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Australian Energy Market Commission
GPO Box 2603
Sydney NSW 2000

Submitted electronically

Re: RPR0016 - Consultation paper: Review into the arrangements for failed retailers' electricity and gas contracts

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make this submission to the Australian Energy Market Commission's (the Commission's) consultation paper for its review into arrangements for failed retailers' electricity and gas contracts.

We support the Commission's decision to proactively assess the Retailer of Last Resort (RoLR) framework. As currently designed, the framework seems ill equipped to address the failure of a large retailer (or a large number of small to medium sized retailers) and the subsequent contagion risk, particularly as long as current market conditions continue (i.e. high wholesale prices, some instances of reduced liquidity). The failure of a large retailer would necessitate a broader intervention similar to some of those described in the appendices to the consultation paper.

Even so, there is considerable merit in assessing potential reforms that could address problems in the short term. The difficulty for the Commission, however, is that it is very challenging to consider how to reduce the risk to the RoLR that comes from having to take on additional customers separately from other elements of the framework and from the oversight of retail operations more broadly. The Commission acknowledges this point and refers to the importance of also considering other elements of the framework for retail regulation that apply prior to the declaration of a RoLR event. These include the initial designation of a RoLR (and its ongoing suitability for that status), AEMO's prudential oversight and credit support arrangements, and the mechanism for RoLR cost recovery.

Furthermore, there is only so much that can be addressed through amendments to energy law and rules. The Commission acknowledges that insolvency and contract law are equally relevant and that it will need to work closely with other agencies and consult with entities outside the energy sector to consider the full range of impacts and assessment of potential solutions.

Broadly, we see significant challenges in the proposals that have been suggested by the Commission, with most of these challenges stemming from the more practical implications of implementing its policy goals within existing legal and financial frameworks. These broad and preliminary concerns are set out below for reference and we urge the Commission to take these into account throughout its review process.

Views on AEMC options

(a) Option 1 - Electricity framework

Any measures that give designated RoLRs more certainty about their ability to recover all costs associated with accepting the customers of a failed retailer are welcome. Therefore, the Commission should proceed with option 1.

(b) Option 2 - Electricity framework

This is a reasonable option that the Commission should continue to explore. However, we note that the Australian Energy Regulator already has extensive powers to collect relevant information from market participants and it would not require additional powers to enact this option. The risk that the Commission will need to consider is the potential release of commercially sensitive information, such as the price and terms and conditions of hedging arrangements, to competing entities.

(c) Option 3 - Electricity framework

We believe that the practical challenges of transferring contracts from a failed retailer to a RoLR in some form are such that we do not consider options 3a or 3b to be feasible. This is because it requires parties such as generators being obligated to enter into a contract with a new counterparty, potentially under terms and conditions over which they have limited or no control.

This will likely have significant negative consequences for the broader market, such as necessitating the variation of many existing contracts, reducing contract market liquidity, or higher risk premiums or more restrictive terms in future contracts.

(d) Option 4 - Electricity framework

We see significant challenges with option 4. With respect to over-the-counter hedges, we are concerned that option 4 suggests that a failed retailer would be required to cherry-pick in-the-money contracts under a singular International Swaps and Derivatives Association (ISDA) Master Agreement. This is because option 4 contemplates a failed retailer selling only its 'in-the-money' hedges to fund RoLR costs, as distinct from closing out all its positions under the ISDA default regime.

Practically, this has the effect of violating the '*single agreement'* concept detailed in Section 1(c) of the ISDA Master Agreement, which will affect the manner in which ISDA agreements operate and are treated in energy markets. In Australia, this could have potential implications on:

- the operation of close-out mechanics under ISDA Master Agreements;
- the classification of ISDA based agreements under the *Payment Systems and Netting Act 1998 (Cth)*; and
- the manner in which *ipso facto* reforms affect ISDA Master Agreements generally.

In short, a counterparty to a hedging contract executed under the ISDA framework is not in general entitled to unilaterally sell or close-out an in-the-money confirmation. Any regulatory requirement which seeks to impose such a requirement would create significant risk for counterparties and financiers, and would likely reduce liquidity.

An alternative way of dealing with this would be to move away from the concept of 'selling' hedges in lieu of a framework that allows for the benefits of such hedges to be synthetically passed through to a RoLR. However, even this process presents difficulties if the RoLR event is triggered by insolvency; this is because a synthetic pass-through arrangement would require the counterparty to the hedge to be solvent to honour and receive the benefits of a hedge arrangement it has in place. Insolvency is an event of default under ISDA Master Agreements and will usually allow the non-defaulting party to terminate and close-out an agreement.

The Commission acknowledges the legal complexities of implementing this arrangement, and we urge it to fully consider the potential implications that such an arrangement has on the pillars of ISDA contracting and contract market liquidity. We note that a large proportion of contracting in energy markets occurs using these arrangements and also that any distortion of ISDA legal pillars would have significant impacts on the manner in which counterparties assess and manage contractual risk.

We are also concerned that the sale process contemplated under option 4 does not allow a counterparty to a failed retailer's contract to properly diligence counterparty risk. This means that the sale process could result in the counterparty (who is out of the money) paying funds to an entity that it has not assessed through its established internal processes for risk management (i.e. the RoLR). This creates a risk that a counterparty to a failed retailer could end up holding a contract with an entity that fails to meet either its internal or externally imposed counterparty risk (creditworthiness) and 'Know Your Client' (for example, financial services licensing) requirements. An ISDA Agreement may impose ongoing collateral or margin requirements on the counterparty, and it is unclear how such requirements would operate under option 4.

(e) Gas direction expansion

We are concerned with suggestions to extend the RoLR arrangements for gas beyond the current scope, i.e. where there is no declared wholesale gas market or short term trading market or where, in the opinion of the Australian Energy Regulator, sufficient capacity or gas is not available in a short term trading market.

Any changes to the current framework have the potential to fundamentally alter retailers' decisions about entry and exit, and the incentives for generators to offer contracts on reasonable terms to all retailers. The Commission will be able to consider these issues in more detail and with reference to its assessment criteria as it progresses this review.

Retailer conduct

We note the Commission's concerns about retailer conduct during the recent energy crisis and in particular, where some retailers notified their customers of impending price changes or actively encouraged them to consider other service providers. Red and Lumo strongly support closer analysis of retailer conduct to determine if there has been any breach of Australian Consumer Law, and of energy law and rules. As the Commission is aware, the latter include an obligation on retailers to notify consumers in advance of any price changes, which in the case of electricity sold to small consumers must take a prescribed form that explains how the new price compares to the Default Market Offer.

However, we encourage the Commission and other regulatory agencies to carefully consider the impact of any new measures that it might be considering to address perceived misconduct. Additional controls on what is currently legitimate commercial activity could negatively impact competition. For example, controls on conditions of exit, such as limits on how a business can dispose of assets that are not carefully designed or subject to impact assessment, have the potential to change the risk profile of retail operations, create incentives to exit the industry in response to specific events or circumstances, and undermine competition.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland, South Australia and in the ACT to over 1.2 million customers.

We thank the Commission for the opportunity to respond to its consultation paper. Please contact Geoff Hargreaves, Regulatory Manager on 0438 671 750 if you have any further queries or want to discuss this submission in more detail.

Yours sincerely

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