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Australian Energy Market Commission
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AEMC Consultation Paper – RoLR review into the arrangements for Failed Retailer's electricity and gas contracts – PUBLIC

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise 4,500MW of generation capacity.

EnergyAustralia warmly welcomes the opportunity to make this submission to the AEMC's Consultation Paper on its Review into the arrangements for Failed Retailer's electricity and gas contracts.

This review is important and timely. The RoLR framework needs to update from a framework that contemplates sporadic failures of small retailers caused by a few days of high spot prices, to a framework that contemplates cumulative retailer failures in a short period of time resulting from prolonged price volatility, and the failure of a large retailer that could harm consumers and lead to market inoperability. Unfortunately, given the bumpy transition it is prudent for these types of scenarios to be reflected and provided for within the retail framework.

At a high level, regarding electricity contract issues, we see that there is a problem to solve but that the problem could be reframed and start with assurances that the RoLR framework – as a last resort emergency industry-wide support measure is not being "gamed". The appropriate policy response is to both review the RoLR definitions to ensure that the entry point to the RoLR regime is not set too low, and to reallocate some of the cost and risk placed on Designated RoLRs back to the Failed Retailer via Option 4 of the AEMC's consultation paper. While there are complex legal issues that arise around Option 4, we emphasise that the magnitude of the problem warrants overcoming those legal issues to establish a more resilient RoLR framework for the future. We also support Option 1 as a simple solution that can be implemented quickly.

Regarding gas contracts, we largely support the AEMC's proposed improvements to the gas directions power. Given the physical constraints of the gas network we also suggest that pipeline capacity contracts and DWGM Entry and Exit Capacity Certificates should also be included in the directions power as they are a key component in ensuring the physical supply of gas to customers of the Failed Retailer.

Our full submission below is divided into a discussion about the electricity contract and gas contract issues.

ELECTRICITY CONTRACTS

1. The problem statement and appropriate policy responses

The AEMC discusses the problem of a rapid transfer of a large number of customers without significant notice presenting a systemic risk of cascading retailer failures and increased cost to the Designated RoLR. We consider the AEMC's problem statement may describe the symptoms rather than the problem itself.

The AEMC's terms of reference are quite narrow and focus on exploring access to hedging contracts as the solution to the problem. This suggests that the AEMC is not concerned with *all* types of RoLR events but specifically RoLR events where value remains in the hedging contracts and should transfer to the Designated RoLR.

We therefore consider the problem statement is actually more focussed around whether the RoLR framework incentivises Retailers to game the RoLR mechanism, and selectively use it as a way to exit the market (similar to AFMA's views). For example:

- Retailer buys insufficient hedges for their customer load, and
- when the retailer is exposed to unsustainable spot prices for their customer load, the Retailer chooses to trigger a RoLR event to offload their customer base via the RoLR regime onto a Designated RoLR. The Designated RoLR has no choice but to take those customers on, even if they are short in their wholesale position, and
- then the Failed Retailer sells whatever "in the money" hedge contracts they hold, where contract market values have increased since they were originally acquired.

In the above example, the Retailer is incentivised to separate its customer base and to dispose of it via the RoLR regime, but retain its valuable hedge book for its benefit. As there is no cost to triggering a RoLR, the RoLR pathway is likely more commercially attractive than keeping the customer base and hedge book together for sale as a bundle.

Once a Retailer triggers a RoLR event, the risk taken by the Failed Retailer is transferred to the designated Retailer and its customers, and all customers (where there is RoLR cost recovery). It is this impact, in an emergency scenario designed to ensure continuity of supply, which makes this a market problem and justifies changes to the RoLR framework.

Risks should be allocated to the party best placed to mitigate them. There is a clear disconnect with this principle under current RoLR arrangements, where a Designated RoLR has no control over minimising the financial risk taken by the Failed Retailer, but bears the full cost of that risk after a RoLR event is triggered.

From a policy perspective, it makes sense to address this problem statement and misallocation of risk via two policy responses:

A. Policy Response A: Review the entry point to the RoLR regime to ensure it is not set too low to allow gaming. i.e. review the RoLR event definitions. Discussed more in section 2 below.

B. Policy Response B: Reallocate some of the risk imposed on Designated RoLRs back to the Failed Retailer (via transferring the proceeds of any sale of the hedge book to the Designated RoLR). We support both Options 1 and 4 in the AEMC's Consultation Paper for the reasons set out in section 3 below. In particular, Option 4 will achieve several positive outcomes:

   - If the Failed Retailer must pay any proceeds back, this will act to reverse the incentive to trigger a RoLR event to begin with.

   - It will reduce the cost to the Designated RoLR, its customers and all customers (where there is RoLR cost recovery). We provide further details around the materiality of RoLR costs in the last section of this submission.

   - By supporting the financial resilience of the Designated RoLR, it also reduces any systemic risk of cascading RoLRs which would start by the Designated RoLR failing.

2. Policy response A: Review the definitions of RoLR event

As discussed above, the RoLR event definitions should be reviewed to ensure they are appropriately defined so that they do not incentivise gaming the RoLR regime. There are two definitions of RoLR event which are problematic because they permit a:

- Retailer to *choose* to trigger the definition where a RoLR exit is more commercially attractive than alternative exit pathways;

- Retailer exit that is temporary i.e. the Retailer can re-enter the market and sell energy to customers at a later time. This contradicts the intent of the RoLR regime and encourages gaming because the RoLR is reversible; and,

- Retailer to continue to trade financial contracts after the RoLR event allowing them to sell and benefit from their hedge book.

The two potentially problematic definitions of RoLR event are:

- Suspension of wholesale trading (electricity and gas)[1] – We agree with AFMA's submission that the market default rules appear to have been written to ensure AEMO is able to suspend the participant before AEMO are exposed to non-payment, but this would cover where a Retailer is able to pay but chooses not to. Similar concerns apply to a retailer ceasing registration or its registration being revoked where this can be voluntarily triggered.

- Cessation of the sale of energy[2] – We understand a Retailer can choose to cease selling to its customers which will trigger a RoLR event. It is still possible for the Retailer to maintain its wholesale trading registration (i.e. AEMO may not suspend them) and for the Retailer to retain its Retail authorisation i.e. RoLR event is only temporary, Retailer can commence selling later. **[Confidential:**

  One solution is for the AEMC to make this definition more permanent by requiring that if this type of RoLR event is triggered, then the AER must revoke the Retail Authorisation.

  We also note that the above two definitions could also be removed, because they would be covered under other definitions if they were serious in nature. E.g. if there was a suspension in the wholesale market due to non-payment, this may lead to eventual insolvency and winding up.

- Lastly, the RoLR event definition based on the appointment of an insolvency official[3] could also be reconsidered. This captures the time that the Retailer is under voluntary administration which

[1] Section 122 of NERL, definition of "RoLR event" (b) and (c)
[2] Section 122 of NERL, definition of "RoLR event" (f)
[3] Section 122 of NERL, definition of "RoLR event" (d)

may mean the company is ultimately handed back to directors at a later point. Removing this from the RoLR event definition would mean that the voluntary administrator would operate the company's assets keeping the contract hedge book and customer base "whole". This may reduce the incentive for the hedge book to be sold off. Should an order for winding up be made following voluntary administration, then this would be the appropriate boundary for a RoLR event to be triggered and the customer base to be transferred to the Designated RoLR. Option 4 would remain relevant to the winding up RoLR event definition.

3. Policy response B: AEMC options 1 and 4

We agree with AFMA's views in its submission regarding the potential adverse impacts on financial markets associated with Options 3(a) and (b), and that 3(b) has limited effectiveness and provides negligible cost relief to the Designated RoLR. In a similar way, Option 2 as the match making service, does not provide any cost relief to the Designated RoLR and raises confidentiality issues around the sharing of commercially sensitive information.

Option 1: Clarifying RoLR cost recovery

We fully support the implementation of Option 1 to clarify that wholesale energy and hedging costs can be recovered via the RoLR cost recovery mechanism.

Our interpretation of the NERL and the AER's RoLR guidance is that a Designated RoLR can already recover these costs. The AER's RoLR Statement of Approach refers to "incremental energy costs"[4] of supplying the Failed Retailer's customer load being recoverable. This option therefore does not present a significant change and should be progressed quickly. We support making the recovery of wholesale energy and hedging cost explicit in the NERL and AER guidance to provide certainty to Designated RoLRs. Wholesale energy and hedging costs should include:

- Initial costs at spot market pricing (i.e. unhedged) for the first 24 hours.
- Further cost of buying at spot market prices on subsequent days to reflect a period of time from notification of the RoLR event to when the Designated RoLR is able to complete a hedged position. That period involves the time taken to receive the metering data to forecast customer load, develop a wholesale position, and then the time to enact hedging contracts.
- Even after the additional load is hedged, the ROLR should be able to recover the higher wholesale energy costs secured under short term hedging, where not covered by the retail tariff.

We also consider the same arguments apply to allow the recovery of green costs. E.g. LGC certificates.

The AEMC questions whether providing this certainty is of limited benefit because of the time taken for RoLR costs to be paid which means the Retailer will experience short term cash flow issues. We firmly believe that providing the certainty will still be valuable and assist the Designated RoLR in obtaining bridging finance until the costs are received.

Other improvements to the RoLR cost recovery process

We also propose additional improvements to the RoLR cost recovery mechanism:

[4] As referenced in the AER's ROLR final statement of approach, see section 5.3 in particular, scenario 1 (RoLR final statement of approach Nov 2011 (aer.gov.au))

- *Changes to the AER's assessment criteria* - Under section 166 of the NERL, the AER must be guided by principles including the RoLR "will itself bear some of the costs, in proportion to its customer base".[5] This criterion is inconsistent with the intent of the AEMC's current review and should be removed.

- *Pass through of distributor payment determination across multiple regulatory periods* - Under the NERL, the distributor payment determination mechanism is key. However, one gap in the framework is that the distributor payment determination mechanism does not seem to allow pass through of costs incurred in one regulatory period in subsequent regulatory periods.[6] Resolving or clarifying this gap will be critical to allowing costs to be spread across a longer time period to lower impact on customer bills and price shock.

- *Review of RoLR cost recovery process* - An expedited review into the practicality of the AER's RoLR cost recovery process should be undertaken, to ensure that the onus is placed on the right parties. For example, the RoLR cost recovery requires a quantification of the benefits that the Designated RoLR will accrue (which will offset the costs claimed), which involves forecasting how long customers stay with the Designated RoLR. This level of detail could be determined by the AER as a default (with industry consultation).

Option 4

As an important complement to Option 1, we strongly support the implementation of Option 4 to directly address the problem statement and reallocate the cost and risk from the Designated RoLR back to the Failed Retailer.

Moreover, although Option 1 ensures a RoLR can recover its wholesale and hedging costs, Option 4 provides the crucial additional benefit of also lowering those RoLR costs to begin with.

As option 4 does not involve the novation of contracts from the Failed Retailer to the Designated RoLR it avoids the pitfalls of Options 3(a) and (b), while still providing the main benefit – transferring the value of the hedge book.

We note that Option 4 will be easier to implement for RoLR events that do not involve insolvency as the AEMC might be able to impose obligations on the Failed Retailer under the NERL. However, we also recognise that Option 4 may face legal barriers for the RoLR events based on insolvency or a winding up order. As per section 2, we submit that the appointment of an insolvency official could be removed as a RoLR event, which would mean only resolving the legal issues for the RoLR event involving a winding up order.

Overcoming the potential legal barriers is warranted given the materiality of the issue (discussed in detail in the last section). Possible workarounds that could be considered include changing insolvency laws to deem the AER/Designated RoLR as a "secured creditor" or achieving the same effect under the energy licence conditions. Another workaround is requiring the Failed Retailer to sell its contracts immediately before triggering a RoLR event (for the proceeds to be transferred), but we acknowledge the unfair preference obligations under insolvency law would have to be significantly changed.

The AEMC discusses a materiality threshold and risk periods for options 3(a) and 3(b). With respect to Option 4, we do not see a need for these features. Further, these features also have design issues:

- Designing a materiality threshold (e.g. size of Failed Retailer) to trigger Option 4 will be exceedingly difficult given the materiality will change, depending on wholesale market conditions.

[5] section 166(1)(c) of the NERL
[6] rolr notice of final instrument november 2011 D2011-02303516 (aer.gov.au) , p 16. Issue raised by United Energy and Multinet.

- Unlike Options 3(a) and (b), setting risk periods to define high and low risk periods to determine when different parts of the option are used, is not necessary for Option 4. This is because the sale of any hedge book and the transfer of any proceeds will occur at a single point in time.

GAS CONTRACTS

4. Expanding the RoLR gas directions framework

Currently the AER's directions powers under section 137 of the NERL do not extend to making directions regarding gas storage contracts. We agree with the AEMC's proposal to expand the RoLR framework to include storage contracts. In addition, **we submit that the gas directions power should also extend to capacity certificates and transport contracts as these are all potentially required to physically deliver gas to the Failed Retailer's customers.**

5. Other improvements to the gas directions power

We agree with the AEMC's proposals to improve the gas directions power as follows:

- Broadening the trigger for the RoLR gas directions to make explicit that the AER may consider prevailing market conditions and pricing.

- Increasing the direction powers for gas supply, pipeline capacity and transmission capacity contracts from its current level of three months to a longer period of 6 months, for the following reasons:

    - A three-month period is insufficient, it does not reflect the time taken for a Designated RoLR to negotiate a new contract/novation with the gas producer, where there is no express obligation for a gas producer to offer the original pricing that was in place for the Failed Retailer. We propose 6 months is a reasonable and necessary period, even if a new requirement to negotiate in good faith or best endeavours is introduced.

    - From a customer tenure perspective, a 6-month period will also better reflect that Designated RoLRs must supply large customers for 6 months.[7] i.e. the direction on the gas producer to supply gas needs to last for 6 months. For mass market customers, Retailers generally buy gas for 12 months.

    - 3 months is also inadequate given the gas directions power will likely be used at the time wholesale gas prices are high, the shorter coverage does not allow any chance for the market to restabilise before a new supply contract needs to be in place to supply RoLR customers. For example if the RoLR event happened at the beginning of winter (this year for example), the 3-month coverage would mean that Designated RoLRs will be in the market negotiating for gas for RoLR customers when prices are likely to be the highest.

- A new requirement to negotiate in good faith or with best endeavours is critical to addressing the inherent incentive for a gas producer to not genuinely negotiate with the Designated RoLR so that they can go to an auction instead to maximise the value of their gas. *Both* negotiation in good faith and best endeavours should be included. However, we recommend that the obligation should be stronger to encourage a better price outcome for the

[7] Section 168 of the NERL provides that a Designated RoLR may, at any time, serve a notice on the large customer stating that its default agreement in place because of the RoLR will be terminated after a period of 6 months after the transfer date.

Designated RoLR. i.e. A requirement to negotiate in good faith and best endeavours to reflect the original price terms of the contract between the gas producer and the Failed Retailer. This is important to acknowledge the same problem statement for gas, and that without addressing price, the problem is not resolved. The only difference is the "windfall" here is not obtained by the Failed Retailer, but the gas producer is nonetheless obtaining a windfall it would not otherwise have received but for the failure of the Retailer when that value could be used to support the RoLR regime.

6. Retailer behaviour during volatile market conditions

The AEMC has been tasked with considering unusual retailer behaviour, where retailers encouraged customers to leave them and then sold hedging contracts at significantly higher values.

This retailer behaviour undermines customer confidence in the market and inflicts reputational damage to the whole sector. However, when compared to a RoLR, there are different impacts on the market.

Outside a RoLR, where a Retailer tells customers to leave them, customers will transfer to multiple Retailers and presumably Retailers will only take on that customer if they have sufficient buffer in their wholesale position. In the RoLR context, designated Retailers must take on the Failed Retailer's customers regardless of their wholesale position. This key difference is a reason why regulatory intervention is necessary in the RoLR context but may be less so outside it.

We do not support regulatory intervention at this time. However, the AEMC and AER should continue to monitor the materiality of this issue. There is potentially a tipping point if this conduct were to become widespread or market conditions were very poor, which could mean negative impacts on the function of the market. For instance, if no retailers were in the position to take on the customers etc.

7. Materiality of RoLR wholesale energy and hedging costs

To provide information on the materiality of costs that a Designated RoLR may face, we have matched the AEMC's example in box 1 of the Consultation Paper. Our estimate of costs is materially higher.

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If you have any questions in relation to this submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761).

Yours sincerely,

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