideration would need to be given to any changes to the NERL and relevant RoLR

9 NERL, section 166. Under the AER's RoLR guidelines, applications must be made within nine months of the relevant RoLR event. See AER, Retailer of last resort statement of approach, November 2011.

10 NERL, section 166(3)(a).

11 NERL, section 140(3).

12 AER, Retailer of last resort statement of approach, November 2011.

13 Ibid, p.18-19.

documents published by the AER. Costs would be recovered through the current mechanisms and paid for by customers through network changes. Different contract types and whether a contract is terminated or remains in-force are irrelevant to whether the relevant costs can be recovered under the proposed solution in Option 1.

Initial observations for stakeholder feedback

The Commission's initial observations of the benefits and risks associated with Option 1 are set out below and in Figure 5.1 for stakeholder feedback.

- *Benefits*:
  - greater clarity may reduce the systemic risks associated with taking on a large number of customers in a short period
  - relatively simple to implement through the NERL and RoLR guideline published by the AER (noting that, to the extent that amendments are required to the RoLR guideline, the appropriate consultation procedures will need to be followed).
- *Risks*:
  - may increase costs to customers if RoLRs are not incentivised to efficiently manage costs following a RoLR event.

Figure 5.1: Option 1 initial observations for stakeholder feedback

Assessment criteria	Initial observations
Criterion 1: Efficiency	No improvement in costs to customers from current arrangements as cost-recovery is ultimately paid for by customers through distribution charges.
Criterion 2: Appropriate allocation of risk	Clarifying cost recovery to explicitly include wholesale and hedging costs may reduce the systemic risks of taking on many customers in a short period. However, should cashflow issues emerge as a result of the RoLR event, this may not prevent cascading failures and is no better than current arrangements.
Criterion 3: Incentives	If not well-designed, may incentivise designated RoLRs to not minimise costs and result in significant cost recovery bills for customers.
Criterion 4: Predictability and stability	Improves clarity to the designated RoLR that it can recover wholesale costs associated with a RoLR event and thereby reduces the costs and systemic risks associated with a RoLR event Can be consistently applied across all categories of electricity derivative contracts and RoLR events.
Criterion 5: Simplicity and transparency	Explicitly setting out how costs may be recovered will facilitate clear guidance on RoLR cost recovery for wholesale and hedging costs
Criterion 6: Timing and uncertainty	Practically may be implemented through the existing regulatory framework for the RoLR cost recovery scheme.

Source: AEMC analysis
Note: Colours indicate the following estimated impacts of the option relative to current arrangements: dark green — notably better, light green — marginally better, grey — no change, orange — risk, red — high risk.

QUESTION 9: OPTION 1 KEY POLICY ISSUES

1. Do you agree or disagree with the initial observations for option 1? Please explain and provide evidence.
2. Do you have specific feedback on any aspect of option 1 including feasibility or implementation?

5.1.2 Option 2: Matchmaking service

While the AER currently has the ability to issue RoLR gas directions, it does not have an automatic information gathering power for all RoLR events. Option 2 proposes to expand the categories of information a failing retailer must provide to the AER for the purposes of the RoLR scheme to include all contracts held that service its customer load and the conditions under which they are held, including counterparty details. Further, Option 2 proposes that information related to the contracts would be shared with the designated RoLR. The AEMC's initial view of how this would operate in practice is set out in Box 2.

BOX 2: OPTION 2 SIMPLIFIED ILLUSTRATIVE EXAMPLE

In the lead up to the RoLR event and transfer of customers: the failing retailer, must submit information about its current contract positions to the AER as part of the initial information it provides.

Following the RoLR event and transfer of customers: the AER provides the information on contract positions held by the failed retailer to the designated RoLR.

The designated RoLR(s) may then go out to market and seek to strike contracts with the counterparties of contracts previously held by the failed retailer. This option would effectively serve as an information "matchmaking service" and there is no obligation on any parties to negotiate a contract.

Jurisdictions are developing legislative reforms to enable new gas and electricity contract market monitoring powers for the AER.[14] The Commission intends this RoLR requirement would complement, not replace, those market monitoring powers should they be introduced.

Initial observations for stakeholder feedback

The Commission's initial observations of the benefits and risks associated with this option are set out below and in Figure 5.2 for stakeholder feedback.

- *Benefits*:
  - potentially reduce regulatory burden on and improve information provided to the AER to not need to issue additional information requests
  - improve transparency for the designated RoLR on the contracts that were used to service the customers it receives in a RoLR event and therefore potentially increase the chances and timeliness of the RoLR securing new contracts.
- *Risks*:
  - may not improve price outcomes to the designated RoLR relative to the existing arrangements.

14 The Department of Climate Change, Energy, Environment and Water recently concluded consultation on Australian Energy Regulator Wholesale Market Monitoring and Reporting Framework. The consultation paper can be found here.

Figure 5.2: Option 2 initial observations for stakeholder feedback

Assessment criteria	Initial observations
Criterion 1: Efficiency	No improvement in costs to customers from current arrangements through the RoLR scheme Match-making service may improve the efficiency with which the designated RoLR can seek out new contracts Reduce the regulatory burden on the AER to ask for this information each time a failing retailer may be at risk of a RoLR event and improve the speed with which the AER can access it.
Criterion 2: Appropriate allocation of risk	No improvement to the risks faced by the designated RoLR in taking on many customers in a short period.
Criterion 3: Incentives	May facilitate new contracts to be struck in a shorter period, otherwise no change to the current arrangements.
Criterion 4: Predictability and stability	Likely may use the same arrangements for OTC and exchange-traded derivatives contracts. However, practically this would have different implications for the designated RoLR: • OTC counterparty would allow the designated RoLR to seek out that counterparty to negotiate a new contract • exchange-traded counterparty would only allow the designated RoLR to purchase a new contract on an exchange.
Criterion 5: Simplicity and transparency	Improves the transparency of what contracts were held by the failed retailer, potentially reducing re-contracting time.
Criterion 6: Timing and uncertainty	Practically may be implemented through the existing regulatory framework for the information to be provided to the AER for the RoLR scheme.

Source: AEMC analysis

Note: Colours indicate the following estimated impacts of the option relative to current arrangements: dark green — notably better, light green — marginally better, grey — no change, orange — risk, red — high risk.

QUESTION 10: OPTION 2 KEY POLICY ISSUES

1. Do you agree with the initial observations for Option 2? Please explain and provide evidence.
2. Do you have specific feedback on any aspect of Option 2 including feasibility and implementation?

5.1.3 Option 3a: Introduce a directions framework with reference to the current contracts but at the current market prices

Electricity retailers source the energy needed to service their customers through the gross-pool spot market, therefore designated RoLRs without sufficient hedging protection face the risk of spot price exposure (rather than a risk of insufficient physical supply, which is an issue that arises in relation to gas). To mitigate this price risk, Option 3a would seek to replicate the existing NERL section 137 RoLR gas directions powers to apply to electricity hedging contracts for failed electricity retailers (an explanation of these is set out in section 2.5.1).

This solution comprises multiple parts. First, the AER's information gathering powers would be improved such that it can access the failing retailer's contract information to make an informed decision on whether to issue a direction.

Second, the Commission considers a trigger would be needed upon which the AER may issue such a direction. This trigger may involve a materiality threshold such as a retailer failure above a certain size, liquidity constraints or extreme market conditions. We would need to consider whether there is any likely effect on the ability of retailers to obtain credit under this solution. This is because, if a direction is issued to a failed retailer under this scenario, the failed retailer's creditors may not be able to claim the full expected value of the remaining assets (that is, electricity hedging contracts). The Commission is seeking stakeholder views on appropriate triggers.

Third, the direction, if issued, would likely have two parts following the RoLR event and transfer of customers to the designated RoLR:

1. For a pre-defined high-risk period — a direction from the AER to the failed retailer and counterparties to the failed retailer's contracts to provide to the designated RoLR, either through contracts or payments, the equivalent price protection provided by any hedging instruments identified by the AER.
2. For a predefined medium-term period — a direction from the AER to the failed retailer and counter-parties to the failed retailer's contracts to negotiate new contracts with reference to current market prices.

The Commission's initial views in relation to the periods that may be of high risk and costs to the designated RoLR are set out in section 4.2.

These two parts of the direction have different implications depending on whether the contract is terminated or in force and whether the hedging instrument was exchanged-traded or purchased OTC (described in section 2.4 and appendix D.1). The Commission's preliminary view on how this option may work under each scenario is described below for the high-risk (Table 5.3) and the medium-term (Table 5.4) directions. The intention is that this would facilitate the transfer of electricity contracts between the failed retailer and the designated RoLR. However, we recognise this would require the consent of the clearing house for exchange traded contracts, or a directions power for clearing houses noting these entities are not governed by energy law and rules.

The Commission notes these issues are highly complex and seeks stakeholder views on the benefit and practicality of these scenarios, and any risks or barriers.

The Commission's initial view of how Option 3a may work using a simplified illustrative example is set out in Box 3.

Table 5.3: **Option 3a — high-risk period direction**

	EXCHANGE TRADED HEDGING CONTRACTS	OTC TRADED HEDGING CONTRACTS
Contract still in force	Direction issued by the AER to the **failed retailer** to offer price protection equivalent to the failed retailer's hedge position for the high-risk period. The failed retailer may either: • sell the contract at contracted price with consent of the **counterparty** (e.g. ASX Clear (Futures)) • pay the difference between the current market price and contracted price to the designated RoLR.	Same as for exchange-traded hedging contracts still in force
Contract terminated as a result of the RoLR event	Direction issued by the AER to the **counterparty** to the terminated contract (ASX Clear (Futures)) to offer price protection equivalent to the failed retailer's terminated hedge position for the high-risk period. The counterparty must either: • sell a new contract in the same terms at equivalent contracted price • pay the difference between the current market price and contracted price to the designated RoLR.	Direction issued by the AER to the **counterparty** to the terminated contract (a generator or financial institution) to offer price protection equivalent to the failed retailer's terminated hedge position for the high-risk period. The counterparty must either: • sell a new contract in the same terms at equivalent contracted price • pay the difference between the current market price and contracted price to the designated RoLR.

Table 5.4: Option 3a — medium-term period negotiations

	EXCHANGE TRADED HEDGING CONTRACTS	OTC TRADED HEDGING CONTRACTS
Contract still in force	Direction issued to the **failed retailer** and **counterparty** (e.g. ASX Clear (Futures)) to negotiate a new contract with reference to the failed retailer's medium-term contract(s) at current market price.	Direction issued to the **failed retailer** and **counterparty** (e.g. generator) to negotiate a new contract with reference to the failed retailer's medium-term contract(s) at mark-to-market value
Contract terminated as a result of the RoLR event	Direction issued to the **counterparty** to the terminated contract (e.g. ASX Clear (Futures)) to negotiate a new contract with reference to the terminated medium-term contract(s) at current market price.	Direction issued to the **counterparty** to the terminated contract (e.g. generator) to negotiate a new contract with reference to the terminated medium-term contract(s) at current market price

Note: In all circumstances, the designated RoLR has the option, but not the obligation to purchase negotiate for these contracts at current market value.

BOX 3: OPTION 3A SIMPLIFIED ILLUSTRATIVE EXAMPLE

The following illustrative example seeks to highlight the practical implications of Option 3a. For simplicity, this example focuses on a NSW failing retailer that uses ASX-traded derivative contracts to manage its load. Through consultation, we hope to gain a clearer understanding of how this option may work under each scenario.

Failing retailer:

- uses 10MW base futures contracts to manage its load purchased from the ASX
- retailer failure due to not meeting its AEMO prudential requirements and therefore is not suspended from ASX trading (and contracts remain in force).

The failing retailer purchases the following contracts to manage its load on 29 October 2021 (it makes no other purchases):

- 10MW Q3 2022 base futures contract for $66/MWh (total price of $1,457,280)
- 10MW Q4 2022 base futures contract for $60/MWh (total price of $1,325,800)
- 10MW Q1 2023 base futures contract for $75/MWh (total price of $1,620,000).

When a retailer enters into a futures contract as buyer, it enters into an agreement to buy electricity at a predetermined price at a specified time in the future. Therefore, the price for the electricity that it will use in the future is determined in advance of the period where it is used. In the example, the failing retailer has entered into a futures contract under which it has agreed to pay $4,402,080 on the expiry date of the contract, as a financial hedge against spot price volatility.

On 30 June 2022, the retailer fails due to not meeting its AEMO prudential requirements. This triggers a RoLR event and its customers are transferred to the designated RoLR. The now failed retailer's contracts with the ASX remain in force and now have the following market value:

- 10MW Q3 2022 base futures contract for $345.23/MWh (total price of $7,622,678)
- 10MW Q4 2022 base futures contract for $263.49/MWh (total price of $5,817,859)
- 10MW Q1 2023 base futures contract for $245/MWh (total price of $5,292,000).

The AER determines that a trigger was reached and issues a direction to the designated RoLR and the failed retailer. This results in two things happening immediately following the transfer date:

1. For a predefined high-risk period — direction to provide the designated RoLR with all contracts used to manage price risk.
2. For a predefined medium-term period — direction to negotiate new contracts with reference to the current contract at mark-to-market value.

For the purposes of this example, the high risk period is 3-months following the transfer date and the medium-term period is the 9-months following the high-risk period. One year is addressed through the directions process after which the designated RoLR must acquire hedging contracts as it does for the rest of its load.

1) High-risk period direction

The designated RoLR has the right, but not the obligation, to access equivalent hedging to reduce spot exposure for 10MW of base futures equivalent load. To facilitate this, the failed retailer must either:

- **sell** the 10MW Q3 2022 contract to the designated RoLR at the price it was originally purchased for thereby allowing the designated RoLR to:
  - pay the failed retailer for the contract coverage: $1,457,280
  - receive the 10 MW base futures contract coverage from the failed retailer
  - reduce spot exposure by $3,518,448 (the difference between what the designated RoLR paid for the contract and the closing price for the contract which typically corresponds to time-weighted average price in the quarter).
- **pay** the designated RoLR the difference between the original price of the Q3 2022 base futures contract and the price on 30 June 2022 to effectively reduce the anticipated spot exposure for that period. In this case the designated RoLR:
  - receives $6,165,398 from the failed retailer (the difference between the purchase price on 29 October 2021 and the base futures price on 30 June 2022)
  - receives no contract

- is more than sufficiently protected from spot price exposure as market outcomes were milder than initially anticipated.

The counterparty to the contract (in this case, ASX Clear (Futures)) is not required to do anything as the failed retailer is still recognised as able to buy and sell contracts on the ASX.

2) Medium term direction

As with the high-risk period direction, the designated RoLR has the right, but not the obligation, to negotiate the contracts in the medium-term period with the failed retailer.

The negotiation must be based on the failed retailer's contract with reference to current market conditions. In this instance a simple negotiation would have the following outcomes if the designated RoLR wished to purchase the contracts with reference to the contract price on the transfer date (30 June 2022). The designated RoLR would buy from the failed retailer:

- for Q4 2022 — 10MW base futures contract for $263.49/MWh
- for Q1 2023 — 10MW base futures contract for $245/MWh
- for Q2 2023 — no contracts would be purchased as the failed retailer did not hold any.

The negotiation would need to be done within a predefined negotiation period with reference to a specific set of market conditions (e.g. within a range of prices in the month following the transfer date) as market conditions change regularly. This is to minimise the likelihood of the designated RoLR stalling negotiations in the hope prices may fall or the failed retailer stalling negotiations in the hope that prices may rise.

Initial observations for stakeholder feedback

The Commission's initial observations of the benefits and risks associated with this option are set out below and in Figure 5.3 for stakeholder feedback.

- *Benefits*:
  - reduce the systemic risks associated with taking on a large number of customers in a short period
  - reduce costs to customers for the high-risk direction period if contracts are 'in the money'
  - reduce overall costs to customers if contracts in the medium-term could not otherwise be purchased.
- *Risks*:
  - likely complex to implement and difficult to enforce including relying on entities that are not governed by energy laws and rules
  - may increase the risks and costs associated with entering the market if potential creditors may not be able to claim the full expected value of the remaining assets in the event of failure
  - may incentivise the failing retailer to sell or transfer contracts prior to failure.

Figure 5.3: Option 3a initial observations for stakeholder feedback

Assessment criteria	Initial observations
Criterion 1: Efficiency	Reduce overall costs to customers for the high-risk direction period if contracts held by the failed retailer are 'in the money'. Reduce overall costs to customers if the contracts could not otherwise be purchased, potentially reduces the costs the RoLR may seek to recover through the cost recovery scheme. Negotiation requirement may improve the efficiency with which the designated RoLR can seek out new contracts
Criterion 2: Appropriate allocation of risk	Initial coverage in the high-risk period on terms provided to the failed retailer reduces systemic risk for the designated RoLR in taking on many customers in a short period. Requirement to negotiate new contracts with reference to the failed retailer's contracts may reduce re-contracting time. May increase the risks and costs associated with entering the market if potential creditors may not be able to claim the full expected value of the remaining assets in the event of failure.
Criterion 3: Incentives	May incentivise the failing retailer to sell or transfer contracts to not be the subject of the direction.
Criterion 4: Predictability and stability	Can broadly apply across all contracts with some nuances around who participates in negotiations with the RoLR: • exchange traded: clearing house such as ASX Clear (Futures) (if terminated) and the failed retailer (if still in-force) • OTC traded: the counterparty to the contract, likely a generator (if terminated) and the failed retailer (if still in-force) Incentives to frustrate negotiations that would need to be managed if the failed retailer's contract is in the money relative to current market conditions: • the designated RoLR: to keep the direction on foot for as long as possible (negotiations or purchasing contracts at market value would be more costly).
Criterion 5: Simplicity and transparency	Can broadly apply across all contracts, however complexity for determining current market prices for bespoke OTC contracts that may require negotiation principles or guidance.
Criterion 6: Timing and uncertainty	Practically may be implemented through the NERL, similar to the s.137 RoLR gas directions powers. Sensitive to implement as this option addresses price, cost, and financial stability risks rather than risks to physical supply. Complex implementation for the AER to issue directions to counterparties to contracts not typically regulated in energy such as ASX Clear (Futures) and financial institutions.

Source: AEMC analysis

Note: Colours indicate the following estimated impacts of the option relative to current arrangements: dark green — notably better, light green — marginally better, grey — no change, orange — risk, red — high risk.

QUESTION 11: OPTION 3A KEY POLICY ISSUES

1. The Commission recognises this option is complex and may raise practical and legal challenges. We therefore seek stakeholder feedback on the following:
   a. barriers to either gaining the agreement to transfer contracts or for issuing a direction to a financial institution (such as ASX Clear (Future) or a financial institution)?
   b. implementation challenges — how broad are the legislative changes may be needed to give effect to this option?
   c. appropriate triggers for the making of a direction?
2. Do you agree or disagree with the initial observations for option 3a? Please explain and provide evidence.
3. Do you have specific feedback on any aspect of option 3a including feasibility, implementation or detailed design?

5.1.4 Option 3b: Introduce a directions framework with reference to current contract at the contracted price

As set out above, electricity retailers source the energy needed to service their customers through the gross-pool spot market. Therefore, designated RoLRs without sufficient hedging protection face the risk of spot price exposure. To mitigate this price risk, like Option 3a above, Option 3b would seek to replicate the existing NERL section 137 RoLR gas directions powers to apply to electricity hedging contracts for failed electricity retailers (section 2.5). However, unlike Option 3a which is by reference to the existing contract with the failed retailer but at the current market price, Option 3b proposes that the relevant contract be negotiated or novated at the contracted price. To the extent that this realises a cost saving to the designated RoLR, additional measures would need to be put in place to ensure these are passed to customers through lower prices.

This solution comprises multiple parts. First, the AER's information gathering powers would be improved such that it can access the failing retailer's contract information to make an informed decision on whether to issue a direction.

Second, a trigger would be needed upon which the AER may issue such a direction. This trigger may involve a materiality threshold such as a retailer failure above a certain size, liquidity constraints or extreme market conditions. As with Option 3a, we would need to consider whether there is any likely effect on the ability for retailers to obtain credit under this solution. This is because, if a direction is issued to a failed retailer under this scenario, the failed retailer's creditors may not be able to claim the full expected value of the remaining assets (that is, electricity hedging contracts). The Commission is seeking stakeholder views on appropriate triggers.

Third, the direction, if issued, would have two parts following the RoLR event and transfer of customers to the designated RoLR:

1. For a pre-defined high-risk period — a direction from the AER to the failed retailer and counterparties to the failed retailer's contracts requiring them to provide to the designated RoLR, either through contracts or payments, the equivalent hedge protection provided by any hedging instruments identified by the AER.
2. For a predefined medium term period — a direction from the AER to the failed retailer and counterparties to negotiate new contracts with reference to the current contract at the original price the failed retailer paid for the contract.

The Commission's initial views in relation to the periods that may be of high risk and costs to the designated RoLR are set out in section 4.2.

The two parts of the direction have different implications depending on whether the contract is terminated or in force and whether the hedging instrument was exchanged-traded or purchased OTC (described in section 2.4 and appendix D.1). The high risk period direction is the same as described in section 5.1.3. The Commission's preliminary view on how this option would play out for the medium-term direction scenario is described below (Table 5.5). The intention is that this would facilitate the transfer of electricity contracts between the failed retailer and the designated RoLR. However, we recognise this would require the consent of the clearing house for exchange traded contracts, or a directions power for clearing houses noting these entities are not covered by energy law and rules.

The Commission notes these issues are highly complex and seeks stakeholder views on the practicality of these scenarios and any risks or barriers.

Table 5.5: Option 3b — medium-term period negotiations

	EXCHANGE TRADED HEDGING CONTRACTS	OTC TRADED HEDGING CONTRACTS
Contract still in force	Direction issued to the **failed retailer** and **counterparty** (e.g. ASC Clear (Futures)) to negotiate a new contract with reference to the failed retailer's medium-term contract(s) at their contracted price.	Direction issued to the **failed retailer** and **counterparty** (e.g. generator) to negotiate a new contract with reference to the failed retailer's medium-term contract(s) at contracted price.
Contract terminated as a result of the RoLR event	Direction issued to the **counterparty** to the terminated contract (ASX Clear (Futures)) to negotiate a new contract with reference to the terminated medium-term contract(s) contracted price.	Direction issued to the **counterparty** to the terminated contract (e.g. generator) to negotiate a new contract with reference to the terminated medium-term contract(s) at contracted price.

Note: In all circumstances, the designated RoLR has the option, but not the obligation to purchase negotiate for these contracts at current market value.

The AEMC's initial view of how this would practically play out using a simplified illustrative example is set out in Box 4.

BOX 4: OPTION 3B SIMPLIFIED ILLUSTRATIVE EXAMPLE

The following simplified illustrative example seeks to highlight the practical implications of this option. For simplicity this example focuses on a NSW failing retailer that uses exchange-traded derivative contracts to manage its load. Through consultation, we hope to gain a clearer understanding of how this option may play out under each scenario.

This example is the same as the example used to describe Option 3a to highlight the difference in outcomes. Therefore, the information used in the case study and the high-risk direction period is identical to the example used to describe Option 3a. The key difference between the options is the medium-term period which is described below.

2) Medium term direction

As with the high-risk period direction described in Option 3a in Box 3, the designated RoLR has the right, but not the obligation, to negotiate the contracts in the medium-term period with the failed retailer.

The negotiation must be based on the failed retailer's contract with reference to the original contract price. In this instance a simple negotiation would have the following outcomes if the designated RoLR wished to purchase the contracts with reference to the contract price on the date it was originally purchased (29 October 2021). The designated RoLR would buy from the failed retailer:

- for Q4 2022 — 10MW base futures contract for $60/MWh
- for Q1 2023 — 10MW base futures contract for $75/MWh
- for Q2 2023 — no contracts would be purchased as the failed retailer did not hold any.

This would result in significant hedging benefits for the designated RoLR thereby reducing systemic risks, wholesale costs and costs to customers. Relative to the transfer date of 30 June 2022, purchasing these contracts would result in more than $8,165,000 savings for the designated RoLR. However, this would result in an opportunity cost to the counterparty of the contract for not being able to strike a new contract at the higher market price.

Initial observations for stakeholder feedback

The Commission's initial observations of the benefits and risks associated with this option are set out below and in Figure 5.4 for stakeholder feedback.

- *Benefits*:
  - reduce the systemic risks associated with taking on a large number of customers in a short period
  - reduce costs to customers for both the high-risk direction and medium-term negotiation periods if contracts are 'in the money'
  - reduce overall costs to customers.
- *Risks*:
  - likely to be complex to implement and difficult to enforce including relying on entities that are not governed by energy laws and rules
  - may increase the risks and costs associated with entering the market if potential creditors may not be able to claim the full expected value of the remaining assets in the event of failure
  - may incentivise the failing retailer to sell or transfer contracts to another entity prior to failure.

Figure 5.4: Option 3b initial observations for stakeholder feedback

Assessment criteria	Initial observations
Criterion 1: Efficiency	Reduce overall costs to customers for the high-risk direction period if contracts held by the failed retailer are 'in the money'. Reduce overall costs to customers, reduces the costs the RoLR may seek to recover through the cost recovery scheme if contracts held by the failed retailer are 'in the money'. Negotiation requirement may improve the efficiency with which the designated RoLR can seek out new contracts
Criterion 2: Appropriate allocation of risk	Initial coverage in the high-risk period on terms provided to the failed retailer reduces systemic risk for the designated RoLR in taking on many customers in a short period. Requirement to negotiate new contracts with reference to the failed retailer's contracts at the originally agreed value will reduce costs to the designated RoLR and facilitate lower prices for customers (especially larger loads). May increase the risks and costs associated with entering the market if potential creditors may not be able to claim the full expected value of the remaining assets in the event of failure.
Criterion 3: Incentives	May incentivise the failing retailer to sell or transfer contracts to not be the subject of the direction.
Criterion 4: Predictability and stability	Can broadly apply across all contracts with some nuances around who participates in negotiations with the RoLR: • exchange traded: clearing house such as ASX Clear (Futures) (if terminated) and the failed retailer (if still in-force) • OTC traded: the counterparty to the contract, likely a generator (if terminated) and the failed retailer (if still in-force) Incentives to frustrate negotiations that would need to be managed if the failed retailer's contract is in the money relative to current market conditions: • the failed retailer – because they would make more money by selling the contract at current market price • the counterparty to the contract – because they would make more money by negotiating a new contract at current market price
Criterion 5: Simplicity and transparency	Can broadly apply across all contracts, however complexity for determining and enforcing clearing houses to negotiate with reference to the contract price that may be materially different to the current market price, especially after margining.
Criterion 6: Timing and uncertainty	Practically may be implemented through the NERL, similar to the s.137 RoLR gas directions powers. Sensitive to implement as this option addresses price, cost, and financial stability risks rather than risks to physical supply. Sensitive to implement as 'in the money' contracts may give competitive advantage to the designated RoLR Complex implementation for the AER to issue directions to counterparties to contracts not typically regulated in energy such as ASX Clear (Futures) and financial institutions.

Source: AEMC analysis
Note: Colours indicate the following estimated impacts of the option relative to current arrangements: dark green — notably better, light green — marginally better, grey — no change, orange — risk, red — high risk.

QUESTION 12: OPTION 3B KEY POLICY ISSUES

1. The Commission notes this option is likely to be complex to implement and may have unforeseen consequences. The Commission seeks stakeholder feedback on the following:
   a. adverse market impacts in requiring that a contract be negotiated on its original terms?
   b. barriers to issuing a direction to any entity including a financial institution (such as ASX Clear (Futures)) to negotiate a contract at the initially agreed (book value) price?
   c. implementation challenges — how broad are the legislative changes that may be needed to give effect to this option?
   d. appropriate triggers for the making of a direction?
2. Do you agree, disagree or have feedback on the initial assessment for Option 3b? Please explain and provide evidence.
3. Do you have specific feedback on any aspect of Option 3b including feasibility or implementation?

5.1.5 Option 4: Use failed retailer's 'in the money' electricity contracts to minimise RoLR cost recovery

The NERL incorporates a process through which a designated RoLR can apply to the AER to recover the costs that it incurs on or after a RoLR event (section 5.1.1 and appendix A.4). Option 4 would seek to make explicit that RoLR cost recovery includes wholesale and/or hedging costs incurred to serve the new customers in a defined period after the RoLR event. However, unlike Option 1 where the costs were recovered through the current mechanisms, under Option 4, the costs would firstly be paid for by the failed retailer through the sale of its 'in the money' hedges. If some or all of the value of the failed retailer's contracts can be accessed and used for this purpose, an option is to amend the RoLR cost recovery arrangements to only include any net costs incurred by the RoLR in taking on the failed retailer's customers.

How the failed retailer contributes to the RoLR cost recovery scheme would be different depending on whether the contract is terminated or in force and whether the hedging instrument was exchanged-traded or purchased OTC (described in section 2.4 and appendix D.1). The Commission's preliminary view on how this option may work under each scenario is described below Table 5.6. However, the Commission notes these issues are highly complex and is exploring the legal issues associated with this kind of regulatory reform, in addition to the policy merit of the potential solutions. With this in mind, the AEMC seeks stakeholder views on the benefits and practicality of these potential solutions, and any risks or barriers.

The United Kingdom recently implemented some similar short term reforms to improve the financial resilience of the retail market to supplier of last resort events including a 75% tax on contracts sold by a failed retailer if it deliberately tried to make its contracts unavailable for use in their Special Administrator Scheme. Ofgem recently finished consultation on exploring some longer term measures similar to Option 4 to preserve the value of the failed retailer's contracts. These are described in the section 1.2 and appendix B.

Table 5.6: **Option 4 — failed retailer funding the cost recovery payments**

	EXCHANGE TRADED HEDGING CONTRACTS	OTC TRADED HEDGING CONTRACTS
Contract still in force	Direction issued to the **failed retailer** to sell all 'in the money' contracts used to service its customers. The proceeds of this sale are paid into a separate fund that is used to pay for the designated RoLR's cost recovery.	Same as for exchange-traded hedging contracts still in force.
Contract terminated as a result of the RoLR event	Direction issued to the **counterparty** to the terminated contract (e.g. ASX Clear (Futures)) to pay the remaining contract balance at the point of termination into a separate fund that's used to pay for the designated RoLR's cost recovery.	Same as for terminated exchange-traded hedging contracts.

Initial observations for stakeholder feedback

The Commission's initial observations of the benefits and risks associated with Option 4 are set out below and in Figure 5.5 for stakeholder feedback.

- *Benefits*:
  - reduce the systemic risks associated with taking on a large number of customers in a short period
  - reduce costs to customers for both the high-risk direction and medium term negotiation periods if contracts are 'in the money'
  - reduce overall costs to customers
- *Risks*:
  - likely highly complex to implement and difficult to enforce
  - may increase the risks and costs associated with entering the market as a small retailer
  - may incentivise failing retailer to sell or transfer contracts prior to failure
  - may increase costs to customers if retailers not incentivised to efficiently manage well following a RoLR event.

Figure 5.5: Option 4 initial observations for stakeholder feedback

Assessment criteria	Initial observations
Criterion 1: Efficiency	Reduce overall costs to customers for the high-risk cost recovery period if the failed retailer's contracts used to fund the cost recovery are 'in the money'. Outside the high-risk period, no improvements to overall costs to customers relative to current arrangements. Requirement for the failed retailer to sell its contracts to fund the cost recovery scheme may enable the designated RoLR to quickly seek out new contracts.
Criterion 2: Appropriate allocation of risk	Clarifying cost recovery to explicitly include wholesale and hedging costs may reduce the systemic risks of taking on many customers in a short period. However, should cashflow issues emerge as a result of the RoLR event, this may not prevent cascading failures and is no better than current arrangements. May increase the risks and costs for new retailers as the likelihood of recovering costs through assets (i.e., customers and contracts) in the event of retailer failure would be significantly impacted by this option.
Criterion 3: Incentives	May incentivise the failing retailer to sell or transfer contracts prior to the RoLR event or hold them within separate corporate entities to not be the subject to funding the cost recovery. If not well-designed, may incentivise designated RoLRs to not minimise costs and result in significant cost recovery bills for customers.
Criterion 4: Predictability and stability	Can broadly apply across all contracts with variations depending on whether contracts remain in force or terminated: • remain in force: the failed retailer would be forced to sell its contracts and pay the proceeds of the sale into a separate fund that would be used to pay for the designated RoLR's cost recovery • terminated: the amount paid for the contract up until the point of termination is already paid to the counterparty to the contract. The counterparty would then pay the remaining balance at the point of termination into a separate fund that would be used to pay for the designated RoLR's cost recovery.
Criterion 5: Simplicity and transparency	Explicitly setting out how costs may be recovered will facilitate clear guidance on RoLR cost recovery for wholesale and hedging costs
Criterion 6: Timing and uncertainty	Sensitive to implement as this option addresses price, cost, and financial stability risks rather than risks to physical supply Complex implementation for interaction for the order of creditors if the RoLR event triggered by an insolvency Complex implementation for establishing the cost recovery fund, enabling timely access, and enforcing the fund's use Complex implementation for existing contracts that have agreed terms for termination and sale.

Source: AEMC analysis

Note: Colours indicate the following estimated impacts of the option relative to current arrangements: green — notably better, light — marginally better, grey — no change, orange — risk, red — high risk.

QUESTION 13: OPTION 4 KEY POLICY ISSUES

1. The Commission notes this option has some challenges and is exploring the legal issues associated with this option. We seek stakeholder feedback on the following:
   a. if the RoLR event is triggered by insolvency official appointment, how would this intersect with the line of creditors for the failed retailer?
   b. whether and how a fund or separate place for proceeds of contracts may be held in the event of retailer failure?
   c. implementation challenges — how broad are the legislative changes that may be needed to give effect to this option?
2. Do you agree or disagree with the initial observations for option 4? Please explain and provide evidence.
3. Do you have specific feedback on any aspect of option 4 including feasibility, implementation or detailed design?

5.2 Expanding the AER directions for gas to include storage contracts

Currently the AER's directions powers under section 137 of the NERL do not extend to making directions regarding gas storage contracts. Expanding the RoLR framework to include storage contracts would give the designated RoLR the option to have the necessary contractual ability to cover the peak demand of the customers that they would be responsible for after a retailer fails. Gas storage contracts can be a useful tool to manage peak demand days when the amount of gas contracted through supply agreements may not be adequate to meet customer demand. See appendix C.2.3 for more information on storage contracts.

The Commission considers that since the RoLR scheme was first introduced in 2011, gas storage contracts have become a commonly used product to assist gas retailers to manage their gas use over the longer term. Therefore, we are looking for stakeholder views on the appropriateness of contracts that are primarily used over longer periods to minimise the risk of RoLR events triggering financial stress.

Initial observations for stakeholder feedback

The Commission's initial observations of the benefits and risks associated with this option are set out below and in Figure 5.6 for stakeholder feedback.

- *Benefits*:
  - contractual ability to cover peak demand for new customers received from the RoLR event
  - potentially reduces the need for the designated RoLR to apply for cost recovery for peak demand not covered by gas supply contracts.
- *Risks*:

- may support the designated RoLR beyond the high risk period, potentially providing the designated RoLR with a competitive advantage
- the materiality of the use of storage contracts may not be sufficient to warrant its inclusion.

Figure 5.6: Initial observations on RoLR directions for gas storage contracts for stakeholder feedback

Assessment criteria	Initial observations
Criterion 1: Efficiency	Give the designated RoLR the contractual ability to cover peak demand for new customers received from the RoLR event Potentially reduces the need for the designated RoLR to apply for cost recovery for peak demand not covered by gas supply contracts, thereby reducing overall costs to customers
Criterion 2: Appropriate allocation of risk	The materiality of the use of storage contracts may not be sufficient to warrant its inclusion May reduce systemic risks or costs for the designated RoLR and customers if customer load varies throughout the year such that gas supply contracts require storage to effectively manage load May support the designated RoLR beyond the high-risk period, potentially providing the designated RoLR with a competitive advantage
Criterion 3: Incentives	Similar to other RoLR gas directions arrangements
Criterion 4: Predictability and stability	Can broadly apply across all contracts with some nuances around who participates in the auction.
Criterion 5: Simplicity and transparency	Similar to other RoLR gas directions arrangements Potentially complex to determine how the gas in the storage facility (as the case may be) should be treated
Criterion 6: Timing and uncertainty	Practically may be implemented as it currently exists for gas in the NERL. May be sensitive for depending on the duration of the storage agreement and the potential competitive advantage it could provide to the designated RoLR.

Source: AEMC analysis
Note: Colours indicate the following estimated impacts of the option relative to current arrangements: green — notably better, light — marginally better, grey — no change, orange — risk, red — high risk.

QUESTION 14: EXPANDING AER ROLR GAS DIRECTIONS TO INCLUDE STORAGE CONTRACTS

1. Should the AER's existing powers in relation to making directions under NERL section 137 be expanded to include storage contracts?
2. The Commission notes this option raises complex issues and we seek stakeholder feedback on the following:
    a. Whether the gas held in storage and the contract for storage should be considered together or separately?
    b. If separately, how should any gas already held within the storage facility be treated?

5.3 Improving the current AER directions for gas supply

The Commission considers it is worth analysing potential improvements to the current RoLR gas directions framework. This section therefore sets out some potential issues to be considered.

The AER currently has the power to direct contracts for gas supply and pipeline capacity to the designated RoLR under section 137 of the NERL, as described in chapter 2. The recent RoLR event of Weston caused the AER to use its powers to direct gas supply for the first time, however, pipeline capacity directions remain untested.

Set out below are some proposed amendments to the AER's power under section 137 of the NERL. While the Commission considers these changes are feasible and may develop detailed policy solutions for feedback in Stage 2 of the Review, early feedback is encouraged to feed into the recommendations for electricity retailer contracts. The Commission's initial view is that potential opportunities for improvement in the directions framework include:

1. Broadening the trigger for the RoLR gas directions to make explicit that the AER may consider prevailing market conditions and pricing in the context of the NERO and NGO.[15]
2. Increasing the directions powers for gas supply, pipeline capacity and transmission capacity from its current level of three months to a longer period, both to ensure continuity of gas supply to the designated RoLR to service its new customers and facilitate a longer negotiation period between the relevant parties to negotiate new gas contracts.
3. Clarifying whether a direction should continue regardless of whether the contract expires or would have expired during the direction period. The Commission considers the current provisions are ambiguous and it is not immediately clear in the existing wording what would occur if the contract were to expire during the direction period.

15 Currently, section 137(1) of the NERL states that the AER may issue a direction for gas supply if there is no declared wholesale gas market or short term trading market or where, in the opinion of the AER, sufficient capacity or gas is not available in a short term trading market.

4. Including an express requirement for all entities involved in the direction (the designated RoLR, the failed retailer and the gas producer) to negotiate in good faith or with best endeavours to negotiate new contracts. For contracts that remain in-force, consider including a requirement that the benefit of the direction must be passed to the designated RoLR and affected customers.

The Commission considers to the extent it is appropriate, these changes would also apply to RoLR gas directions for pipeline capacity, storage contracts and options that explore directions for electricity retailer contracts.

QUESTION 15: IMPROVING THE CURRENT AER DIRECTIONS FOR GAS SUPPLY

1. Should the trigger for the AER issuing directions be amended? If yes, please provide feedback on the following options:
    a. broaden the trigger such that the AER may consider prevailing market conditions and pricing in the context of the NERO and NGO?
    b. introduce a materiality threshold such that RoLR events above a certain size or impact threshold may result in the AER issuing a RoLR gas direction?
    c. any other thresholds you consider may be appropriate?
2. Are there any risks or issues you anticipate with increasing the directions period?
3. How should a direction where a contract expires during the direction period be treated?
    a. an express requirement for the direction to continue regardless of whether the contract expires or would have expired during the direction period?
    b. the direction ends when the original contract terms end?
4. Should there be a set of negotiation principles between the designated RoLR and the failed retailer?
    a. If so, what principles should be included?
    b. What risks are associated with negotiation principles being introduced?

6 RETAILER BEHAVIOUR DURING VOLATILE MARKET CONDITIONS

In the recent volatile market conditions, the Commission observed some unusual retailer behaviour. This included a retailer almost doubling its retail price offers in a 20-day period, and assertively encouraging its customers to leave its services. Following this conduct, there are reports that the retailer then sold its hedging contracts for more than $40 million.[16]

While there is no evidence of customers having supply or disconnection issues as a result of such conduct, large and sudden shifts in offers, combined with assertive requests to change retailers may result in broader customer or market harm that may warrant consideration of regulatory reforms. As energy is an essential service, it may warrant a higher threshold of behaviour from retailers in terms of communication and offers to be in the long term interest of customers.

The Commission is exploring the nature and magnitude of the problem arising from this conduct (if any) and seeks stakeholders views on these issues. For example, the Commission considers the following issues warrant further exploration in this review:

- rapid increases in customer offers with little notice
- assertive communications requesting customers to change retailers
- electricity retailers not appropriately hedging customer load thereby being exposed to large changes in wholesale prices
- significant and potentially speculative contract market activity by physical market participants.

QUESTION 16: NATURE AND MATERIALITY OF THE PROBLEM

1. Do you consider that the above retailer behaviour is an issue that should be considered further in this Review?
2. Do you consider this is a material issue? If yes, please explain and provide evidence.

16 Australian Financial Review, https://www.afr.com/companies/energy/energy-retailers-investigated-for-100m-hedges-20220707-p5azvc.

7 LODGING A SUBMISSION

Written submissions on this consultation paper must be lodged with Commission by 10 November 2022 online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code RPR0016.

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Where practicable, submissions should be prepared in accordance with the Commission's guidelines for making written submissions. The Commission publishes all submissions on its website, subject to a claim of confidentiality.

All enquiries on this project should be addressed to Sam Markham at sam.markham@aemc.gov.au.

ABBREVIATIONS

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AFMA	Australian Financial Markets Association
ASX	Australian Securities Exchange
Commission	See AEMC
DMO	Default Market Offer
DWGM	Declared Wholesale Gas Market, in Victoria
FEX	Finance and Energy Exchange
GSA	Gas supply agreement
GTA	Gas transportation agreement
ISDA	International Swaps and Derivatives Association, Inc.
MCE	Ministerial Council on Energy
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National electricity objective
NERL	National Energy Retail Law
NERO	National energy retail objective
NGL	National Gas Law
NGO	National gas objective
Ofgem	UK Office of Gas and Electricity Markets
OTC	Over-the-counter, referring to contracts
PPA	Power Purchase Agreement
RoLR	Retailer of Last Resort
SoLR	Supplier of Last Resort (used in the Great Britain retail market)
STTM	Short term trading market
ToR	Terms of Reference

A RETAILER OF LAST RESORT SCHEME

This appendix sets out additional detail on the existing regulatory framework for a failed retailer to exit the market through the RoLR mechanism.

Table A.1: Key terms

ROLR TERM	DESCRIPTION
Designated RoLR	A registered RoLR who is appointed or is taken to be appointed as a designated RoLR for a RoLR event. (NERL section 122)
Failed retailer	A retailer (or former retailer) in relation to whom a RoLR event has occurred. (NERL section 122)
RoLR event	The NERL defines the following events or circumstances as "RoLR events": • revocation of retailer's authorisation; • suspension of the right of a retailer to acquire electricity or gas from the wholesale exchange or wholesale gas or short term trading market (AEMO initiated) or ceasing to be a registered participant; • appointment of an insolvency official; • an order to wind up the retailer is made or a resolution is passed to wind up the retailer; • the retailer ceases selling energy (for reasons other than the transfer or surrender of its retailer authorisation; or • transfer of all or some of its customers to another retailer; or • selling or otherwise disposing of all or part of its business); • any other event or circumstances prescribed in the National Regulations. (NERL section 122)
RoLR cost recovery scheme	A designated RoLR can apply to the AER to recover the costs that it incurs on or after a RoLR event. A default RoLR may also apply to recover costs incurred in preparing for RoLR events. (NERL Division 9)
Transfer date	The date on which the customers of the failed retailer are transferred to the relevant designated RoLR. On and from the transfer date, and in relation to the customers transferred to it and subject to and in accordance with the RoLR Procedures, the designated RoLR assumes the functions and powers of the failed retailer under the energy laws. (NERL section 136(2)(e) and 140)
RoLR scheme	Means the RoLR scheme constituted by the NERL, the RoLR procedures and the National Regulations. (NERL section 122)

ROLR TERM	DESCRIPTION
RoLR cost recovery guiding principles	In assessing a RoLR cost recovery scheme application, the AER must be guided by the following principles: (a) the registered RoLR should be provided with a reasonable opportunity to recover the reasonable costs that it incurs with respect to the RoLR scheme, (b) the recovery of costs should allow for a return commensurate with the regulatory and commercial risks with respect to the RoLR scheme, (c) the registered RoLR will itself bear some of the costs, in proportion to its customer base. (NERL section 166)

Source: NERL

A.1 RoLR registration

The AER must both initially and afterwards at such times as it considers appropriate call for an expression of interest from retailers for registration as a RoLR.[17] A retailer may lodge an expression of interest with the AER either in response to an AER call for expressions of interest or at any other time.[18] A RoLR expression of interest may contain proposals as to:

- customers or classes of customers the retailer will accept as its customers if it were to be appointed a designated RoLR in respect of a RoLR event
- numbers of customers the retailer will accept if it were to be appointed a designated RoLR in respect of a RoLR event
- variation to the retailer's RoLR cost recovery scheme.[19]

The NERL requires a "default RoLR" to be appointed by the AER at all times for each electricity connection point.[20] In practice, default RoLRs are typically AGL, Origin, EnergyAustralia or a government-owned entity. Retailers can also submit an expression of interest to the AER to become an 'additional RoLR'. The AER has established two categories of additional RoLRs:

- Firm offers – offers by a retailer to act as an additional RoLR under the terms of its expression of interest (which identifies the number and classes of customers it can take on in a RoLR event). This provides the AER confidence with other options other than the default RoLR.[21]
- Non-firm offers – an expression of interest by a retailer to act as an additional RoLR but, prior to appointment, the AER will confirm with the retailer whether it is prepared and

17 NERL, section 124(1).
18 NERL, section 124(2).
19 NERL, section 124(4).
20 NERL, section 125.
21 AER, RoLR guidelines, p. 6.

capable of being appointed under the terms and conditions of the expression of interest.[22]

The AER must maintain and publish a register of RoLRs.[23]

A.2 RoLR designation

When a RoLR event is triggered, a designated RoLR is appointed for each electricity connection point, and is responsible for taking on new customers and facilitating customer transfers from the failed retailer. Under the NERL, the default RoLR is taken to be appointed as the designated RoLR, unless the AER appoints a registered RoLR as a designated RoLR in respect of a RoLR event before the event actually occurs, and notifies AEMO before the transfer date.[24]

When determining whether to appoint a registered RoLR as the designated RoLR, the AER must consider:

- whether the registered RoLR has a RoLR cost recovery scheme, and if so what costs are recoverable and what is the amount of those costs
- the imminence of the RoLR event
- the RoLR criteria, which includes:
  - the extent to which the retailer has the necessary organisational and technical capacity to meet the obligations of a RoLR
  - the extent to which the retailer has adequate resources or access to adequate resources so that it will have the financial viability and financial capacity to meet the obligations of a RoLR
  - whether the retailer is suitable to be a RoLR taking into consideration the number and class of customers the retailer has and the areas which the retailer serves.[25]

The AER may consider appointing more than one designated RoLR for a RoLR event if the AER is of the opinion that it is appropriate to do so. When making the appointments, the AER must allocate responsibility for particular customers or classes of customers to each designated RoLR in a manner consistent with the RoLR guidelines.[26]

A.3 AEMO credit support requirements

A market participant which does not meet the acceptable credit criteria must provide an amount of credit support to AEMO which is at least equal to its maximum credit limit (MCL).[27] AEMO can change a participant's prudential settings at any time with one business day's

22 AER, RoLR guidelines, p. 6.
23 NERL, section 127.
24 NERL, section 132.
25 The AER can also take into consideration any other matters the AER considers relevant in the circumstances. NERL, section 133.
26 NERL, section 134.
27 NER, clause 3.3.5. AEMO determines an MCL for each participant based on a two per cent probability that a participant's outstandings to AEMO will exceed its MCL by the time the participant is suspended from the market, restricting residual settlement risk to very low probability events. The two per cent probability is referred to as the NEM prudential standard. This is set out in NER clause 3.3.4A.

notice.[28] Any changes that result in an increased MCL require the participant to increase its level of credit support.

A failure by the retailer to provide this increased credit support by the relevant time constitutes a default event.[29] AEMO may then issue a default notice to the participant.[30] If this is not rectified by 1pm the following day (or a later deadline agreed to in writing by AEMO), then AEMO may issue a suspension notice, under which AEMO notifies the market participant of the date and time from which it is suspended from the activities specified in the notice.[31]

Since the RoLR has responsibility for the acquired customers from the time of the transfer date specified in the RoLR notice,[32]its outstandings to AEMO will increase over the following month as energy is consumed. Nonetheless, it is required to procure additional credit support within 24 hours after being notified by AEMO.[33] Practically, this notification could be immediately, or up to a week after acquiring the additional customers.

One of the AEMC's recommendations endorsed by Energy Ministers in August 2022 for implementation and explained in section 1.1.2 is to extend the timeframe for a RoLR to meet AEMO's increased credit support requirements. This will reduce the immediate financial burden of acquiring mandatory additional customers and prevent the risk of default or suspension.

A.4 RoLR cost recovery arrangements

Part 6 Division 9 of the NERL includes a process for RoLRs to apply to the AER for cost recovery for the costs incurred in participating in, or preparing for, a RoLR event.[34] A registered RoLR cannot recover costs otherwise than in accordance with a RoLR cost recovery scheme determined under Division 9.[35] The designated RoLR does not take on any of the liabilities or obligations of the failed retailer.

In deciding whether to grant or refuse an application for cost recovery, the AER must be guided by the following principles:

- the registered RoLR should be provided with a reasonable opportunity to recover the reasonable costs that it incurs with respect to the RoLR scheme
- the recovery of costs should allow for a return commensurate with the regulatory and commercial risks with respect to the RoLR scheme

28 NER, clause 3.3.8(m).

29 NER, clause 3.15.21(a). AEMO's current prudential monitoring process allows credit support to be delivered by 10.30am Sydney time on the MCL effective date.

30 NER, clause 3.15.21(b).

31 NER, clause 3.15.21(c).

32 NERL, section 140.

33 NER, clause 3.3.18.

34 NERL, section 166. Under the AER's RoLR guidelines, applications must be made within nine months of the relevant RoLR event. See AER, Retailer of last resort statement of approach, November 2011.

35 NERL, section 165.

- the registered RoLR will itself bear some costs, in proportion to its customer base.[36]

The AER must determine that a distributor/s are to make payments towards the cost of the cost recovery scheme (a RoLR cost recovery scheme distributor payment determination).[37] Such a determination is taken to be a regulatory change event and a positive change event, for the purposes of the NER.[38] The distribution determination or access arrangement (as the case may be) for the distributor that is required to make payments under the RoLR cost recovery scheme is taken to be amended so as to render payments the distributor makes in respect of electricity as positive pass through amounts approved under the NER and as approved cost pass throughs allowing variation of the distributor's reference tariffs, in respect of gas.[39] Distributors are required to make payments to the RoLR in accordance with their liability under the RoLR cost recovery scheme distributor payment determination.[40]

One of the AEMC's recommendations endorsed by Energy Ministers in August for implementation explained in section 1.1.2 is to improve clarity and certainty of RoLR cost recovery arrangements.

36 NERL, section 166(7).
37 NERL, section 167(1).
38 NERL, section 167(2).
39 NERL, section 167(4).
40 NERL, section 167(3).

B INTERNATIONAL POLICY RESPONSES

B.1 Financial resilience measures in Great Britain

The Great Britain retail market has seen a large increase in retail competition in recent years. In the 5 years from 2016 to Q1 2022, 48 new retailers entered the market, often with business models that relied on a larger proportion of energy from short-term markets with a greater exposure to wholesale prices and capital provided by customers pre-paying for electricity.[41] These factors combined put strain on retailers when wholesale prices sharply increased, and some customers did not pay bills. As a result, from 2019 to end Q1 2022, 51 retailers exited the market.

These market conditions prompted Ofgem to consider how retail financial resilience may be enhanced in Great Britain. In May 2022, Ofgem made changes to limit the risk of the failed retailer holding contracts in a different corporate entity and therefore may not be accessible following a retailer failure:[42]

- the retailer must have some legally enforceable rights over the assets used to manage its business, including hedges, set out in the updated Financial Resilience Principles
- the retailer must have back-to-back agreements to prevent a third-party or parent company from liquidity valuable hedge positions.

In July 2022, Ofgem consulted on options to preserve the value of hedge positions following a retailer failure so the benefit may be realised by the SoLR or special administrator, and ultimately customers:[43]

- Option 1: a Licence change that requires that proceeds from liquidated 'in-the-money' hedges be paid directly by the counterparty to those positions into a separate trust, the money from which can therefore be paid to the SoLR in the event of retailer failure. This process is made easier under the Special Administration Regime.
- Option 2: a change to the contractual arrangement between customer and retailer that the retailer, in the event of insolvency, pays to the SoLR (acting on behalf of the customer) all costs incurred as a result of the retailer's insolvency, thus creating a debt owed to the customer, enforceable by the SoLR.
- Ofgem also considered transferring hedge positions from a failed retailer to a SoLR but decided against consulting on this approach, deeming it too difficult to implement.

The UK government has also implemented a temporary Public Interest Business Protection Tax currently in place for 12 months to 28 January 2023.[44] This is essentially a windfall

41 Ofgem noted in its Strengthening Retail Financial Resilience consultation that "whilst we recognise that, given the scale, pace, and duration of the price shock in the gas market, there would have been some supplier failures, too many suppliers operated with insufficient risk management practices and capital to manage their commercial risks and protect consumers." Ofgem, *Strengthening retail financial resilience*, Policy Consultation, 20 June 2022, London p. 6.

42 Ofgem, *Decision on the proposed guidance on the operational capability and financial responsibility principles*, decision letter to stakeholders, 23 May 2022, London.

43 The Special Administrator Regime (SAR) places a special administrator at the failing retailer to minimise costs to consumers and ensure security of supply. This mechanism is used when the SoLR regime is impractical, likely because it is a large retailer that has failed, and the customer base is too large to be realistically managed by a SoLR.
Ofgem, *Strengthening retail financial resilience*, Policy Consultation, 20 June 2022, London pp. 65-72.

44 HM Revenue & Customs, *Public interest business protection tax*, technical note, 28 January 2022, London.

profits tax to reduce the incentive for retailers to enter into insolvency and profit from the liquidation of 'in-the-money' hedge positions. In cases where a person has actively contributed to the energy retail business entering 'special measures' (Special Administration Regime, Supplier of Last Resort), has taken steps to make an asset unavailable for use for the benefit of the business, and the value of the asset exceeds £100 million, a tax of 75% of the asset's 'adjusted value' is applied. An adjustment of 10% is taken from the taxable amount to reflect the potential money lost in taking these steps. However, this tax has not yet been used or tested in court.

B.2 Other arrangements to enhance financial resilience and support customers with rising wholesale prices

Elsewhere in Europe, a range of schemes have been implemented to boost financial resilience and protect customers. These schemes include government financial support to retailers, bill subsidies and renationalising the energy retail sector.

Government financial support

In Germany, a scheme has been implemented which sees KfW, a government-owned bank, provide loans to retailers to cover large margin calls.[45] The intention of this scheme is to bolster liquidity as large margin calls may discourage hedging or shift contracts to OTC. This process has already been utilised by gas company Uniper, who have fully used a €9 billion credit facility, and the German government subsequently purchased a 99% stake for a further €8 billion.[46]

The German government has also updated the Energy Security of Supply Act and Energy Industry Act to include Price Adjustment Rules.[47] Closures of the Nord Stream gas pipelines have meant disrupted gas supply from Russia to Germany, and these rules allow retailers to pass the costs of these disruptions onto customers. The netted price adjustment instrument allows for the costs associated with buying large volumes of substitute gas, the values of which are independently assessed, to be passed on to customers uniformly. In April, the German government has also appointed an administrator at Gazprom Germania in order to ensure better security of gas supply.[48]

The Austrian Government has opened a €2 billion credit line for Wien Energie after they faced margin calls of €1.75 billion in a single day.[49] Wien Energie is owned by the City of Vienna and services around 2 million customers. As such, insolvency risk from large margin calls threatens the stability of the entire Austrian energy market, hence the liquidity support from the Austrian Government.

45 Federal Ministry for Economic Affairs and Climate Action, Federal Ministry of Finance, *New hedging instrument (margining) launched by the German Federal Government to protect companies affected by war*, media release, Berlin, 17 June 2022.

46 Uniper, *Agreement on amended stabilization package: Federal Government acquires 99% stake in Uniper*, media release, Düsseldorf, 21 September 2022.

47 Federal Ministry for Economic Affairs and Climate Action, *Federal Government equipping itself to cope with heightening tensions on the energy markets: federal cabinet adopts revision of Energy Security of Supply Act*, media releases, Berlin, 5 July 2022.

48 Bundesnetzagur, *Bundesnetzagur decides to appoint administrator for Gazprom Germania*, media release, Bonn, 08 April 2022.

49 F Murphy, 'Austria grants credit line to Vienna utility squeezed by power price surge', *Reuters*, 31 August 2022.

The UK government will implement an Energy Markets Financing Scheme. This is aimed at improving liquidity in energy markets and will provide GBP 40 billion of support for energy companies facing large margin calls amidst wholesale price volatility.

Bill subsidies

Government subsidies are currently commonplace in Europe. In light of rising wholesale prices, the following government support mechanisms have been established:

- **Germany** placed a windfall tax on non-gas generators to finance a €65 billion subsidy for customer energy bills. In the German government's view, the wholesale electricity prices seen in Europe are a result of high gas prices and therefore non-gas generators are making excess profits, the taxing of which can be used to fund this subsidy.[50]
- **Austria** introduced vouchers for energy bills equal to €150 per household and a retail subsidised price cap lasting until June 2024.[51]
- **Great Britain** has announced several policy measures to provide cost-of-living support to customers and financial support to businesses.[52] These include:
  - For household customers — the Energy Bill Support Scheme gives £400 to support bills, and Energy Price Guarantees will subsidise energy bills such that an average household can expect to pay no more than £2,500 per year for the next two years, an expected reduction of £1,000. This price guarantee is expected to cost the UK government £31 billion.
  - For businesses — the Energy Bill Relief Scheme — a 6-month support scheme aimed at businesses and non-domestic consumers and is expected to cost £26 billion.
- **France** introduced a "tariff shield" in autumn 2021 which saw regulated gas prices be frozen and electricity prices limited to a 4% increase.[53]

Renationalising retailers

The French government is also undertaking a full nationalisation of EDF to buy back the small proportion of EDF it does not already own.[54] Furthermore, the French government is expanding its Regulated Access to Historical Nuclear Energy (ARENH) system.[55] This system is a requirement for 25% of France's nuclear capacity, which is entirely owned by EDF, to be made available to retail competitors.[56]

50 The Federal Government, *The third relief package*, Press and Information Office of the Federal Government, Berlin, 5 September 2022, https://www.bundesregierung.de/breg-en/news/third-relief-package-2123130.

51 Federal Ministry of Finance, *Finance Minister Magnus Brunner says 150-euro energy costs voucher will now go to 4 million households*, media release, Vienna, 29 April 2022; M Eder, 'Austria to Cap Power Prices to Help Households With Rising Costs', *Bloomberg*, 5 September 2022.

52 HM Treasury, *The growth plan 2022*, policy paper, 23 September 2022, London, pp. 13-14, 25, 32.

53 J Castex (Prime Minister of France), *Un bouclier tarifaire pour faire face à la hausse des tariffs du gaz et de l'électricité*, Paris, 30 September 2021.

54 A Lawson, 'France to pay nearly €10bn to fully nationalise EDF', *The Guardian*, 19 July, 2022.

55 Commission de régulation de l'énergie, *ARENH*, glossary, https://www.cre.fr/Pages-annexes/Glossaire/arenh.

56 EDF, *Exceptional measures announced by the French Government*, media release, Paris, 13 January 2022.

Suite of proposals by the European Union

The European Commission, in a recent meeting of energy ministers, has introduced several proposals to reduce the impact of the energy crisis on customers across the European Union:[57]

- Revenue cap to be placed on 'inframarginal' generators. This cap is applied to low marginal cost, non-fossil fuel generators, such as VRE and nuclear and imposes a cap of €180/MWh. This is essentially a tax on revenue earned above €180/MWh which is paid to member state governments.
- 'Solidarity Contribution' which is to be applied to coal, gas, and oil companies and taxes profits above a 20% increase on the previous three years. Once again, this is to be paid to member state governments and be redirected towards consumers.
- On the demand side, the European Commission has proposed an obligation on member states to identify the 10% of hours with the highest expected price and reduce demand in those hours by 5%. This reduction in peak demand is part of a broader proposal to reduce overall demand.
- Requirements on member states that 80% of underground gas storage capacity be entirely filled before winter 2022/23 and 90% be filled before winter 2023/24. Increased gas storage, as well as an agreement among EU countries to reduce gas demand by 15% by March 2023, have been implemented with the aim of reducing Europe's dependency on gas and alleviating the associated high prices.[58]

B.3 Other Mechanisms to manage retailer failure

SoLR schemes

Other countries that have Supplier of Last Resort (SoLR) mechanisms as a precaution for retail failure includes the UK, Ireland, Austria, Norway, Belgium, the Netherlands, Italy and Denmark. Some other European countries have a SoLR-style scheme that places the Distribution Network Operator as the supplier of last resort which is distinct from the RoLR scheme where another energy retailer is appointed.

Germany

Following a retailer failure, customers are transferred to the largest retailer in the service area. The maximum price that these retailers may charge of customers passed on in this process is regulated by law, usually at 30% above the typical rate. There is no specific provision under this scheme to utilise the hedging positions of failed retailers.[59]

57 European Commission, *Proposal for a council regulation on an emergency intervention to address high energy prices,* explanatory memorandum, 14 September 2022, Brussels.

58 European Parliament, Council of the European Union, *Regulation (EU) 2022/1032 of the European Parliament and of the Council*, regulation, 29 June 2022, Brussels.

59 Act on Electricity and Gas Supply (Energy Industry Act – EnWG) Section 36-39; ebiX Business Group, *Survey: Supplier of Last Resort (SoLR)*, European forum for energy Business Information eXchange, 2 November 2020.

France

Following a retailer failure, the French Minister for Energy will publish the locations and number of customers affected by the retailer failure and call for applicants to service these customers. Retailers that meet a threshold of customers already being served in the relevant service areas are required to apply. The Minister then allocates customers accordingly.

Retailers can charge a higher price to customers for emergency supply; however this price is regulated on a case-by-case basis thereby giving price certainty for retailers to recover customer costs. This process does not make provisions to preserve the hedging positions of failed retailers.[60]

New Zealand

The New Zealand arrangements are quite different to the RoLR scheme and other arrangements discussed in this appendix. The New Zealand arrangements for retailer failures is a longer process, and focuses first on letting retailers, if possible, resolve their financial situation themselves. Where this cannot be done, customers are given seven days to choose a new retailer for themselves. This spreads the risks associated with suddenly taking on new customers across a greater number of retailers, reducing the chance of cascading failure. After the seven-day period, remaining customers are transferred to a new retailer by the Electricity Authority. [61]

In dealing with hedge positions in retailer default events, the Electricity Industry Participation Code outlines the approach for Hedge Settlement Agreements, which are a specific type of hedge that operate as a contract between two parties and the clearing manager for a predetermined price and quantity to be sold. In the event of retailer default, the clearing house simply cancels these contracts.[62]

60 Electricity — Code l'énergie Articles R333-17 to R333-29; gas — Code l'énergie Articles R443-14 to R443-27.

61 Electricity Authority, *Guideline for managing trader default situations*, guideline, 7 May 2021, Wellington.

62 Electricity Industry Participation Code 2010 (NZ) Clause 14.48, 14.9.

C CONTRACTS USED BY RETAILERS FOR ELECTRICITY AND GAS

Contracts are widely used across both the NEM and the east coast gas markets. Contracting allows retailers to minimise their exposure to volatile spot prices by entering into hedge contracts that fix or minimise the variation in their wholesale input costs for the period of the contract.[63]

C.1 Contracts used by electricity retailers

Financial products are the key contracts used by electricity retailers to manage risk. The NEM operates as a gross pool market, where generators bid in different quantities of generation at different prices. Demand and supply vary continuously throughout the day, and in turn, so does the electricity price. Fluctuations in price between the market floor price (-$1,000/MWh) and the market price cap ($15,500/MWh) create significant risks for retail participants.

The contract market plays a crucial role in allowing parties to manage their exposure to price volatility and uncertainty associated with the wholesale spot market outcomes.[64]

Electricity hedge contracts allow counterparties to agree to a fixed price for a financial transaction in the future based on the price of an underlying asset or commodity, such as the NEM spot price.[65] Importantly, spot prices provide the basis for forward contracting to manage risk.[66]

There are broadly two ways in which electricity hedge contracts are bought and sold:

- Exchange traded derivatives — The ASX and FEX are the two exchanges that facilitate contract trading in Australia. The contracts traded on the ASX are standardised, anonymous, and all prices and quantities are publicly available. Electricity futures products are available for Queensland, NSW, Victoria and South Australia.
- OTC contracts—OTC contracts are generally bi-lateral, bespoke and negotiated between the parties. These may include PPAs, load following hedges, swaps, caps and options.

C.1.1 Exchange-traded derivatives

Electricity futures and options are trading tools that allow businesses to anonymously manage risk or trade on volatility[67]. The ASX and FEX offer a range of different contracts for the NEM which can be categorised into three main contract types: futures, caps and options.

Description of the contracts

ASX electricity futures and options are cash settled contracts for difference (CFDs). They are written on standardised terms to facilitate trading on an exchange. Cash settlement enables

63 ACCC, Inquiry into the National Electricity Market, May 2022 report, p. 7.

64 Ibid.

65 AEMC, Contingency arrangements for five minute settlement implementation, Consultation paper, 5 August 2021, p. 26.

66 AEMC, Five Minute Settlement, draft determination, 5 September 2017, p. 5.

67 ASX, here

persons to participate in the exchange-traded market without having any interest in the physical electricity market. For these agreements the buyer and seller agree on a strike price, the buyer of the cap or swap then pays the wholesale spot price, while the seller agrees to pay them the difference between the strike price and the spot price if the spot is higher than the strike and vice versa in a swap contract where the buyer will pay the seller if the spot is less than the strike.[68]

Exchange-traded contract periods are monthly, quarterly and financial or calendar years for strips.

Futures: A futures contract is a legal agreement to buy or sell a particular commodity asset, or security at a predetermined price at a specified time in the future.

Using the products offered by the ASX, the futures available for the east coast electricity markets, excluding Tasmania, are:

- Monthly and quarterly futures: The buyer of a futures contract agrees to pay the seller the difference between the strike price and the spot price if the spot price is below the strike price. Whereas the seller agrees to pay the buyer the difference between the strike price and the spot price where the spot price is above the strike price.[69] Additional contract terms for these futures contracts are specified below.
- Peak load quarterly futures: peak load futures operate similarly to the quarterly futures mentioned above, however, the contract conditions only apply from 7.00 am – 10.00pm Monday to Friday and exclude public holidays and any other days determined by the ASX. A retailer may purchase these products if there is a significant difference between the profile of their customer demand by time of day and day of week.

Retailers will typically use futures to hedge the average or baseload component of their customer load profile. As they are a contract for a fixed number of megawatts for all hours of the contract period depending on the pricing in the cap and swap markets. Speculators often enter into futures and other hedges to meet other market needs. They do this by evaluating the risk of different events in the market and by selling other complimentary instruments.

Cap: A cap contract involves a party agreeing to sell to the other party (buyer) a fixed volume of energy for a fixed price when the spot price exceeds a specified price, which is typically \$300/MWh. This provides the buyer of the contract with insurance against electricity spot prices above this threshold between \$300.01/MWh and the market price cap of \$15,500/MWh.

Retailers typically use cap contracts to cover the flex in their load and uncertainty of high price events. Retailers may assess their risk position in terms of the number of hours of MPC that they can withstand and then buy caps to match that risk profile. This takes significant levels of simulation and replaying of historical outcomes to test the veracity of their strategy.

ASX contract terms specify that both futures and cap contracts, excluding peak load contracts, are comprised of 1 Megawatt of electrical energy per hour based on a base load

68 AER, Draft interim qualifying contracts and firmness guideline, May 2019, p. 21

69 AER, Draft interim qualifying contracts and firmness guideline, May 2019, p. 21.

profile (that means all hours in a period). Where the base load profile is defined as the Wholesale Electricity Pool Market base load period from 00:00 hours Monday to 24:00 hours Sunday over the duration of the Contract duration.[70]

Options: Options are contracts that give the holder the right, without the obligation, to enter into a contract at an agreed price, volume and term in the future. The buyer pays a premium for this added flexibility. An option can be either a call option (giving the holder the right to buy the underlying financial product) or a put option (giving the holder the right to sell the underlying financial product).

Options contracts can include standard options, such as captions and swaptions, which would be the right, but not the obligation, to buy (call) or sell (put) an underlying product such as a swap (a swaption) or a cap (a caption). Options contracts can also include average rate options, which are also commonly referred to as "Asian options".[71]

Clearing process

The following counterparty process is based on information from the ASX. The Commission understands this process is broadly similar for any exchange traded products.

The clearing of executed trades performs a critical role in the operation of Australia's financial markets. Clearing services help to reduce counterparty risk and provide transaction efficiency and certainty for investors.

The clearing process on the ASX is facilitated by the clearing house ASX Clear(Futures). As the central counterparty, ASX Clear(Futures) becomes the seller to every buyer and the buyer to every seller, making it liable for completing all cleared transactions on the relevant market. This occurs through a contractual process known as novation, in accordance with the operating rules of ASX Clear.[72]

Under novation, the original market contract between the trading participant representing the buyer and the trading participant representing the seller is discharged and replaced with two new contracts: one between ASX Clear(Futures) and the clearing participant representing the buyer, and the other between ASX Clear(Futures) and the clearing participant representing the seller. In this way ASX Clear(Futures) becomes the counterparty assuming the credit risk.

A trading participant is a broker authorised to trade on ASX's market, typically for a client, while a clearing participant is typically a broker authorised to clear trades through ASX's clearing house. We understand this process to be similar for FEX, as the clearing process is broadly similar across exchanges.

In any financial market transaction, market participants are subject to credit risk. Credit risk is defined as the risk that a counterparty defaults, or fails to make payment or perform on a transaction prior to or upon settlement. The amount at risk is quantified as the then-current

70 ASX, Contract specifications, March 2020, p. 21.

71 AER, Draft interim qualifying contracts and firmness guideline, May 2019, p. 23.

72 ASX, Clearing, available here.

mark-to-market value of the transaction plus any estimated change in that value over the term of the transaction.[73]

The credit default risk protection requires counterparties to post margin with the exchange to cover the amount of credit risk which is determined and managed through a mark-to-market process. As a result of this process, there is very little credit default risk involved and barriers to entry to this form of trading are therefore lower than the OTC market.[74]

Payment streams

Exchange-traded derivatives are purchased and settled through standard terms and conditions, the payment streams for ASX listed contracts are outlined below:

- **Futures:** Contracts are typically settled a few business days after the last trading day for the contract and are cash settled at the settlement price.[75] The Cash Settlement Price is calculated by taking the average of the five-minute Wholesale Electricity Pool Market base load spot prices over the Contract Quarter (or month, as applicable), rounded to the nearest cent.[76]
- **Cap:** Similar to futures, cap contracts are cash settled according to the same time frames as swap contracts. The cash settlement price for cap contracts differs as it only 'pays out' where the five-minute spot price exceeds $300/MWh and is subject to the following formula:[77]

Cash settlement price = (C - (300 × D)) / E Where:

C = the sum of all base load five-minute spot prices for the Region in the Calendar Quarter greater than $300/MWh.

D = the total number of base load five-minute spot prices for the Region in the Calendar Quarter greater than $300/MWh.

E = the total number of base load five-minute spot prices for the Region in the Calendar Quarter.

- **Option:** Options may be exercised on any business day up to and including the day of expiry. In-the-money options are automatically exercised at expiry.

Using the ASX's base load strip options, upon exercise, the holder will receive four base load calendar quarterly futures positions at prices equivalent to the option strike price, after applying the current curve ratio determined from the previous business day's settlement price

73 Foreign exchange committee, Tools for Mitigating Credit Risk in Foreign Exchange Transactions, November 2010, p. 1.

74 The mark to market process involves payments at the end of each day to 'settle' the change in value of the option over that day. Productivity Commission, Electricity network regulatory frameworks, June 2013, p. 838.

75 The ASX uses the settlement price of the contract as confirmed three business days after the last trading day.

76 ASX, Contract specifications, March 2020, p. 21.
The ASX still includes 'the arithmetic average of the wholesale electricity pool market base load spot prices over a half hourly basis' in its contract specifications. However, it notified the market that the reference price of Australian electricity futures would be determined using the 5-minute electricity spot price following the commencement of five-minute settlement. The ASX notice is available here.

77 ASX, Contract specifications, March 2020, p. 25.

of the four quarterly futures contracts underlying the relevant Strip Futures Product, as outlined in the ASX contract specifications.[78]

C.1.2 OTC contracts

OTC contracts are a direct agreement between two parties and as such allow a high level of flexibility in their terms. Once entered into, most OTC contracts are governed by the 2002 ISDA Master Agreement published by the ISDA, as a supplemented by an industry standard electricity addendum published by the AFMA.[79] Some typically used OTC contracts are described below:

Vanilla contracts: Vanilla contracts are typically swaps (equivalently referred to as base futures for exchange-traded products), caps, and options contracts. See the section above for more details on these cap and option contracts.

Retailers typically use swap contracts to hedge the variable spot price. This is achieved by agreeing to buy from the counterparty a specified volume of electricity at a fixed price and sell to the counterparty the same volume of electricity at a variable spot price. Under this arrangement, the parties would typically agree to cash settle the swap so that no sale of electricity will actually occur.

If the spot price is below the fixed price, the retailer will pay the counterparty the difference between the fixed price payment amount and the spot price payment amount. However, if the spot price is above the fixed price, the counterparty will pay the retailer the difference between the fixed price payment amount and the spot price payment amount.[80]

PPAs: Typically, a power purchase agreement (PPA) is an agreement between an electricity generator and a purchaser, sometimes referred to as the off-taker, for the sale and supply of energy. There typically three kinds of PPAs used in the Australian sector:[81]

- Corporate PPAs: deals with renewable energy projects by public and private sector buyers
- Utility PPAs: deals between electricity retailers and renewable energy projects
- Government PPAs: auctions by government for renewable energy.

The corporate PPA, is an agreement between an entity that owns and operates a wind or solar farm and an organisation that purchases the power and/or green certificates generated by the wind or solar farm.

A typical corporate PPA is a financial CFD entirely separate from the retail electricity bill. The buyer pays a fixed price per MWh to the solar or wind farm (usually with an annual escalation factor). In exchange, they receive the revenue from the production sold in the wholesale electricity market and usually the green certificates.[82]

78 Ibid.

79 AEMC, Contingency arrangements for five minute settlement implementation, Consultation paper, 5 August 2021, p. 26.

80 AER, Draft interim qualifying contracts and firmness guideline, May 2019, p. 21.

81 Business Renewables Centre-Australia (2021) Corporate Renewable Power Purchase Agreements: State of the Market 2021, p. 9.

82 Ibid. p. 6.

ARENA has reported that there has been a substantial growth in retail PPAs. In a retail PPA, the buyer pays for electricity and/or LGCs from a solar or wind farm through the retailer's contract with the project; that is, the buyer is not a direct party to the PPA between the project and retailer. There is a contracted price for the output from the solar and wind farm and contracted price(s) for the electricity supplied by the retailer when the solar or wind farm is not generating.[83]

Previous reports have indicated that there has historically been no clear preference for PPAs from wind or solar projects.[84]

Load following hedges: In practice, this type of hedge is a fixed price, variable volume swap, meaning that the holder pays a certain price for all energy consumed. [85] These contracts are typically offered to smaller retailers who do not wish to set up the staff and systems necessary to maintain a contract book of their own. A load following hedge will cover all of their customer load. However, it is typically purchased at a premium as the counterparty, which may be a larger retailer, takes the risk for having the appropriate contracting in place to cover their load.

Proxy Revenue Swaps: Similar to a PPA this instrument does not relate directly to the output from the generator in every period. Rather it relates to the typical/expected output from the generator over a 12-month period. This then separates the instantaneous risk from the PPA into a more annual average. The generator must keep an eye on the average production from the facility over the period but maintenance and outages are less of a concern. These can become firmer instruments against which the counterparty could elect to provide firm hedges.

Payment process

Exchange-traded products are marked to market at the end of each day and are subject to standard settlement and prudential processes that are not negotiable. However, OTC contracts permit greater flexibility in their terms, including the ability to negotiate bespoke payment arrangements tailored to each individual party. In addition, margining does not automatically apply unless the parties separately agree margining terms.

Counterparty risks

These instruments are often for a term several years in the future (they can be much longer than those traded on the exchanges), meaning that each party bears some risk that the counterparty will become insolvent before the contract becomes due (credit default risk). As a result, traders will often choose only to enter into a contract with a party that has an acceptably high credit rating or appropriate credit support.[86]

83 Ibid.

84 Business Renewables Centre-Australia (2019) Corporate Renewable Power Purchase Agreements: State of the Market 2019, p. 9.

85 AER, Draft interim qualifying contracts and firmness guideline, May 2019, p. 25.

86 Productivity Commission, Electricity network regulatory frameworks, June 2013, p. 838.

C.1.3 Electricity contract transparency

Exchange-traded products have transparency over the current price, the volume of products traded and open interest for each traded product in the market. The AER and ACCC provide monitoring and reporting on the NEM contract market through their respective Wholesale Markets Quarterly report and Inquiry into the National Electricity Market reports but only to the extent that the publicly available information provides them with a view of traded volumes and open interest levels.

The Financial Services Reform Act 2001 (Cth) includes disclosure provisions that relate to OTC markets. In general, however, the bilateral nature of OTC markets tends to make volume and price activity less transparent than in the exchange traded market.[87] AFMA's annual survey reports aggregate unaudited information on data provided voluntarily by their members on volumes but it does not include price.

C.2 Contracts used by gas retailers

Contracts used by gas retailers in Queensland, NSW and South Australia include:

- Gas supply agreements
- Transmission and distribution system capacity contracts
- Storage and flexibility contracts

Arrangements in Victorian gas markets are different, however, Victoria also has a separate RoLR scheme for both gas and electricity. Therefore, gas contracts used in Victoria are not discussed here.

C.2.1 Gas supply agreements

Description, parties and risk

GSAs are wholesale supply agreements negotiated between sellers (producers) and buyers (retailers). Historically, long term gas contracts traditionally locked in prices and other terms and conditions for several years to assist in underwriting investments in capital intensive, long-lived assets. Other terms can include delivery arrangements for the gas, such as maximum daily volumes, take or pay arrangements as well as others specified through negotiations.

In recent years the industry shifted towards shorter terms for these contracts, with review provisions.[88] While bilateral contracts will remain a fixture of the east coast market, more flexible and sophisticated means of managing gas portfolios are increasingly important to participants.

For GSAs between retailers and producers, there are a number of counterparty risks specific for each party. Retailers face a risk that the producer is unable to deliver the volume of gas, timing of gas or any of the terms specified in the contract. Producers primarily face a risk that the retailer defaults on its payment obligations.

87 AER, state of the energy market 2009, p. 91.
88 AER, State of the energy market, 2021, p. 192

Purchasing process and payment streams

The purchasing process for GSAs is specific to each counterparty, there may be specialised consultancy firms that may act as a matchmaker between buyers and sellers. Given that these contracts are bilateral and specific to each party there is not a central platform to buy and sell these contracts. However, specialised firms may act as an intermediary between buyers and sellers.

Payment terms for GSAs can be bespoke and specific to each counterparty, as outlined above for electricity over the counter contracts these contracts may use a standard set of terms and conditions in practice.

GSAs may use the standard terms and conditions specified within the ISDA 2002 master agreement and use the AFMA Australian cash-settled gas trading addendum. This may mean in practice that gas OTC contracts broadly use mostly the same terms and conditions.

Transparency

Public information about contract prices is unclear. Much of the pricing is private and negotiated contract outcomes are often bespoke. There is also disparity between the type of information available to large participants that are frequently active in the market and information available to smaller or less active players. This imbalance may favour larger incumbents in price negotiations.[89]

Publicly traded companies may have the obligation to disclose GSAs that they enter into, however, this disclosure may not provide price transparency. The AEMC is aware that disclosures primarily provide transparency across the volume and time horizon of the supply agreements.

The ACCC reports on trends in gas contracting arrangements, including prices, through their Gas Inquiry.[90] Additionally, the AER monitors the performance of gas markets and publishes data from that monitoring in reports such as the annual State of the Energy Market and Wholesale Markets Quarterly report.

C.2.2 Transmission and distribution capacity

Description and parties and risk

Gas pipeline businesses earn revenue by providing access (selling capacity) to parties needing to transport gas.

The most common service provided by transmission pipelines is haulage – that is, transporting gas in a forward direction from an injection point on the pipeline to an offtake point further along. Haulage may be offered on a firm (guaranteed) or interruptible (only if spare capacity is available) basis. Some customers seek backhaul too, which is reverse direction transport. Gas can also be stored (parked) in a pipeline on a firm or interruptible basis. As the gas market evolves, more innovative services are being offered, including

89 Ibid.

90 ACCC, Gas Inquiry 2017-2025 July 2022 interim report.

compression (adjusting pressure for delivery), loans (loaning gas to a third party), redirection and in-pipe trades.

Distribution networks consist of high, medium and low pressure pipelines, which run underground. The high and medium pressure mains provide a 'backbone' that services high demand zones, while the low pressure pipes lead off high pressure mains to commercial and industrial customers and residential homes. While the nature of gas transmission services is evolving to meet changing market needs, distribution pipeline businesses tend to offer fairly standard services – namely, allowing gas injections into a pipeline, conveying gas to supply points and allowing gas to be withdrawn.

The financial risk associated with counterparty failure for transmission and distribution capacity agreements is low given that most service providers are fully regulated. The main risk is primarily a delivery risk for retailers if a pipeline suddenly comes out of operation.

Payment process

Gas pipeline businesses earn revenue by selling capacity in their pipelines to customers needing to transport gas. A customer buys access to that capacity under terms and conditions that include an access price. The AER sets access prices for full regulation pipelines in eastern Australia and the Northern Territory under broadly similar rules to those applied to electricity networks.

The owners of other pipelines are free to set their own prices, including those subject to light regulation and the recent Part 23 provisions. Light regulation pipeline owners must publish their prices, but these prices are not independently vetted.

Transparency

As outlined above fully regulated and light regulated pipelines are required to publish the price for their services. Fully regulated pipelines have their access prices set by the AER, broadly similar to the process for electricity networks.

The AEMO gas bulletin board provides visibility on which participants are contracted with each pipeline through their bulletin board shipper lists.[91] These lists do not provide any transparency over the level of pipeline capacity or type of contract each party has with the pipeline.

Pipeline capacity trading reforms

In the absence of a direction, the designated RoLR can access pipeline capacity through the net pool market facilitated by the pipeline capacity trading reforms. The AEMC's 2016 East Coast Wholesale Gas Market and Pipelines Framework Review recommended introducing a number of pipeline capacity trading reforms. These reforms include the CTP and the DAA where excess pipeline capacity may be traded.[92]

91 AEMO gas bulletin board shipper lists available here

92 AEMO, Pipeline capacity trading: Overview, November 2018, pp. 16-18.

C.2.3 Storage facilities and line pack storage

When demand for gas peaks, such as on cold winter days, additional supply over the amount contracted through supply agreements may be required to meet customer demand. Gas suppliers can use gas storage facilities or linepack accounts to deliver additional volumes of gas to meet these demand peaks over short periods of high demand as well as over seasonal winter demand periods.

Gas storage facilities

There are currently only two gas storage facilities that allow access to third parties, these being the Iona underground gas storage and the Dandenong LNG facility, both located in Victoria. The Dandenong facility can only deliver into the Victorian DWGM and falls outside the scope of the Review as Victoria has a separate RoLR scheme to manage retailer failures.

The Iona facility is connected to the southwest pipeline, which delivers gas towards the DWGM, and the Port Campbell Adelaide pipeline which delivers gas to South Australia. Iona offers injection and withdrawal services for both pipelines.

The Iona facility charges for injection and withdrawal, as well as a fixed storage charge for the amount of gas stored. Storage at Iona is not a regulated service and as such the AER does not set the tariff amount like they do for transmission services. Contract terms, such as the price for each service offered, would be negotiated, and agreed to upon the signing of the contract.

The prices for Iona storage services are not published but are visible through the ACCC's gas inquiry reports.[93]

The key risks that are associated with storage services are counterparty and delivery risks. If the storage provider were to default on their obligations to provide storage services, the risk for a retailer is that there would not be sufficient gas available to meet their customer's demand.

Park and loan services

Transmission pipelines may offer storage services as they can store gas along the length of the pipeline. The amount of gas that can be stored is dependent on the length of the pipeline, the amount of compression on the pipeline, the inlet pressure and the minimum delivery pressure allowable at the delivery point. Transmission pipelines in east coast Australian gas markets are typically subject to full regulation and have the price for reference services set by the AER.

Using the standard terms applicable for APA-owned transmission pipelines, which are broadly the same terms applicable to the other fully regulated transmission pipelines, park and loan services are available on a firm and interruptible basis.

The park and loan service outlines the receipt of gas, or gas to be stored within a specified pipeline or locations up to a reserved level of maximum daily qualities and without

93 ACCC, Gas inquiry 2017-2025 July 2022 interim report, p. 88.

interruption for firm park services.[94] The loan service is the opposite of the park service and involves borrowing gas from the pipeline and injecting the borrowed quantity back at a later date.

The payment process for pipeline storage services is like any regulated gas transmission service, with standard terms and conditions available on the respective pipeline owner's website. The risks associated with pipeline storage are similar to those above for storage facilities, however, regulated services typically have a lower risk profile than unregulated services.

C.3 Other gas products

The AEMC is aware that other contracts or products are used by gas retailers, including contracts on the Gas Supply Hub and locational swaps and derivative contracts. However, these are not the subject of the Review as the AEMC understands these are either net pool markets where excess capacity is traded or rarely used.

94 APA gas transmission services and descriptions available here.

D WHAT HAPPENS TO A FAILED RETAILER'S CONTRACTS FOLLOWING A ROLR EVENT

The table below provides a high level assessment of how different RoLR event may impact different contracts that may be held by the failed retailer.

To develop this table, the Commission has relied on publicly available or standardised information. Where stakeholders have further or different information, we welcome this through submissions.

D.1 Derivative contracts used by electricity retailers

The contracts described in this section are typically used by electricity retailers to manage price risk. These contracts include exchange traded derivative contracts and OTC-traded power purchase agreements (a form of OTC contract).

D.1.1 Exchange-traded derivative contracts

The following is based on the ASX rules for exchange-traded derivatives.[95]

Table D.1: Electricity exchange-traded derivatives

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
Revocation of retailer authorisation	RoLR event unlikely to give rise to a right to terminate the contract. The ASX 24 Operating Rules do not appear to have any obligations on Trading Participants to hold a retailer authorisation. Accordingly, no suspension or termination rights arise from the revocation of a retailer authorisation.
Suspension of wholesale trading rights	RoLR event unlikely to give rise to a right to terminate the contract. The ASX 24 Operating Rules do not appear to have any obligations on Trading Participants to hold wholesale trading rights. Accordingly, no suspension or termination rights arise from the suspension of

95 The ASX rules can be found here.

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
	wholesale trading rights.
Appointment of insolvency official	RoLR event likely triggers a right to terminate the contract. Under the ASX 24 Operating Rules, if the Market Operator (i.e., the ASX) considers that an event of default in relation to a Trading Participant (including that it is under administration), the Market Operator may take certain actions including suspending the Trading Participant's admission as a Trading Participant and cancelling certain Market Transactions, where those transactions have not been reported to the clearing house for registration (rule [5160]). Once the transaction has been registered with the clearing house, the clearing house becomes the counterparty and will have certain rights under the ASX Clear (Futures) Operating Rules. Under those Rules, the appointment of an insolvency official is likely to constitute an event of default which triggers rights for the clearing house to (among other things): terminate and auction off all or any Open Contracts; 'Close Out' all or any Open Contracts; transfer any Open Positions to another clearing participant (with the written authority of the transferee); or terminate Open Contracts at a price determined by ASX Clear (Futures) in accordance with the Rules. Termination rights may be subject to the recently introduced ipso facto regime (appendix D.3).
Order or resolution for winding up	RoLR event likely triggers a right for the ASX to cancel certain contracts, in limited circumstances. Like the appointment of an insolvency official, an order or resolution for winding up would constitute an event of default under the ASX 24 Operating Rules. Refer to the analysis in the 'Appointment of insolvency official' row.
Cessation of sale of energy	RoLR event unlikely to give rise to a right to terminate the contract. The ASX 24 Operating Rules do not appear to have any obligations on Trading Participants to sell energy. Accordingly, no suspension or termination rights arise from the cessation of the sale of energy.

Source: AEMC

D.1.2 OTC traded PPAs

As there are no 'standard' PPA terms available, the following information has been based on a sample of usual PPA terms.

Table D.2: Power purchase agreements

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
Revocation of retailer authorisation	RoLR event unlikely to give rise to a right to terminate the contract. Generally, a party would have a right to terminate a PPA if the other party was in breach of its material obligations under the agreement. However, the AEMC considers it unlikely that holding a retailer authorisation would be considered to be a material obligation such that a termination right would automatically be enlivened by a revocation of retailer authorisation. It is more usual that a requirement to hold the appropriate authorisations would be expressed as a warranty.
Suspension of wholesale trading rights	RoLR event unlikely to give rise to a right to terminate the contract. Please refer to the analysis in the 'Revocation of retailer authorisation' column, which we consider would likely apply equally to the suspension of wholesale trading rights.
Appointment of insolvency official	RoLR event likely triggers a right to terminate the contract. Typically, an insolvency event (including the appointment of an insolvency official) would constitute a default and would give rise to termination rights. This might involve the issue of a default notice and a subsequent 'cure period', following which, if the default were not rectified, the non-defaulting party could terminate the agreement or potentially suspend the provision of services. Termination rights may be subject to the recently introduced ipso facto regime (appendix D.3). Where a contract is not terminated and remains a company asset there are obligations on insolvency practitioners (appendix D.4) and liquidators rights in relation to pre-appointment transfers (appendix D.5) that must be considered.
Order or resolution for winding up	RoLR event likely triggers a right to terminate the contract. Like the appointment of an insolvency official, an order or resolution for winding up would very likely

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
	constitute an insolvency event. Refer to the analysis in the 'Appointment of insolvency official' row.
Cessation of sale of energy	RoLR event unlikely to give rise to a right to terminate the contract. It is not clear that the cessation of the sale of energy alone would have any impact on a PPA.

Source: AEMC

D.2 Physical contracts used by gas retailers

Physical contracts used by gas retailers that are the subject of the Review are bilaterally traded physical contracts that have bespoke terms. As such, the Commission has relied upon publicly available information and standard terms when analysing whether and how a contract may remain in force or trigger a right to terminate as a result of a RoLR event.

D.2.1 Gas Supply Agreement

There is no standard gas supply agreement so the following has been based on a sample of usual GSA terms.

Table D.3: Gas supply agreement

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
Revocation of retailer authorisation	RoLR event unlikely to give rise to a right to terminate the contract. Generally, a party would have a right to terminate a GSA if the other party was in breach of its material obligations under the agreement. However, the AEMC considers it unlikely that holding a retailer authorisation would be considered to be a material obligation such that a termination right would automatically be enlivened by a revocation of retailer authorisation. It is more usual that a requirement to hold the appropriate authorisations would be expressed as a warranty.
Suspension of wholesale trading rights	RoLR event unlikely to give rise to a right to terminate the contract. Refer to the analysis in the 'Revocation of retailer authorisation' row, which we consider would likely apply

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
	equally to the suspension of wholesale trading rights.
Appointment of insolvency official	RoLR event likely triggers a right to terminate the contract. Typically, an insolvency event, including the appointment of an insolvency official, would constitute a default and would give rise to termination rights. This might involve the issue of a default notice and a subsequent 'cure period', following which, if the default were not rectified, the non-defaulting party could terminate the agreement or potentially suspend the provision of services. Termination rights may be subject to the recently introduced ipso facto regime (appendix D.3). Where a contract is not terminated and remains a company asset there are obligations on insolvency practitioners (appendix D.4) and liquidators rights in relation to pre-appointment transfers (appendix D.5) that must be considered.
Order or resolution for winding up	RoLR event likely triggers a right to terminate the contract. Like the appointment of an insolvency official, an order or resolution for winding up would very likely constitute an insolvency event. Refer to the analysis in the 'Appointment of insolvency official' row.
Cessation of sale of energy	RoLR event likely causes contract to remain in force. It is not clear that the cessation of the sale of energy alone would have any impact on a GSA.

Source: AEMC

D.2.2 Transmission transportation agreements

The following table is based on APA's standard form gas transport agreement, this table also covers in-pipe storage (park) services, as well as firm and flexible transport.

Table D.4: Gas transmission transportation agreements

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
Revocation of retailer authorisation	RoLR event unlikely to give rise to a right to terminate the contract. Retailer authorisation would likely be a required 'Approval' under the terms of the APA GTA. APA may refuse to provide services, or suspend the provision of services, if the retailer fails to maintain any 'Approval', which would likely include its retailer authorisation (cl 2.1(b)(ii)). However, in most cases this is unlikely to trigger termination, in and of itself. A revocation of retailer authorisation will only enliven a right to terminate the contract in very specific circumstances related to force majeure. If loss of Approval (that is retailer authorisation) is beyond the retailer's reasonable control, it may be a force majeure event, in which case the parties' rights are suspended. Termination rights only arise in the event of prolonged force majeure (cl 25.7).
Suspension of wholesale trading rights	RoLR event unlikely to give rise to a right to terminate the contract. It is likely that a retailer's wholesale authorisation would also constitute an 'Approval' under the APA Gas Transportation Agreement. Refer to the analysis in the 'Revocation of retailer authorisation' row.
Appointment of insolvency official	RoLR event likely triggers a right to terminate the contract. The appointment of an "insolvency official" to the retailer would likely mean that it meets the definition of 'Insolvent' (which includes if a controller or receiver is appointed to a party or if a party is in liquidation or administration) and therefore the retailer would be in 'Financial Default'. If the Financial Default is not cured within 7 Business Days, then APA may either: • terminate the Gas Transportation Agreement; or • suspend its obligations under the Gas Transportation Agreement until the Financial Default is cured; or • sue for damages and exercise any other available legal and equitable remedies (cl 21.3). Termination rights may be subject to the recently introduced ipso facto regime (appendix D.3). Where a contract is not terminated and remains a company asset there are obligations on insolvency

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
	practitioners (appendix D.4) that must be considered. If the retailer has sought to transfer its interests shortly prior to having a liquidator or other insolvency practitioner appointed, a liquidator may be able to unwind the disposal of the company's interest in the contract, if it is found to be an uncommercial or 'creditor defeating' transaction. However, the unwinding of such transactions is predicated on the company going into liquidation see appendix D.5 for more information.
Order or resolution for winding up	RoLR event likely triggers a right to terminate the contract. Like the appointment of an insolvency official, an order or resolution for winding up would very likely meet the definition of 'Insolvent'. Refer to the analysis in the 'Revocation of retailer authorisation' row.
Cessation of sale of energy	RoLR event unlikely to give rise to a right to terminate the contract. It is not clear that the cessation of the sale of energy constitutes a loss of / failure to maintain an Approval, a failure by the retailer to meet its obligations under the APA Gas Transportation Agreement, nor that it would itself constitute an insolvency event of a force majeure event. In those circumstances, it is not clear that the cessation of the sale of energy alone would have any impact on the APA Gas Transportation Agreement.

Source: AEMC

D.2.3 Distribution pipeline Reference Service Agreement

The following table is based on JGN's approved reference agreement for the NSW gas distribution network.

Table D.5: Distribution reference service agreements

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
Revocation of retailer authorisation	RoLR event unlikely to give rise to a right to terminate the contract.

TRIGGER	IMPACT ON FAILED RETAILER CONTRACTS
	JGN may suspend the delivery of Gas and is not obliged to provide the Services, if the retailer "is not a registered participant in its registrable capacity as a "User" or "Self-contracting User" under Rule 135AE of the NGR or the User is not an Exempt Seller under the NERL" (cl 20.1).
Suspension of wholesale trading rights	RoLR event unlikely to give rise to a right to terminate the contract. There is no evidence that the suspension of wholesale trading rights would impact the JGN approved Reference Service Agreement.
Appointment of insolvency official	RoLR event likely triggers a right to terminate the contract. If the retailer is placed under external administration, then JGN may terminate the agreement or may cease providing Services or cease providing services to the relevant Delivery Points (cl 23.1). Termination rights may be subject to the recently introduced ipso facto regime (appendix D.3). Where a contract is not terminated and remains a company asset there are obligations on insolvency practitioners (appendix D.4) and liquidators rights in relation to pre-appointment transfers (appendix D.5) that must be considered. Clauses 23.4 and 23.5 provide for the preservation of certain rights following termination and the cessation of services, respectively — broadly, they relate to rights that arose prior to termination or cessation, including in relation to certain payments to JGN.
Order or resolution for winding up	RoLR event likely triggers a right to terminate the contract. Like the appointment of an insolvency official, if the retailer is subject to an order for winding up, or if a winding up resolution is passed, then JGN may terminate the agreement or may cease providing Services, or cease providing services to the relevant Delivery Points (cl 23.1). Refer to the analysis in the 'Appointment of insolvency official' row.
Cessation of sale of energy	RoLR event unlikely to give rise to a right to terminate the contract. It is not clear that the cessation of the sale of energy alone would have any impact on the JGN-approved Reference Service Agreement.

Source: AEMC

D.3 Ipso facto regime

Contractual clauses that trigger an automatic right to terminate the contract upon the occurrence of a specified event, for example, the appointment of an insolvency official, are referred to as "ipso facto clauses".

In 2018, the *Corporations Act 2001* (Cth) was amended to include an automatic stay that prevents a counterparty from enforcing certain ipso facto clauses where a company becomes subject to certain insolvency procedures, including, relevantly for the RoLR framework:

- the appointment of a voluntary administrator; and
- the appointment of a receiver or controller to all, or substantially all, of the company's assets.

The automatic stay will only apply where:

- the contract/arrangement was entered into after 1 July 2018; and
- none of the ipso facto exclusions apply.

Certain contracts are excluded, including a contract that is a licence, permit or approval issued by a government authority.[96]

The stay will prevent the counterparty from exercising certain rights, including the right to terminate the contract, which arise automatically and solely because the company is subject to the insolvency process, or otherwise because of its financial position. The stay does not prevent the counterparty from enforcing all rights, and they may still enforce rights that arise due to a performance breach, such as a payment default. Irrespective of whether triggered by an insolvency event, the counterparty may also enforce the following rights:

- a right to charge default interest
- a right to perform obligations of the insolvent company under the contract
- a right to assign or otherwise transfer rights or obligations.

Conversely, while the stay is in force, the insolvent company will also not be able to require its creditors to provide new advances or credit under the relevant contract.

96 Under the *Corporations (Stay on Enforcing Certain Rights) Regulations 2018.*

The regime was introduced in 2018 so, given it is relatively new and has not yet been considered by the courts, there are some uncertainties in how it will be applied. However, broadly, whether the ipso facto regime applies will need to be determined on a case-by-case basis having regard to the form of the contract itself.

Relevance to the Review

The Commission understands that, in certain cases, the ipso facto regime may operate to prevent the counterparty to a contract with a failed retailer from terminating the contract if the relevant RoLR event is the appointment of a voluntary administrator or a receiver or controller (that is, certain insolvency officials) and if the criteria for the application of the automatic stay are met.

D.4 Obligations on solvency practitioners

Assuming that the contractual agreements that are the subject of the Review are properly construed as 'assets' of the retailer, then the insolvency practitioner appointed to it, whether that be a receiver, administrator or liquidator, will have duties and obligations in relation to how it deals with the assets of the company.

- In the case of a receivership, the receivers will be obliged to:
  - Take reasonable care to obtain market value when exercising the power of sale of the assets, or, if there is no market value, the best price reasonably obtainable[97]
  - Not fraudulently, wilfully or recklessly sacrifice the property of the company[98]
  - Exercise their powers with a reasonable degree of care and diligence, in good faith, and in the best interests of the company.[99]
- Voluntary administrators are obliged to act in a way to maximise the chances of the business continuing in existence and, if that is not possible, to provide for a better return for the company's creditors than would result from a liquidation.[100] Administrators also owe a fiduciary duty to the creditors and to give due regard to the interests of the creditors as a whole. By extension, while the administrators have the power to sell the assets of the company, they are typically obliged to obtain value for those assets, however, they are not under the same obligations to obtain market value, or the best price.

97 Under s 420A of the *Corporations Act 2001* (Cth).

98 An obligation in common law.

99 Under ss 180 and 181 of the *Corporations Act 2001* (Cth).

100 s 435A of the *Corporations Act 2001* (Cth)

- Liquidators are similarly obliged to gather all the property of the company in liquidation, and salvage as much as possible for the benefit of creditors.

Relevance to the Review

There are clear conceptual issues in seeking to have the relevant insolvency practitioner transfer the contracts to the RoLR, absent them being compelled to do so. This applies equally to the obligation on them to transfer the contracts to RoLR, and the risk that an insolvency practitioner transfers the contract to a related party following their appointment.

D.5 Pre-appointment transfers of contracts

If an energy retailer has transferred their interests in their supply or hedge agreements shortly prior to having a liquidator or other insolvency practitioner appointed, a liquidator may be able to unwind the disposal of the company's interest in the contract, on the basis that it is:

- an uncommercial transaction (that is, if the asset is transferred to another company for less than market value)
- a creditor defeating transaction (that is, a transaction undertaken for the purpose of defeating the rights of the creditors of the company on a winding up).

However, the unwinding of such transactions is predicated on:

- The company going into liquidation. However, this may not happen where, for example, the company goes from a voluntary administration to a deed of company arrangement, or is returned to the control of the directors after the voluntary administration
- The liquidator then prosecuting pursuing the recipient of the rights under the supply or hedge agreements and recovering those rights from the recipient.