AEMC

REVIEW

Australian Energy Market Commission

DIRECTIONS PAPER

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

11 MAY 2023

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.

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SUMMARY

1 Market participants and regulatory agencies gained valuable experience in managing retailer failures during the stressed market conditions in 2022. Using this experience, the Australian Energy Market Commission (AEMC) has completed our stage one feasibility study to improve how electricity and gas retailer failures are managed. Our assessment was informed by 12 stakeholder submissions, discussions with market and government bodies, and further analysis of potential options.

2 This directions paper seeks stakeholder feedback on the options we are considering in stage two to improve how gas and electricity retailer failures are managed. In particular:

- Options to reduce the costs of electricity retailer failures for customers and remaining retailers are:
  - Lowering costs for the designated Retailer of Last Resort (RoLR) by clarifying the market costs it can claim from the RoLR events.
  - Lowering costs for customers by introducing a mechanism to issue the failed retailer a bill for the costs the designated RoLR experienced from the failure.
  - Providing the Australian Energy Regulator (AER) and the designated RoLR with better information to fulfil their functions when a retailer fails.
- Improvements to manage gas retailer failures are:
  - Improving the RoLR gas directions framework to clarify the current arrangements and better support the designated RoLR in managing new customers.
  - Providing the AER and the designated RoLR with better information to fulfil their functions when a retailer fails.
  - Clarifying how the benefits and costs of a RoLR event are shared with customers.

3 Retailer failures are managed through legislation held in the National Energy Retailer Law (NERL). Therefore, any recommendations from this review will need to be endorsed and implemented by Energy Ministers through a package of law changes.

Retailer failures are managed using the RoLR scheme

4 In the event of a retailer failure, the RoLR scheme facilitates the orderly transfer of customers to new retailers without disruption to their electricity or gas supply.

5 Between 2012 and 2022, the RoLR scheme had only been used four times, and the AER had never used its RoLR gas directions powers. The high wholesale prices and reduced liquidity in the contract market that occurred in 2022 put pressure on retailers, resulting in record failures. In 2022, seven authorised retailers failed and triggered RoLR events, including the AER using the gas directions powers for the first time.

Electricity and gas have different approaches to managing risks

6 While the RoLR scheme facilitates a timely transfer of customers to a new retailer it can result in risks and costs for customers and remaining retailers. The failed retailer's customers

are transferred but the contracts that the failed retailer used to manage wholesale price risks are not transferred to the designated RoLR. If retailer failure occurs in volatile market conditions with high wholesale prices, the designated RoLR may face financial stress from being exposed to these prices. For gas retailer failures, there may also be a risk of the designated RoLR being unable to obtain gas.

7 There are different arrangements in electricity and gas to manage this risk:

- In gas, the RoLR scheme has a directions framework that allows the designated RoLR to access the physical gas supply and pipeline capacity contracts previously held by the failed retailer. This provides the designated RoLR with the physical gas it needs to support the transferred customers on the same terms and conditions that were available to the failed retailer for the period of the direction.
- In electricity, where electricity is purchased through the NEM, there is no need for directions to make sure the designated RoLR can supply the transferred customers. The designated RoLR purchases electricity through the NEM and manages its cost risk for supplying the transferred customers via hedging contracts.

We are considering options to reduce the costs of electricity retailer failures

8 While the electricity RoLR scheme facilitates the orderly transfer of customers to the designated RoLR, it has no process to manage the sudden increase in costs incurred by the RoLR from servicing new customers. Therefore, we are exploring two measures to reduce the costs of an electricity RoLR event:

- **Improvements to the RoLR cost recovery scheme**. The intention is to clarify the wholesale and hedging costs that can be claimed by the designated RoLR that relate to the newly transferred customers.
- **Introducing a mechanism to bill the failed retailer for the costs of its failure.** The intention of this option is that the failed retailer would pay for the costs of its failure, and therefore reduce the costs paid by customers through the RoLR cost recovery scheme.

9 We are also considering changes to improve the information that is available to the AER and designated RoLRs. For the AER, a key issue is how it can get the information it needs in a timely way. For designated RoLRs, it relates to the characteristics of the transferred customers.

We are considering improvements to manage gas retailer failures

10 The existing gas RoLR scheme includes a mechanism that allows the AER to direct the failed retailer's gas or pipeline capacity to the designated RoLR. This process reduces the potential risks and costs of gas retailer failures.

11 We are considering improving the current RoLR gas directions framework to better support the designated RoLR manage its new customers by:

- amending the trigger that enables the AER to issue a direction so that financial risks to the RoLR can also be considered (in addition to ensuring physical supply)
- increasing the time a direction applies from three months to a longer period to better reflect the period where the designated RoLR needs the failed retailer's supply contracts
- considering whether the mandatory negotiation process should be modified or removed
- expanding the directions framework to include storage contracts.

12 We are also considering modifications to the existing RoLR gas framework informed by recent experience. Specifically:

- clarifying the circumstances in which a direction applies for contracts that begin or end in the direction period
- clarfiying how the costs and benefits of a RoLR event should be shared with customers
- examining the information that is needed for the AER and designated RoLRs to manage the RoLR event in a timely manner.

We are considering observed retailer behaviour in volatile conditions outside this review

13 In mid-2022, we also observed some retailers allegedly selling their hedges for a profit after actively encouraging their customers to move to other retailers. The observed behaviour has potential consumer harms in the form of financial impacts and erosion of trust in the sector.

14 Our analysis showed that the financial impacts are largely addressed by existing arrangements. However, we consider two additional retail pricing enhancements could further reduce the likelihood of harm. These enhancements would provide more information to customers when retailers change prices and allow the AER to update the Default Market Offer (DMO) outside the normal annual review schedule in response to significant market events.

15 In relation to the potential erosion of trust, given the behaviour has not been widespread to date, we do not consider it warrants a regulatory response. We will continue to work with the AER and Australian Competition and Consumer Commission (ACCC), who monitor the market, to see if other instances of pertinent behaviour emerge.

16 If more instances of this behaviour were to emerge, its unlikely the Commission would consider regulating how retailers buy and sell contracts to be an appropriate response.

Submissions are due by 22 June 2023

17 This directions paper identifies issues and potential solutions for further work. We seek stakeholder feedback to inform our draft recommendations for specific law, rule and guideline changes to improve how electricity and gas retailer failures are managed. Energy Ministers will need to endorse any final recommendations to enable changes to the energy laws.

18 Written submissions responding to this directions paper must be lodged with the Commission by **Thursday 22 June 2023** via the Commission's website, www.aemc.gov.au. A full list of consultation questions can be found below.

19 There are other opportunities for you to engage with us, such as one-on-one discussions or industry briefing sessions. See section 6.4 for further instructions and contact details.

Questions on reducing costs for **electricity** retailer failures

Question 1: What improvements should be made to the RoLR cost recovery framework?

1. Should the costs that can be claimed by a designated RoLR be defined specifically? Please specify what costs should be claimable and how they would be identified. Please also comment on whether these costs should be in reference to the DMO for small customers and not available for customers not subject to the DMO?
2. What period after the RoLR event should market costs be able to be recovered by the designated RoLR? Please explain and provide evidence.
3. How beneficial would progressive or estimated payments be to reducing cash flow issues for the designated RoLR? Are these benefits reduced or removed if the market costs that can be claimed are clarified? Please explain and provide evidence.

Question 2: Should we issue the failed retailer with a bill for the costs of its failure?

1. Do you support the AER issuing a bill to the failed retailer for the RoLR cost recovery scheme? If yes, do you also support the registration of a security interest on the Personal Property Securities Register (PPSR) at the time of retailer registration or this law coming into effect?
2. If yes to 1) are there any likely cost of capital implications for retailer entry, expansion and operation? Please explain and provide evidence.
3. Do you anticipate any issues with the timing of the RoLR cost recovery and the insolvency process? If yes, are these issues made better or worse if the AER is registered on the PPSR?
4. Do you agree a minimum threshold should be applied for this mechanism to reduce the potential barriers to entry or expansion? If yes, what should this threshold be?
5. Are there other issues to which the AEMC should have regard to with this option? Please explain and provide evidence.

Question 3: What information is necessary for the AER and electricity RoLRs to fulfil their duties, and how should it be collected?

1. What information should be provided to the AER and designated RoLRs in electricity RoLR events, and how should that information can be most efficiently collected? Please explain and provide evidence.

Questions on improving how **gas** retailer failures are managed.

Question 1: Should we change the RoLR gas directions triggers?

1. Are there any clarifications needed in the current triggers for gas directions?
2. If the trigger for gas directions should be expanded to consider issues other than physical supply, what should the criteria be? For example, should the AER have discretion or should there be a defined threshold?

3. If the AER has discretion in issuing the direction, what factors should the AER consider? For example, the financial impact to the designated RoLR or current market prices?
4. Would expanding the RoLR direction triggers impact a retailer's decisions to enter or exit the market or their ability to obtain gas supply? Please explain and provide evidence.

Question 2: Should we increase the length of time RoLR gas directions apply?

1. Should the RoLR gas directions period be extended from their current level? If yes, how long should directions last? Please explain and provide evidence.
2. Do you consider increasing the RoLR gas directions period will influence or increase the cost of gas retailers obtaining finance or other incentives to becoming a retailer? If yes, please explain and provide evidence.
3. Would there be benefits in a flexible direction period (e.g. a minimum timeframe with an ability to extend to a specified period)? If so, what criteria should apply to extensions?

Question 3: Should we introduce negotiation principles?

1. Do you support introducing negotiation principles? If yes, what should they include?
2. How should compliance with negotiation principles be measured?
3. Is the need for negotiation principles reduced or removed with a longer directions period?

Question 4: Should we remove the negotiation process?

1. Do you support removing mandatory negotiations if the RoLR gas directions period is extended?

Question 5: How should we clarify what happens to contracts that begin or end during directions?

1. Should a direction cease when the directed contract expires?
2. How should options to extend contracts be treated under the directions framework?
3. Should contracts that are due to commence in the directions period be subject to direction?

Question 6: Should gas storage contracts be considered in the RoLR gas directions framework?

1. Should the gas held in storage be transferred to the RoLR?
    a. If yes, should the RoLR be required to pay the failed retailer for this gas in line with the negotiation principles?
    b. If no, can the storage rights alone be transferred to the RoLR?
2. Are there any issues with Victorian gas facilities being included in the RoLR gas directions framework?
3. Do you consider there are competition issues that should be mitigated? If yes, what measures would be appropriate?
4. Are there any issues with the need to be registered in AEMO's systems to use storage facilities?

CONTENTS

FIGURES

1 WE ARE WORKING TO IMPROVE THE RESILIENCE OF THE RETAIL MARKET

This directions paper seeks stakeholder feedback on the options we are considering to improve how gas and electricity retailer failures are managed. This chapter explores:

- an overview of how retailer failures are managed and the events that triggered this review (section 1.1)
- explanation of the difference between how electricity and gas retailer failures are managed in the context of this review (section 1.2)
- the context for this direction paper.

Our review considers the National Energy Customer Framework (NECF) jurisdictions. Victoria has a Retailer of Last Resort (RoLR) scheme and is outside the scope of this review. However, aspects of the two RoLR schemes interact, especially for the physical supply of gas. Therefore, we are consulting with the relevant organisations in Victoria, including the Victorian Department of Environment, Land, Water and Planning and the Essential Services Commission of Victoria.

1.1 Retailer failures are managed through the Retailer of Last Resort Scheme

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, we would expect to see retailer exits, as new businesses test less successful business models. However, because energy is considered an essential service, the National Energy Retail Law (NERL) sets out a mechanism to protect customers in the event that their retailer fails.

In the event of a retailer failure, the RoLR scheme facilitates the transfer of customers to new retailers without disrupting their electricity or gas supply.[1] If the RoLR scheme is triggered, the Australian Energy Regulator (AER) allocates the customers of the failed retailer to one or more other retailers. These retailers are referred to as designated RoLRs.

The RoLR scheme in gas also has a directions framework. If triggered, this allows the designated RoLR to access the gas supply and pipeline capacity contracts previously used by the failed retailer.

1.1.1 East coast markets saw record high prices and retailer failures in 2022

In 2022, the National Electricity Market (NEM) saw record-high wholesale prices and reduced liquidity in the contract market which put pressure on retailers. The result was a record number of retailer failures. From 24 May to 1 September 2022:

1 Broadly speaking, a retailer failure triggers the RoLR scheme. However, section 122 of the NERL sets out specific circumstances that trigger RoLR events including a retailer going into receivership or becoming insolvent, failing to meet its prudential requirements, or ceasing to be a market participant).

- seven authorised retailers failed and triggered RoLR events:
  - Weston Energy in gas where the AER used the RoLR gas directions power for the first time.[2]
  - 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) also entered administration.

At the same time, the Australian Energy Market Commission (AEMC or Commission) observed some retailers allegedly selling their hedges after actively encouraging their customers to move to other retailers. We were also informed that some RoLRs experienced difficulty accessing contracts to service their new customers.

There is still potential for more retailers to exit the market, particularly for retailers that purchased contracts for future periods at those previously elevated prices.

Prior to the events of 2022, the RoLR scheme was used four times since the NECF was introduced in 2012.

1.2 We have refined options for improving how retailer failures are managed

There are different approaches to managing risks for gas and electricity RoLR events and, therefore, how the Commission has approached the options for improving each process.

1.2.1 Electricity and gas have different approaches to managing risks

While the RoLR scheme facilitates a timely transfer of customers to a new retailer, it can result in risks and costs for customers and remaining retailers. While the failed retailer's customers are transferred to the designated RoLR, the contracts that the failed retailer used to manage wholesale price risks for those customers are not transferred. If retailer failure occurs in volatile market conditions with high wholesale prices, the designated RoLR may face financial stress from being exposed to these prices or being unable to obtain gas.

There are different arrangements in electricity and gas to manage this risk:

- In gas, the RoLR scheme has a directions framework that allows the designated RoLR to access the physical gas supply and pipeline capacity contracts previously held by the failed retailer. This provides the designated RoLR with the physical gas it needs to support the transferred customers on the same terms and conditions that were available to the failed retailer for the period of the direction.
- In electricity, where electricity is purchased through the NEM there is no need for directions to make sure the designated RoLR can supply the transferred customers. The designated RoLR purchases electricity through the NEM and manages its cost risk for supplying the transferred customers via hedging contracts.

2 AER, Weston Energy Pty Ltd, RoLR notice, amended 31 May 2022.

- Both electricity and gas RoLR arrangements allow the designated RoLR to claim costs associated with being the RoLR, although this process has not been used and stakeholders have suggested there is a lack of clarity about what costs can be claimed.

1.2.2 We are seeking to improve the electricity and gas RoLR schemes

The electricity RoLR scheme facilitates the orderly transfer of customers but may increase costs to consumers and expose the designated RoLR to a sudden increase in costs from servicing new customers. Therefore, we are exploring new measures to reduce the costs of retailer failures and improve the resilience of the electricity RoLR scheme.

The gas RoLR scheme does allow the AER to direct the failed retailer's contracts for gas supply or pipeline capacity to the designated RoLR. Our focus for gas is on whether amendments would improve consumer outcomes, the financial resilience of the designated RoLR and the gas RoLR scheme.

1.3 Governments asked for advice when the market was under pressure in 2022

Following the events of 2022, Energy Ministers requested the AEMC provide specialist advice on improving market resilience and managing retailer failures. We 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. These recommendations were informed by previous AEMC reviews into financial resilience (2015), retail competition (2020), the RoLR (2021), and the AER's recent experience in managing retailer failures.[3] Collectively, the recommendations being progressed reduce the risk of a significant retailer failure resulting in significant financial stress or cascading failures for remaining retailers. In addition to this review, some of our key recommendations were to:

- **Implement previously consulted-on improvements to the RoLR scheme.** The immediate reforms to the RoLR scheme included improving the clarity and certainty of cost recovery, and extending the timeframe for a designated RoLR to meet AEMO's increased credit support requirements. These changes were proposed in the AEMC's 2021 RoLR review and supported by recent AER experience administering the RoLR scheme.
- **Explore government-owned retailer participation in the RoLR scheme to prevent cascading retailer failures**. There is no last-resort mechanism to manage significant retailer failures that could trigger cascading retailer failures. We have recommended that government owned retailers could act as RoLRs to prevent cascading failures, and that scenario planning be progressed so the industry's ability to withstand crises is improved.

Jurisdictional governments are considering these recommendations.

3 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.

2 WE ARE CONSIDERING OPTIONS TO REDUCE THE COSTS OF ELECTRICITY RETAILER FAILURES

The Commission is considering options to lower the cost of electricity retailer failures to improve retail market resilience and consumer outcomes. This chapter describes:

- current arrangements and issues with the framework (section 2.1).
- potential options to improve the framework and whether we are:
  - further considering and seeking feedback on the option (section 2.3 to section 2.5)
  - rejecting the option and the rationale (section 2.6 and section 2.7).

2.1 Electricity retailer failures can create costs for consumers and the RoLR, and risks to the market

Retailer failures are managed through the RoLR scheme which transfers customers from a failed retailer to the designated RoLR in the distribution area. This ensures the customers of the failed retailer continue to receive service, but the process can result in high costs for consumers and the designated RoLR, and additionally may create systemic risk. Specifically:

- The costs of the RoLR scheme can be shared with consumers in a distribution area. This can result in prices for all consumers in the distribution area increasing to cover the costs of a retailer failure.
- In order to supply the transferred consumers, the designated RoLR will need to purchase electricity from the wholesale market and hedging contracts to manage its risks. In volatile market conditions, wholesale electricity prices and contract prices are likely to be high, and contracts may or may not be available. Given retail price regulation, the RoLR may have costs that exceed its ability to charge consumers.
- There is a low but potential risk of systemic failure, if a large retailer or many small retailers failed in a short period. This would result in many consumers being transferred to the designated RoLR(s). If the cost of buying energy from the spot market and hedging contracts for the large number of transferred customers was above the revenues those customers generated, then there may be cascading retailer failures.

2.1.1 Electricity retailers use hedging contracts to manage price variation in the spot market

Electricity retailers obtain electricity at the spot price from the NEM for their customers and manage spot market price risk with hedging contracts. The NEM is a gross-pool market where all electricity is sold by generators and purchased by retailers or energy users. Prices in the NEM can currently vary between -$1,000/MWh and $15,500/MWh every five-minutes.[4]

4 This is distinct from east coast gas retailers, who typically rely on bilateral contracts at an agreed price for physical supply. A prudent retailer will typically contract for its expected customer load. Electricity retailers use derivatives contracts that are typically either traded on an exchange or over-the-counter (OTC). For more information on the hedging contracts used by electricity retailers, see the appendix in the AEMC's *Review into the arrangements for failed retailers' electricity and gas contracts*, consultation paper, 13 October 2022.

2.1.2 The RoLR scheme does not support electricity retailers of last resort manage price risks

Following a retailer failure, the designated RoLR receives the failed retailer's customers. While the designated RoLR can obtain electricity from the NEM to supply the transferred customers, there are no arrangements for any hedging contracts to manage the associated price risk.

Retailer failures in the NEM typically occur in periods of spot market volatility and elevated prices. This represents the following risks:

- A designated RoLR and will likely need to purchase extra contracts to manage this spot price risk which may impose additional costs.
- A designated RoLR may face higher costs of servicing its customers that exceed the revenue it can recoup from the transferred customers.[5] This risk scales with the size and number of retailer failures.
- Customers may face higher costs. This could be through higher retail prices for the designated RoLR's customers or for all customers through paying for the RoLR's cost recovery in their distribution charges.[6]

Our stage one consultation paper provided an illustrative example of this risk of costs that cannot be recovered for the designated RoLR (see Box 1). In response, some retailers confidentially commented on the Commission's illustrative example and noted their cost estimates materially exceeded the Commission's estimates.

BOX 1: ILLUSTRATIVE EXAMPLE | WHOLESALE AND HEDGING COSTS OF A ROLR EVENT

Our stage one consultation paper explored this simplified example of the wholesale cost impact of a larger retailer failure. This example estimated the potential magnitude of wholesale costs above the level of the DMO for a larger retailer failure.

Electricity retailer failure results in the transfer of 250,000 residential customers in NSW. The wholesale costs of servicing these customers over the following 70 days is:

- $205 per customer, resulting in $54m 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.

Source: More detail on the assumptions and calculations can be found in our consultation paper. AEMC, *Review into the arrangements for failed retailers' electricity and gas contracts*, consultation paper, 13 October 2022. Box 1, p. 12.

5 Small customers are placed on the designated RoLR's standing offer. The Default Market Offer (DMO) caps these standing offer prices.

6 The RoLR scheme also includes a cost recovery framework that allows the designated RoLR to claim some costs associated with the RoLR event. However, the RoLR cost recovery scheme has never been used following a RoLR event, and the market costs that may be claimed are unclear.

In response to our stage one consultation paper, all 12 stakeholder submissions supported reducing the costs of retailer failures to the designated RoLR(s) and customers. Stakeholders considered this could be achieved by clarifying the market costs that could be claimed through the RoLR cost recovery process and requiring the failed retailer to pay for these costs where possible. Addressing this cost risk is the primary focus of this review as we consider the risk to be material.

2.1.3 Electricity RoLR events may create systemic risks

We consider that improving the RoLR scheme will not remove all risk of cascading retailer failures. Instead, it can only reduce their likelihood by reducing the costs to customers and the designated RoLR. The RoLR scheme is the only mechanism for managing retailer failures in the NEM, which means larger, or many smaller retailer failures, can place significant pressure on RoLRs. Therefore, if a designated RoLR cannot manage the costs of taking on customers following a retailer failure, it could potentially trigger cascading retailer failures.

Stakeholders provided mixed feedback on systemic risks. Some considered the risk was not material or that the RoLR scheme would not sufficiently address the risk and that changes outside the scope of this review would be needed.

In particular, the Australian Energy Council (AEC) provided a balanced perspective on the UK retailer failure case study and their view on how it could apply to the Australian context. The AEC noted that Bulb Energy was a retailer failure that triggered the UK's use of a special administrator scheme that enabled Ofgem to appoint an administrator to run the company.[7] When translated to the Australian context, only four individual retailers or a combined 50 small retailers would have a comparable impact in the NECF jurisdictions. The AEC considered the RoLR scheme and the enhancements in the scope of this review would be unlikely to address a failure of that size and that further work was needed to determine the materiality of the risk before developing proportionate solutions.

The Commission broadly agrees with the AEC's position but considers that improving the RoLR scheme can reduce the likelihood of systemic retailer failures to the extent it reduces the costs incurred by the RoLR of retailer failures. The Commission recommended other measures to address systemic risks to Energy Ministers in 2022. These included extending the time when a designated RoLR must meet its prudential requirements for transferred customers, exploring a government-owned backstop to prevent cascading failures and industry-wide scenario planning to better respond to future crises.

7 In the UK, the Office of Gas and Electricity Markets (Ofgem) uses a supplier of last resort (SoLR) scheme for smaller retailer failures but has a special administration scheme to manage large failures. This allows Ofgem to appoint administrators to run the company for a retailer that's deemed too large to fail and prevents the application of the SoLR scheme resulting in cascading retailer failures.

2.2 There are feasible options to improve the electricity RoLR framework

After considering stakeholder feedback to our stage one consultation paper and further analysis, we consider there are feasible ways to improve the electricity RoLR framework. We are considering and are seeking further feedback on:

- **What improvements should be made to the RoLR cost recovery scheme?** The intention is to increase the certainty that the designated RoLR's wholesale and hedging costs associated with a sudden increase in the number of customers, can be recovered.
- **Should we issue the failed retailer a bill for the costs of its failure?** This option was provided by stakeholders and requires the failed retailer pay for the costs of its exit. This option may reduce the RoLR scheme's costs for customers to the extent that the failed retailer pays this bill. It will also reduce incentives for solvent retailers to deliberately use the RoLR scheme.
- **Clarifying the information that is necessary for the AER and designated RoLR to fulfil their duties.** We are considering the type of information required and how that may be collected. The AER can currently use information gathering powers to obtain information for the AER and the designated RoLR, but this is time consuming.

We are not progressing further work on:

- **An electricity RoLR directions framework.** This option was intended to reduce the risks and costs of a RoLR event. However, it is likely to contradict financial market risk management principles published by the International Swaps and Derivatives Association (ISDA). It may also discourage financial institutions from trading electricity derivatives and encourage retailers to sell contracts before failing. We are therefore not considering this option further.
- **A matchmaking service to reduce search costs**. This option would give the designated RoLR access to the failed retailer's contracts, including counterparty details. It would enable the designated RoLR to identify and contact counterparties that may wish to re-contract. However, we are not considering this option further. This is because it would compromise the confidentiality of ongoing contracts in the case of a solvent failed retailer that can still trade contracts. Furthermore, without a negotiation obligation, a matchmaking service does not improve the designated RoLR's ability to obtain contracts relative to the current framework.

2.3 What improvements should be made to the RoLR cost recovery scheme?

This section describes:

- stakeholder support to clarify what market costs may be claimed through the RoLR cost recovery scheme
- why we are further considering this option and our questions for consultation.

2.3.1 Stakeholders supported further work to clarify claimable market costs

In submissions to our stage one consultation paper, stakeholders unanimously supported clarifying the scope of market costs that can be claimed in the existing RoLR cost recovery framework.[8]

All stakeholders that commented on this issue supported the AEMC developing this approach further.[9] Many noted that the AER guidance is insufficiently clear and has only been used for administrative costs associated with preparing for a RoLR event. Stakeholders noted the following key benefits from greater clarity:

- it may help designated RoLRs obtain finance for the period between the RoLR event and eventual payment
- increased certainty would reduce the risks associated with the RoLR scheme and potentially encourage new RoLR registrations
- it is a simple and feasible solution.

Stakeholders also suggested ways to manage cash flow issues for the period between when a RoLR incurs costs and the RoLR cost recovery scheme is paid.[10] We explore this further in section 2.3.2.

2.3.2 We are considering changes to the RoLR cost recovery scheme

We seek stakeholder views on three issues that may improve the RoLR cost recovery scheme. They are:

- what costs should be claimable as prudent market costs
- the period in which costs can be claimed
- if process changes would benefit the designated RoLR in managing its cash flow.

Currently, the NERL incorporates a process by which a designated RoLR can apply to the AER to recover the costs incurred on, or after, a RoLR event.[11]

- The AER's RoLR guidelines require RoLRs to apply within nine months of the relevant RoLR event.

8 See option 1 on pages 20-22 in the AEMC's *Review into the arrangements for failed retailers' electricity and gas contracts*, consultation paper, 13 October 2022.

9 AFMA, p. 7; Momentum, p 4; AEC, p. 3; EnergyAustralia, Simply, p. 1; Alinta, p. 3; Red Lumo, p. 2; Origin, p. 2; AGL, p. 6; CS Energy, p. 2, and the AER, p. 4 submissions to the consultation paper.

10 Origin, submission to the consultation paper, p. 2.

11 NERL, section 166. A default RoLR may also apply to recover costs incurred in preparing for a RoLR event.

- Following receipt of the application, the AER must publish the application on its website invite stakeholder submissions. The AER must decide whether to grant or refuse the application.[12]
- The AER's decision must be informed by the principles set out in its RoLR guideline.[13] These principles do not explicitly state the wholesale and hedging costs that the AER may consider and the risk period within which the costs could be claimed.

What costs should the designated RoLR be able to claim?

Small customers are transferred from the failed retailer to a designated RoLR's standing offer.[14] The Default Market Offer (DMO) sets a price ceiling for small customer standing offers in the NECF jurisdictions and is set annually by the AER. In elevated market conditions, this could potentially result in the designated RoLR servicing transferred small customers at prices below the cost of supply. To address this, the Commission considers the designated RoLR:

- Should be able to claim the difference between revenues achievable under the DMO and prudent wholesale and hedging costs for small customers transferred on to their standing offers. We are seeking Stakeholder views on these claimable costs, in particular what costs are relevant (for example, electricity spot market costs, prudential costs, hedging costs) and how these would be identified separately from the designated RoLR's other customer costs.
- For large customers, retailers should not have wholesale and hedging cost recovery as the DMO does not apply and the RoLR can therefore offer prices that reflect the costs incurred.

Stakeholders indicated that improved clarity on claimable costs may help designated RoLRs obtain finance for the period between the RoLR event and payment via the RoLR cost recovery scheme process. Increased certainty would also reduce the risks associated with a retailer being a designated RoLR and may potentially encourage new RoLR registrations.

What period after the RoLR event should a designated RoLR be able to recover prudent market costs?

When a designated RoLR receives new customers from the failed retailer, it will not know the consumption profile of those customers, nor have hedging arrangements in place to manage the cashflow risks those additional customers may create. It takes time to address both those issues.

The AER's RoLR guideline requires designated RoLRs to submit a RoLR cost claim states that a RoLR must apply within nine months of the transfer date, but does not specify the period within which costs can be claimed. Implicitly, the current arrangements assume up to a nine-month period of risk where the designated RoLR may face costs it cannot recover from customers due to the RoLR event. This period should be known upfront with additional time to allow the RoLR to prepare and submit the claim.

12 Section 166(5-6) of the NERL.

13 AER, *RoLR guideline*, version 1, November 2011.

14 Work is also underway to explore expanding this to include market offers that are at least as good as the standing offer.

Few stakeholders commented on the length of time for which RoLR cost recovery should apply for. Consistent with the AER guideline, we consider nine months seems to allow sufficient time for the retailer to understand the size and nature of its new load requirements and develop an appropriate contracting strategy to accommodate this. Furthermore, retailers typically progressively build their hedge book to cover expected customer load allowing for factors like expected prices and customer churn.

We consider nine months allows retailers sufficient time to reposition their hedge book to accommodate these factors and the new customers.

Would process improvements help the designated RoLR manage potential cash flow issues?

Stakeholders raised potential cash flow challenges for the designated RoLR in the period between incurring costs to manage its new customers and receiving payment from the RoLR cost recovery scheme. Origin noted that cash flow issues may persist even if there was explicit guidance on what wholesale and hedging costs could be recovered through the RoLR cost recovery scheme.[15] Some potential options that could address this cash flow issue, if necessary, include that RoLRs:

- are paid once based on estimated costs with a true-up later once costs are determined by the AER using actual costs incurred
- make and receive multiple cost recovery claims rather than one cost recovery claim.

QUESTION 1: WHAT IMPROVEMENTS SHOULD BE MADE TO THE ROLR COST RECOVERY FRAMEWORK?

1. Should the costs that can be claimed by a designated RoLR be defined specifically? Please specify what costs should be claimable and how they would be identified. Please also comment on whether these costs should be in reference to the DMO for small customers and not available for customers not subject to the DMO?
2. What period after the RoLR event should market costs be able to be recovered by the designated RoLR? Please explain and provide evidence.
3. How beneficial would progressive or estimated payments be to reducing cash flow issues for the designated RoLR? Are these benefits reduced or removed if the market costs that can be claimed are clarified? Please explain and provide evidence.

15 Origin, submission to the consultation paper, p. 2.

2.4 Should we bill the failed retailer for the costs of its failure?

This section describes:

- stakeholder support to recover costs from the failed retailer in response to our stage one consultation paper
- the option we are exploring to issue the failed retailer a bill
- our questions for stakeholder feedback on the risks and benefits of this option.

2.4.1 Stakeholders supported recovering costs from the failed retailer and proposed alternative options

In submissions to our stage one consultation paper, stakeholders supported further work to require the failed retailer to pay for the RoLR cost recovery, rather than customers.[16]

However, stakeholders raised several issues with the option which proposed using the failed retailer's 'in-the-money' hedges to pay for the RoLR cost recovery:

- 'In-the-money' contracts would be virtually impossible to identify and isolate.[17] In Australia, counterparties will typically pay a net closeout position (which is the closing balance of all contracts held with a counterparty) if a termination is triggered. This means that a sum of money from all contracts may be available but specific contracts will not be identifiable.
- If payment is only sourced from the failed retailer's hedging contracts, this may encourage the retailer to sell its hedges before failing.[18]
- There may be cash flow issues for the designated RoLR if the cost recovery payment depends on receiving funds from the failed retailer. Therefore, this option should not depend on those funds to progress the cost recovery payment.[19]
- It may disincentivise retailers from entering the market and result in higher costs to customers or reduced competition.[20]

Some stakeholders proposed alternative models that sought to address the above issues.

- AFMA proposed the failed retailer should bear the costs from its entire asset base, rather than through hedges alone.[21] This is described in section 2.4.2.
- Momentum proposed exploring the AEMO reallocations framework to transfer value to the designated RoLR in the event of a retailer failure.[22] We are not considering this option further because the AEMO reallocations framework reflects bilateral agreements that are part of the market settlement process. For each transaction in the reallocations

16 See option 4 on pages 36-39 in the AEMC's *Review into the arrangements for failed retailers' electricity and gas contracts*, consultation paper, 13 October 2022.
AFMA, p. 8; Momentum, p. 5; AEC, p. 4; EnergyAustralia, p. 5; Origin, p. 3; AGL, p. 4; CS Energy, p. 4 and the AER, p. 4 submissions to the consultation paper.

17 Red Lumo, p. 3; AFMA, pp. 3-5; and CS Energy, p. 4 submissions to the consultation paper.

18 Origin, p. 3; AFMA, pp. 3-5; Alinta, p. 4 and the AER, p. 6 submissions to the consultation paper.

19 Origin submission to the consultation paper, p. 3.

20 Simply, p. 2 and the AER, p. 7 submissions to the consultation paper.

21 AFMA submission to the consultation paper, pp. 7-9.

22 Momentum submission to the consultation paper, p. 5.

framework there is a Credit Participant and Debit Participant. If the RoLR process removed funds from the failed retailer's reallocations, it may offset some of the cost of the retailer failure, but that cost would be borne by the counter-party to the reallocation rather than (potentially) being shared across customers in a distribution area. The cost of the retailer failure would also not be known at the time, so the amounts to retrieve via the reallocations framework would be unclear. Additionally, potential law or rule changes to enable the reallocation funds to be removed from an insolvency process would have to be determined.

Simply Energy opposed the option put forward in consultation on the basis that it would not resolve the contract, costs and cash flow issues quickly enough to be valuable for a designated RoLR.

2.4.2 Should we bill the failed retailer for the costs of its failure?

Informed by AFMA's submission, we are exploring the approach where the AER would issue a failed retailer with a notice for a bill to recover the RoLR costs. We consider this option materially improves upon the option explored in our consultation paper.

This option would expand the existing framework to enable the AER to issue the failed retailer a bill for the costs of its failure. This means that the AER would issue the failed retailer a notice for a pending bill when the RoLR event occurs. Once the designated RoLR has applied to the AER for the RoLR cost recovery scheme and determined the amounts, the AER would then issue the failed retailer a bill.

The likelihood of receiving payment from the failed retailer for this bill depends on the nature of the retailer failure. Specifically, if the failed retailer is

- still solvent it would be required to pay the costs as a debt due and owing
- insolvent the AER would have an outstanding bill, and rank as an unsecured creditor in the insolvency process.[23]

Issuing the failed retailer with a bill reduces incentives for retailers to strategically exit the market when still solvent as they may still receive a bill for the costs of their failure. This was an issue raised in several submissions. However, if the failed retailer is insolvent, this may result in the AER receiving little to no return once the insolvency process is complete, so the mechanism may not offset any or all RoLR costs.

This option could be enhanced by considering ways to increase the likelihood of recovering funds from the failed retailer where the failed retailer is insolvent.

Our preferred option to improve the likelihood of payment is to make the AER a secured creditor within the existing insolvency frameworks. Under this mechanism, when the retailer is granted a retailer authorisation (or for existing retailers, when this law comes into effect) it would be required to provide an 'all assets security interest' on its assets in favour of the AER, which will be registered on the Personal Property Securities Register (PPSR). This would

23 The AER can already receive and manage payments. Currently, the Australian Competition and Consumer Commission handles the receipt of infringement penalty payments for the AER on behalf of the Commonwealth of Australia. All payments received are paid into the Consolidated Revenue Fund.

provide a security interest for amounts owed to the AER under a RoLR cost recovery scheme payment order. Box 2 provides an illustrative example of how this option may work.

BOX 2: ILLUSTRATIVE EXAMPLE | FAILED RETAILER PAYING A BILL FOR THE COSTS OF ITS FAILURE

The following illustrative example seeks to highlight the practical implications this option in various RoLR events.

1. On 1 March 2023, a retailer fails which triggers a RoLR event and its 100,000 customers are transferred to the designated RoLR in the midst of elevated market prices.
2. The AER issues the failed retailer a notice for a pending bill to pay for the RoLR cost recovery. The AER will determine the RoLR cost recovery amount at a later date.
3. The designated RoLR applies for its claimable wholesale and hedging costs over a certain time period and the AER determines the RoLR cost recovery scheme. The AER determines the total cost recovery amount is $10,000,000.
4. The AER issues the failed retailer a bill for the RoLR cost recovery scheme. The likelihood of this being paid depends on the financial status of the failed retailer and the potential mechanisms in place to enhance the likelihood of recovery (examples of which are described below).

Potential payment if the failed retailer is solvent

Some retailer failures that trigger RoLR events may occur when the failed retailer is still solvent. In these instances, once the RoLR cost recovery scheme has been determined, and a bill is issued, the failed retailer would be obligated to pay the bill like any other debt.

Potential payment if the failed retailer is insolvent

<u>If the AER is an unsecured creditor</u>

If the failed retailer is insolvent, then there is a defined process for paying debts, with secured creditors ranking above unsecured creditors. If the AER is an unsecured creditor for the $10,000,000 bill issued for the RoLR cost recovery scheme it may receive little to no return.

<u>If the AER is listed as a secured creditor on the PPSR</u>

If the AER, is registered on the PPSR, then it is deemed a secured creditor in the insolvency process, and will be paid ahead of any unsecured creditors. This increases the likelihood the AER may receive payment towards the $10,000,000 debt.

If the AER receives $1,000,000 from the insolvency process because of its ranking as a secured creditor on the PPSR, this process would facilitate reducing costs to customers by 10 per cent.

Given the insolvency process may cover an extended period, we propose that the designated RoLR should still be able to recover its approved costs through a distribution network cost pass through process. Whatever funds are recovered by the AER at the conclusion of the insolvency process will be treated as a negative cost pass through via the same process. In this way, the designated RoLR can recover its costs ahead of the failed retailer paying some of the bill (or insolvency process being finished), and customers can recoup any costs that recovered from the failed retailer.

A further issue we are considering in relation to issuing a bill to failed retailers is how the timing of the amended RoLR process would align with the timing of insolvency processes.

2.4.3 Are incentives for market entry, expansion or operation impacted by this option?

This new option would introduce an obligation for the failed retailer to pay the costs caused by its exit. This obligation could potentially have an effect on all retailers' long term ability to obtain finance, or increase the cost of such finance and influence barriers to entry, expansion or competition. We seek stakeholder feedback on the following aspects of the option.

Issuing the failed retailer a bill

- Would the risk of the AER issuing a bill in the event of failure increase a retailer's cost of capital and therefore make market entry or expansion harder?

Increasing the likelihood of payment if the failed retailer is insolvent

- If a retailer has to register an 'all assets security interest' on the PPSR in favour of the AER, would there be additional implications for retailer costs and incentives? For example:
  - would the PPSR registration (and the creation of the AER as a potential secured creditor) increase a retailer's cost of capital, and therefore make market entry or expansion harder?
  - would there be any impact on a retailer's ability (in addition to price) to raise loans or equity, which may affect its ability to seek finance to trade out of a difficult market period?

If stakeholders consider there are likely and material negative implications from the above issues, particularly for smaller retailers, we are considering introducing a minimum threshold, above which the AER would issue the bill to a failed retailer (i.e. new/small retailers would not be issued a bill). Such a threshold could be based on cost, customer numbers, annual turnover or the number of customers on market contracts.

QUESTION 2: SHOULD WE ISSUE THE FAILED RETAILER WITH A BILL FOR THE COSTS OF ITS FAILURE?

1. Do you support the AER issuing a bill to the failed retailer for the RoLR cost recovery scheme? If yes, do you also support the registration of a security interest on the PPSR at the time of retailer registration or this law coming into effect?
2. If yes to 1) are there any likely cost of capital implications for retailer entry, expansion and operation? Please explain and provide evidence.
3. Do you anticipate any issues with the timing of the RoLR cost recovery and the insolvency process? If yes, are these issues made better or worse if the AER is registered on the PPSR?
4. Do you agree a minimum threshold should be applied for this mechanism to reduce the potential barriers to entry or expansion? If yes, what should this threshold be?
5. Are there other issues to which the AEMC should have regard to with this option? Please explain and provide evidence.

2.5 What information do the AER and electricity RoLRs need to fulfil their duties?

This section describes:

- stakeholder feedback on electricity RoLRs getting the right information
- our rationale for considering what information electricity RoLRs and the AER should receive, how this information is collected and questions for consultation.

2.5.1 Stakeholders generally supported further work to make sure the AER and RoLRs get the right information

In submissions to our stage one consultation paper, stakeholders generally supported the AER receiving the information it needs to perform its duties.[24] However, stakeholders were concerned about providing the same information to multiple regulatory agencies. They also considered this should be restricted to only include information necessary to manage the RoLR event.

2.5.2 We are further considering what information the AER and RoLRs should receive

Currently, the AER may obtain information through the RoLR regulatory information notice (RIN) process and share this with the designated RoLR in certain circumstances. However, this process of drafting RoLRs RINs and receiving responses can be time-consuming, particularly as retailer failures happen quickly, and the AER and designated RoLRs may need information quickly.

24 Origin, p. 3; Red Lumo, p. 2; AGL, p. 6-7; Alinta, p. 3 and AFMA, p. 7 submissions to the consultation paper.

We seek stakeholder views on what specific information should automatically be made available to the AER and designated RoLRs. This may include the:

- size and shape of the failed retailer's customer load for the year prior to failure to account for seasonal variation
- price of offers to non-residential customers immediately before failure.

Depending on the policy options proposed, we are exploring how to obtain this information most efficiently.

QUESTION 3: WHAT INFORMATION DO THE AER AND ELECTRICITY ROLRS NEED TO FULFIL THEIR DUTIES, AND HOW SHOULD IT BE COLLECTED?

1. What information should be provided to the AER and designated RoLRs in electricity RoLR events, and how should that information can be most efficiently collected? Please explain and provide evidence.

2.6 We have rejected an electricity RoLR directions framework

This section describes:

- stakeholder feedback on introducing an electricity directions framework
- our rationale for not considering this option further.

2.6.1 Stakeholders strongly opposed further considering an electricity directions framework

In submissions to our stage one consultation paper, almost all stakeholders opposed introducing a RoLR directions framework in electricity.[25] Stakeholders opposed this option because they considered it would:

- **Negatively disrupt the contract market**[26]
  - Stakeholders noted introducing a direction could lead to higher risks for both retailers and sellers of contracts. This is because, if triggered, the retailer will have its contracts directed and the seller of the contract will have a contract with a counterparty it has not chosen.
  - If the above risk is material, it may discourage clearing participants from providing clearing services which could increase barriers to new retailer entry (less hedges available) and lead to potentially more vertical integration.
  - It may necessitate variation to many existing contracts which may then attract higher risk premiums or more restrictive terms in future contracts.

25 See options 3a and 3b on pages 25-35 in the AEMC's *Review into the arrangements for failed retailers' electricity and gas contracts*, consultation paper, 13 October 2022.

26 Momentum Energy, p. 7; Origin Energy, p. 3; Red Lumo, p. 2 and CS Energy, p. 4 submissions to the consultation paper.

- **Have significant practical barriers that outweigh potential usefulness**[27]
    - It is not clear who the directed counterparty for exchange-traded contracts would be (whether it's the clearing participant, ASX Clear futures or another party). Without clarity of whom the direction should be issued to, this would make issuing a direction and determining compliance difficult.
    - The direction may create conflicting obligations for insolvency officials whose obligation is to maximise return for creditors. This could result in the failed retailer potentially attempting to sell contracts before failure.
    - Determining the allocation of contracts would be complex if there were multiple RoLRs across different distribution areas. The allocation would affect both the financial position of the designated RoLRs and the costs that may be borne by consumers in different distribution areas.
- **Negatively impact best practice financial market risk management**[28]
    - The designated RoLR who is to receive the contracts in the direction may not meet the 'know your customer' onboarding requirements, ISDA documentation or credit risk approvals.[29] If directed, this could potentially leave the counterparty unable to meet its existing regulatory requirements for financial contracts.
- **Reduce competition and retail market efficiency**[30]
    - A directions framework may incentivise failing retailers to sell hedging contracts before failure, so they are not subject to the direction.
    - The direction may increase the risk of selling hedging contracts and create barriers to entry for new retailers. As a result, it may also provide a competitive advantage to vertically integrated incumbent retailers.

AFMA also noted that a direction with reference to current market prices would be ineffective relative to purchasing contracts from the market following the RoLR designation.

The AER provided the only written submission supporting this option as it considered that the wholesale market price protection of a failed retailer should follow the customer in a RoLR event. In the AER's view, this approach would fairly allocate risk and ensure the failed retailer's customers continue to receive the benefits of the insurance purchased on their behalf.[31]

In addition to written submissions, AEMC staff met with regulatory bodies including the RBA, ASIC and Federal Treasury on this option which reinforced the practical challenges outlined above.

27 Momentum Energy, p. 7; Origin Energy, p. 3; Alinta, p. 4; AGL, p. 7, AEC, p. 3 and AFMA, pp. 3-4 submissions to the consultation paper.

28 CS Energy, p. 4; Alinta, p. 4; AFMA, pp. 3-4; AEC, p. 3 and AGL, p. 7 submissions to the consultation paper.

29 *Suggested Operational Practices for OTC Derivatives Collateral Process*, 28 November 2022, ISDA.

30 Momentum, p. 7; Alinta, p. 4; AEC, p. 3 and Simply Energy, p. 1, submissions to the consultation paper.

31 AER, p. 5, submission to the consultation paper.

2.6.2 We have rejected a directions framework because of significant practical issues

The Commission considers that if this option could be successfully implemented its benefits would be substantial. The designated RoLR would have immediate hedge protection for its new customers should that was previously held by the failed retailer. While this hedge protection may be limited in small retailer failures, we anticipate that a larger failed retailer would have held at least some hedges to manage its customers. This would also ensure the failed retailer did not retain well-positioned hedges. Therefore, this option would reallocate risks from the designated RoLR to the failed retailer, thereby reducing the risks and costs of a retailer participating in the RoLR scheme and costs for affected customers.

However, we consider that the risks and practical issues raised by stakeholders are significant. We are not considering this option further based on the issues raised by stakeholders.

2.7 We have rejected introducing a matchmaking service

This section describes:

- stakeholder feedback on whether a matchmaking service would provide benefits over the existing arrangements
- our rationale for not considering this option further.

2.7.1 Stakeholders queried whether the risks of a matchmaking service outweighed the benefits

We received mixed feedback on whether to introduce a matchmaking service to reduce search costs.[32]

Those who supported the option suggested it would potentially reduce search costs for acquiring new contracts and allow timely information to be obtained by the RoLR.[33] Stakeholders who opposed this option raised the following issues:

- If price information was provided, then it may expose different price points between the supplier and retailers and this may impact ongoing commercial relationships. Most stakeholders opposed the provision of pricing information.
- It would not be able to be used for RoLR events where a failed retailer is still solvent as the contracts are likely to remain in force.
- It may create an enduring competitive advantage for the designated RoLR if it receives commercially sensitive information about hedging arrangements that is not available to the rest of the market.

32 See option 2 on pages 22-24 in the AEMC's *Review into the arrangements for failed retailers' electricity and gas contracts*, consultation paper, 13 October 2022
Seven stakeholders opposed further development: AFMA, p. 7; Momentum, p.5; AEC, p. 3; EnergyAustralia, p. 4; Simply, pp. 1-2; Alinta, p. 3, and CS Energy, pp. 2-3 submissions to the consultation paper. Four stakeholders supported further development: Origin, p. 3; AGL, pp. 6-7; Red Lumo, p. 2, and the AER pp. 4-5, submissions to the consultation paper.

33 AGL, pp. 6-7, and Origin, p. 3 submissions to the consultation paper.

2.7.2 We have rejected a matchmaking service because of its limited benefits

The Commission considers the option would have limited usefulness with potentially large drawbacks. We are not considering this option further based on the issues raised by stakeholders.

Furthermore, as RoLR designations are public, the counterparty can seek out the designated RoLR to offer a contract if it wishes. On balance, this option offers minimal upside relative to the current framework but has potentially significant risks from sharing commercially sensitive information that could reduce competition or disrupt commercial relationships.

3 WE ARE CONSIDERING IMPROVEMENTS TO MANAGE GAS RETAILER FAILURES

The Commission is considering options to improve how gas retailer failures are managed. This chapter describes:

- current arrangements and issues with the framework (section 3.1).
- potential improvements we are considering (section 3.2).
- the issues on which we are seeking stakeholder feedback (section 3.3 to section 3.9).

3.1 Gas retailer failures are managed through a complex framework

3.1.1 Gas retailers rely on physical contracts to supply customers

Gas retailers primarily use physical contracts to supply their customers. These include gas supply, pipeline capacity and storage contracts which are used in combination by a gas retailer in the following ways:

- **Gas supply contracts** are essential for gas retailers to supply their customers. They are wholesale supply agreements negotiated between sellers (typically producers) and buyers (typically retailers). Gas supply contracts are generally gas sales agreements (GSAs), which we refer to throughout this paper.
- **Pipeline capacity contracts** are used to transport gas from where it is produced to where the customers are located. These are typically gas transportation agreements (GTAs) between a retailer and gas transmission and distribution operators. GTAs can specify many factors, however, through this paper we generally refer to the right to move gas from one place to another.
- **Storage contracts** are typically between a retailer and a gas storage facility. They are used to store gas for use at a future period, such as enabling a retailer to meet customer demand on peak days.

3.1.2 The gas RoLR scheme supports the retailer of last resort to supply customers

When a gas retailer fails, the RoLR scheme facilitates the transfer of the failed retailer's customers to a new retailer known as the designated retailer. This operates in the same way as the electricity RoLR process. However, in gas, there is also a framework in the NERL that allows the AER to direct gas supply and pipeline capacity to be supplied to the designated RoLR(s). This provision ensures that the designated RoLR has enough gas to supply the transferred customers.

An outline of the gas directions process is described below:

- **When a RoLR gas direction can be triggered**. The AER may issue a direction when 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 to enable gas supply to the RoLR's new customers.[34]

- **What can be directed?** A direction can apply to contracts held by the failed retailer immediately before the transfer date for pipeline capacity to transport gas, and contracts for gas supply.[35] The contracts held by the failed retailer can be directed regardless of where the supply in the contract comes from. For instance, a failed retailer's contract for gas supply from a Victorian gas field can be made available to a designated RoLR in Queensland.
- **Who is it issued to?** Directions can be issued to distribution or transmission service providers (for pipeline capacity), producers, or any other person that has contracted to sell gas to the failed retailer (for gas supply).[36]
- **What the directed entity must do**. A directed entity must make the 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.[37] The designated RoLR may, but is not obligated to, use any or all of the gas or pipeline capacity.
- **Mandatory negotiations for a replacement or novation of a contract.** As soon as practicable after the transfer date, negotiations should commence for the contracts that were directed. This process facilitates the designated RoLR negotiating for contracts held by the failed retailer for the period after the directions ends.[38]
  - For gas supply, the mandatory negotiations depend on the circumstances of the retailer failure. Two scenarios are set out below:
    - If the contract continues in force despite the RoLR event, the failed retailer must commence negotiations between the designated RoLR and the gas producer.
    - If the contract is terminated because of the RoLR event, the gas producer must commence negotiations with the designated RoLR.
  - For pipeline capacity, the distribution or transmission service provider must commence negotiations with the designated RoLR.
- **If no negotiated agreement is reached.** If there is no agreement after three months from the transfer date, the contract must be put up for sale or dispute resolution begin.
  - For gas supply, the directed entity (either the failed retailer or gas producer) must put the gas that is the subject of the contract up for sale by auction. It must use best endeavours to complete the auction process within an additional three months.[39]
  - For pipeline capacity, the designated RoLR, or the distribution or transmission service provider may commence an access dispute.

34 Clause 137(1) of the NERL.

35 Clause 137(1)(a)-(c) of the NERL. The transfer date is specified in the RoLR notice issues by the AER and is the date on which the customers of the failed retailer are transferred to the relevant designated RoLR. See clause 136(2)(e) of the NERL.

36 Clauses 137(1)(a)-(c) of the NERL.

37 Ibid.

38 Clause 137(12)(a) of the NERL.

39 Clause 137(12)(c)(i)-(iii) of the NERL.

- **When the direction ends.** The direction continues in force until a novation or termination and replacement with a new contract has been completed. Where no agreement is reached, the direction continues in force until:
  - the gas has been sold (gas supply)
  - an access determination has seen an effect (pipeline capacity).

3.1.3 The gas RoLR scheme was recently used for the first time

The gas RoLR scheme and directions framework is complex and, depending on the nature of the retailer failure, involves many parties. During the volatile market conditions in mid-2022, gas retailer Weston Energy failed and triggered a RoLR event. The AER then issued a direction for the gas supply contracts held by Weston to be made available to the designated RoLRs.[40] This was the AER's first use of its RoLR gas directions power. This had two parts.

- The AER directed the gas producer to supply the designated RoLRs, Origin and AGL.
- At the same time, mandatory negotiations commenced between Weston, Origin and AGL, and the gas producers for novation or replacement contracts. This negotiation involved Weston because it failed while still solvent and its contracts remained on foot.

3.2 We found feasible options to improve the gas RoLR framework

Our stage one consultation paper explored several issues or limitations with the current RoLR gas framework. In response to that paper, stakeholders agreed there are issues with the framework and potential improvements that can be made. We have a series of options on which we are seeking additional feedback. In particular, we are examining:

- amending the trigger that enables the AER to issue a direction so that financial risks to the RoLR can also be considered (in addition to ensuring physical supply)
- increasing the time a direction applies from three months to better reflect the period where the designated RoLR needs the failed retailer's supply contracts
- whether the mandatory negotiation process should be modified or could be removed
- expanding the directions framework to include storage contracts.

We are also considering modifications informed by recent experience such as:

- clarifying the circumstances in which a direction applies for contracts that begin or end in the direction period
- clarfiying how the costs and benefits of a RoLR event are shared with customers
- examining the information that is needed for the AER and designated RoLRs to manage the RoLR event in a timely manner.

The majority of the improvements we are considering relate to the operation of the RoLR directions framework and will require changes to the NERL. To help guide stakeholders, Figure 3.1 sets out the potential improvements against the existing arrangements.

40 AER, RoLR notice, Weston Energy, 31 May 2022.

Figure 3.1: Potential improvements to the RoLR gas scheme

		CURRENT PROCESS	POTENTIAL IMPROVEMENTS
Direction to supply gas	When is the direction issued?	When 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.	Amend the triggers for the AER to issue RoLR gas directions to allow the AER to consider current market conditions when issuing a gas direction.
	What can be directed?	A direction can apply to contracts for pipeline capacity to transport gas, and to contracts for gas supply held by the failed retailer. Contracts used by the failed retailer can be directed, regardless of where the contract comes from.	Expand to include storage contracts and storage providers.
	Who is it issued to?	Distribution or transmission service providers (for pipeline capacity) and producers or any other person that has contracted to sell gas to the failed retailer (for gas supply).	
	What the directed entity must do?	Make the 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. The designated RoLR "may but is not obligated to" use any or all of the gas.	
	Contract begins during direction?	Currently ambiguous.	Clarifying the arrangements for these contracts, potentially to make explicit that the direction commences when the contract is due to commence.
	If contract expires in direction?		Make explicit that the direction cannot continue in force after a contract is or would have been due to expire during the direction period.

		CURRENT PROCESS	EXTEND DIRECTION PERIOD	EXTEND DIRECTIONS PERIOD AND REMOVE MANDATORY NEGOTIATIONS
Direction to negotiate	Mandatory negotiations for a replacement or novation of a contract	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. If, after 3 months, no agreement is reached, the failed retailer must put the gas up for sale by auction.	Extend mandatory negotiations from 3 months to a longer period. Include negotiation principles (optional).	Remove required exclusive negotiations. The failed retailer and gas supplier may go out to market immediately and sell the gas supply contract for the period beyond the direction period.
	Going out to market	Failed retailer or counterparty must use best endeavours to ensure the auction is completed and gas is sold within 6 months of the transfer date.	Failed retailer or counterparty must use best endeavours to ensure the auction is completed and gas is sold within a longer period from the transfer date.	Not relevant.
When the direction ends	When the direction ceases	The direction continues in force until a novation or termination and replacement with a new contract has been completed. Where no agreement is reached, the direction continues in force until the gas has been sold.	Same as current.	The direction ceases at the end of the direction period, not when the contract is sold.

Source: AEMC analysis.

3.3 Should we amend the RoLR gas directions triggers?

This section describes:

- stakeholder feedback supporting expanding the RoLR gas directions triggers to include financial risks to the designated RoLR
- our rationale for considering this option further and questions for consultation.

3.3.1 Stakeholders supported expanding the gas directions triggers

In submissions to our stage one consultation paper, stakeholders supported broadening the trigger for RoLR gas directions to allow the AER to consider prevailing market conditions and pricing. Stakeholders agreed that this would enable the RoLR gas direction to address the potential financial issues from a retailer failure.[41]

3.3.2 We are considering changes to the gas directions triggers

The current directions framework is focused on the physical supply of gas but does not consider that a designated RoLR could be put under financial pressure from taking on new customers during high prices. Therefore, we are considering the merit of expanding the trigger so the AER can consider market pricing and physical supply. This would support the designated RoLR in managing the financial impacts of a RoLR event. The specific changes being considered are:

- whether the cost risk of the designated RoLR and systemic risk could be reduced by including financial considerations in the RoLR directions framework
- whether a materiality threshold should guide the AER in considering financial impacts when issuing gas directions
- how this potential change would affect market entry, operation or exit decisions.

Would a financial trigger reduce cost risk to the designated RoLR and systemic risk?

RoLR events can cause financial stress to the RoLR, even if sufficient gas is available in the short term trading markets (STTM). Where gas is available in STTM and the failed retailer's contracts are not directed, the designated RoLR would be required to purchase gas from these markets until a new contract is sourced. The gas available in the STTM may be at elevated prices and create risk of higher prices for customers. If the designated RoLR cannot pass these costs on to customers quickly, it could create financial risks to the designated RoLR which, if it then failed, could lead to system risks.

We note there is no price cap on offers in retail gas markets, so the designated RoLR can raised prices to cover costs. If a RoLR gas direction is not issued for financial reasons, the RoLR may have to purchase gas at elevated prices and pass these on to customers. In this scenario, the new and potentially existing customers of the RoLR would incur higher costs because of the retailer failure. This contrasts with electricity RoLR scheme cost recovery

41 Submissions to the consultation paper, Origin, pp. 1-2. AGL, p. 2. AEC, p. 2. Energy Australia, p. 6. AER, p. 8.

scheme s which are shared by customers within a distribution area. In contrast, if a RoLR gas direction is made for financial reasons, customer prices will not be affected for the period of the direction. This would benefit customers and reduce the financial risk faced by the designated RoLR.

We acknowledge the AEC's view that expanding the trigger would change the intent of the current directions framework, which is solely to maintain physical supply.[42]

Should a materiality threshold guide use of gas directions?

Origin supported expanding the trigger and considered that a materiality threshold could apply, so that the AER would only issue a direction if it considered there would be a material financial impact on the designated RoLR in supplying the transferred customers.[43]

The Commission notes that considering the financial impact on a designated RoLR from taking on new customers is likely more complex than considering whether immediate market conditions are materially elevated from longer term levels. As such, the benefits of a materiality threshold need to be considered against the costs. It would also likely be beneficial for clear guiding principles to be determined to provide certainty to participants and direction to the AER on how a materiality threshold would operate.

Would expanding the RoLR gas direction trigger to include financial impacts affect retail entry and exit or the ability for retailers to obtain supply contracts?

Red Lumo raised concerns that any changes to the current framework may alter retailers' decisions about market entry and exit.[44]

We note that expanding the reasons for a direction may increase the likelihood of directions being issued, which in turn may impact the costs and incentives of being a gas retailer.

Our initial view is that retailers' ability to obtain supply contracts is unlikely to change materially. The gas producer would essentially be unaffected by the direction as they would continue to supply gas on the same contract terms prior to the retailer failure. The only change for the gas producer would be supplying the designated RoLR instead of the failed retailer.

42 AEC, submission to the consultation paper, p. 4.

43 Origin, submission to the consultation paper, p. 2.

44 It also considered changing the RoLR gas directions trigger may change the incentive for generators to offer contracts on reasonable terms to all retailers. Red Lumo, submission to the consultation paper, p. 3.

QUESTION 4: SHOULD WE CHANGE THE ROLR GAS DIRECTIONS TRIGGERS?

1. Are there any clarifications needed in the current triggers for gas directions?
2. If the trigger for gas directions should be expanded to consider issues other than physical supply, what should the criteria be? For example, should the AER have discretion or should there be a defined threshold?
3. If the AER has discretion in issuing the direction, what factors should the AER consider? For example, the financial impact to the designated RoLR or current market prices?
4. Would expanding the RoLR direction triggers impact a retailer's decisions to enter or exit the market or their ability to obtain gas supply? Please explain and provide evidence.

3.4 Should we increase the length of time RoLR gas directions apply?

This section describes:

- stakeholder feedback supporting increasing the RoLR gas directions period from three months to a longer period such as six months
- our rationale for considering this option further and questions for consultation.

3.4.1 Stakeholders supported looking at increasing the time RoLR gas directions apply

In submissions to our stage one consultation paper, stakeholders generally considered the current three month directions period insufficient. Stakeholders reflected on the recent experience following the Weston failure and considered three months does not reflect the time required to negotiate a new contract or the novate existing contracts.[45] The AEC, EA and the AER considered that increasing the directions period to six months would better reflect the time necessary for the RoLR to put contractual arrangements in place to supply the RoLR affected customers.

The AER also noted that directions are most likely needed when wholesale gas markets are under extreme pressure, and the market will need longer than three months to return to more normal operating conditions.[46] In the AER's view, market pressures, coupled with a short directions period, can create incentives for the failed retailer to not cooperate in negotiations. There may be benefit in exploring a directions period potentially longer than six months. Otherwise, these incentives could leave the designated RoLR searching for alternative supplies, or potentially without the physical supply to service the new customers. We explore the interaction between extending the length of time for which a direction applies and the interactions with the failed retailer's negotiation incentives in section 3.5.

45 Submissions to the consultation paper, AEC, p. 4. Momentum, p. 3. AGL, p. 2. EnergyAustralia, p. 6. AER, p. 8.
46 AER, submission to the consultation paper, p. 8.

3.4.2 We are further considering increasing the time RoLR gas directions apply

The Commission is considering extending the RoLR gas directions period. Before recommending an extension, the Commission will examine how a change to the directions period would impact the market. We are interested in stakeholder views on the following.

How long should the RoLR gas directions period be?

The direction length should support the designated RoLRs to appropriately manage the increased gas demand of the transferred customers, while not giving an unfair competitive advantage to the designated RoLR or creating barriers to entry for other retailers. The Commission's initial view is this period is likely more than three months but less than 12 months.

How long is needed to understand the requirements of transferred customers?

Increasing the time a direction applies would enable the RoLR to determine the gas requirements for the transferred customers and work out the best arrangement to find gas to serve these customers. Arrangements could include reaching an agreement for the directed contracts or going out to market for a new contract. However, if the information provided to a designated RoLR is improved, this may reduce the time needed to understand the requirements of transferred customers.

How long is needed to reach a negotiated agreement for gas contracts?

Gas contracts are typically bespoke and account for specific issues or other contracts held by both the buyers and sellers, such as delivery arrangements for the gas.[47] Given the bespoke nature of these contracts, negotiations for the designated RoLR to obtain the physical supply may require more time than three months to complete.

Extending the RoLR gas directions period will give a designated RoLR access to the failed retailer's contracts for a longer period. Therefore, the potential value to the failed retailer of selling these contracts will be diminished. We also seek stakeholder views on whether extending the RoLR gas directions period will affect retail competition or market entry.

Some stakeholders proposed six months as the appropriate RoLR gas directions period. We seek stakeholder views on whether this date remains appropriate in the context of the other issues described above.

Should the RoLR gas directions period be fixed or flexible?

Given the varying market conditions in which a RoLR event can occur, providing for a set length of time in which a direction can apply may not be appropriate in all circumstances. There may be conditions where a short direction is the most efficient choice and others where a longer period is required. In addition to a simple change in timeframe, we welcome stakeholder feedback on potentially including flexibility in the timeframe that directions apply.

47 AEMC, Review into the arrangements for failed retailers' electricity and gas contracts, Consultation paper, 13 October 2022, p. 62-63.
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.

For example, there could be a minimum amount of time a direction can apply for, combined with the ability for the AER to extend directions.

> QUESTION 5: SHOULD WE INCREASE THE LENGTH OF TIME ROLR GAS DIRECTIONS APPLY?
>
> 1. Should the RoLR gas directions period be extended from their current level? If yes, how long should directions last? Please explain and provide evidence.
> 2. Do you consider increasing the RoLR gas directions period will influence or increase the cost of gas retailers obtaining finance or other incentives to becoming a retailer? If yes, please explain and provide evidence.
> 3. Would there be benefits in a flexible direction period (e.g. a minimum timeframe with an ability to extend to a specified period)? If so, what criteria should apply to extensions?

3.5 Should we change the negotiation process in RoLR gas directions?

This section describes:

- stakeholder feedback supporting the introduction of negotiation principles
- our rationale for considering negotiation principles further or potentially removing the negotiation process entirely and questions for consultation
- our rationale for not considering options that remove the failed retailer from negotiations.

3.5.1 Stakeholders supported changing the mandatory negotiation process

The mandatory negotiation process occurs when a direction is issued and allows the directed parties to negotiate for the transfer or novation of the failed retailer's contracts for the period after the RoLR gas direction ends. In response to our stage one consultation paper, stakeholders supported introducing a requirement that all parties negotiate in good faith or with best endeavours.[48] EnergyAustralia and the AER considered that negotiation principles would assist in addressing the mismatch of incentives faced by the failed retailer, which are discussed in section 3.5.2.

AGL proposed removing the failed retailer from the negotiation process, based on their experience in the Weston retailer failure. They proposed that a gas direction should allow for relevant gas contracts to be novated to the RoLR, at their discretion, without involvement from the failed retailer. Origin -supported a similar approach.[49]

3.5.2 Should we introduce negotiation principles?

The Commission agrees with stakeholders that negotiation principles could help the mandatory negotiation process. However, the principles must have a clear objective before they can be determined. We consider that:

48 Submissions to the consultation paper, AEC, p. 5. EnergyAustralia, p. 6. Origin Energy, p. 2. AGL, p. 2.

49 submissions to the consultation paper, AGL, p. 2. Origin, p. 2.

- negotiation principles could assist reaching an agreement between the designated RoLR, gas producer and failed retailer. This would support the intent of the RoLR scheme by helping the designated RoLR supply the transferred customers. A secondary objective in line with the NERO/NGO is that the gas should be provided to customers at a reasonable price. Therefore, the financial position of the designated RoLR is also a relevant consideration.
- the AER and EnergyAustralia suggested principles could:
  - require the failed retailer to forgo profits from the negotiation. This would, in the AER's view, benefit the RoLR and transferred customers by facilitating a negotiated outcome[50]
  - require the negotiated outcome to reflect the pricing terms of the original contract between the producer and the failed retailer.[51]

If these principles were introduced, they would prevent the failed retailer from profiting on the negotiation and potentially reduce overall costs to the designated RoLR and customers if the failed retailer held a profitable GSA.

However, these principles may encourage the failed retailer to frustrate negotiations. This is because the failed retailer, or insolvency official's, interest is to maximise the return from the agreement or wait until the mandatory negotiation period passes and sell their gas on market (described in Box 3 on the next page).

The Commission is interested in how such principles would work in practice; in particular, how would the negotiating parties' compliance with the principles be measured, assessed and enforced? In the Commission's view, introducing negotiation principles would only be beneficial if they could overcome the conflicting commercial incentives of the negotiating parties. In the absence of compliance requirements, it's not clear whether principles would be effective.

We are also seeking stakeholder views on whether extending the time RoLR gas directions apply would reduce the need for negotiation principles. It may be that increasing the time directions apply increases the time a failed retailer would have to wait out the negotiation process before it could sell its contracts on the open market. If the directions period is sufficiently long, this may encourage the failed retailer to come to an agreement and receive value for their contracts before the direction ends.

50 AER, submission to the consultation paper, p. 9.

51 EnergyAustralia, submission to the consultation paper, p. 7.

BOX 3: ILLUSTRATIVE EXAMPLE | ROLR GAS DIRECTION AND SUBSEQUENT NEGOTIATIONS WITH THE FAILED RETAILER.

The following illustrative example highlights the potential incentive for the failed retailer to retain the gas supply contracts during elevated market conditions.

A retailer holds a five-year gas supply agreement (GSA) for 100 GJ of gas per day, at $10/ GJ. This GSA perfectly matches the retailer's customer demand. One year after this deal is made, the retailer fails and triggers a RoLR event. Their customers are transferred to a designated RoLR, however, the failed retailer is still solvent and the GSA remains on foot.

The AER issues a RoLR gas direction. This direction requires the failed retailer to commence negotiations for the novation or termination and replacement of this contract with the designated RoLR and gas producer. The negotiation is for contracts after the directions period. This is because during the direction the designated RoLR has access to the failed retailer's contracts on the same terms that were available to the failed retailer immediately before failing.

The forward price for the next four years is $20/GJ. Therefore, the GSA has a high resale value which the failed retailer will be incentivised to achieve. This may be to sell on the open market rather than sell to the RoLR.

The RoLR requires this contract to continue supplying the transferred customers but may have limited alternative options for supply given elevated market conditions. This may result in the failed retailer profiting from the sale of their GSA or frustrating negotiations for the duration of the mandatory negotiation period so it can sell the contract on the open market.

Source: AEMC analysis

QUESTION 6: SHOULD WE INTRODUCE NEGOTIATION PRINCIPLES?

1. Do you support introducing negotiation principles? If yes, what should they include?
2. How should compliance with negotiation principles be measured?
3. Is the need for negotiation principles reduced or removed with a longer directions period?

3.5.3 Should we remove the mandatory negotiation process?

The Commission is also considering if increasing the duration of directions removes the need for mandatory negotiations. We consider this option would remove the failed retailer from participating in negotiations for gas supply when the contracts remain on foot. Furthermore, it removes the ability of the designated RoLR to negotiate exclusively and potentially obtain a highly competitive contract. We consider the advantage from exclusive negotiation could be particularly large if the failed retailer held contracts that were due to expire in several years' time.

If the directions period is extended sufficiently, the designated RoLR should have enough time to find new gas supplies by the time the direction expires. Removing the mandatory negotiations would allow the failed retailer to sell the remaining gas after the end of the direction as soon as the direction is issued.

> QUESTION 7: SHOULD WE REMOVE THE MANDATORY NEGOTIATION PROCESS?
>
> 1. Do you support removing mandatory negotiations if the RoLR gas directions period is extended?

3.5.4 We are not considering options to remove the failed retailer's negotiation rights

The Commission is not considering options that remove the failed retailer from negotiations or automatically novate their contracts. The two options considered were to:

- require all new supply agreements to include a termination trigger that applies if a RoLR event occurs, and
- automatically novate contracts from the failed retailer to the designated RoLR, at the designated RoLR's discretion, if a RoLR event occurs.

Require new supply agreements to include a termination trigger for RoLR events

One approach would be to make a RoLR event trigger a termination of the contact between the failed retailer and the counterparty who supplies the gas to them. This would ensure that the failed retailer would not be involved in the negotiations as they would no longer be a relevant party to the contract. This option would also lead to consistent negotiation processes between the designated RoLR and gas supplier regardless of the nature of the retailer failure.[52] While this option automatically removes the involvement of the failed retailer in contract negotiations, the Commission is concerned that this would create significant risk for the gas supplier, pipeline operator or other counterparties. This is because the failed retailer would no longer have any obligations to the contract, including any take-or-pay obligations it may have had.

Automatically novating directed contracts from the failed retailer to the designated RoLR

AGL proposed novating all relevant gas contracts from the failed retailer to the RoLR, with the RoLR having the ability to select contracts. The failed retailer would be unable to frustrate negotiations. Origin supported this approach.[53]

The AEMC considers that a novation of all relevant gas contracts from the failed retailer to the RoLR would be similar in effect to the termination trigger option described above. This is because it would remove the failed retailer's rights to the contract if the RoLR decides to take

52 We note the mandatory negotiation process between the designated RoLR and gas supplier may still have issues where the gas supplier seeks to maximise its return. Therefore, this option may not lead to a better outcome than the current negotiation process.

53 submissions to the consultation paper, AGL, p. 2. Origin, p. 2.

on the contract. In contrast, the termination trigger would remove the failed retailer's contractual rights and obligations regardless of whether the RoLR takes up the contracts.[54]

We also consider that gas retailers may hold a complex portfolio of contracts to service their customers that are typically bespoke. In the event of a retailer failure, automatically novating these contracts to the designated RoLR may not make sense in all scenarios, particularly where the failed retailer's customers are transferred to multiple designated RoLR. This could be because the one supply contract may be used to supply customers transferred to multiple RoLRs in different distribution areas.

AGL also suggested that this should not require any trigger and could apply to all gas retailer failures. We are not considering this as it is a significant departure from the current RoLR gas directions framework and would not consistently work across all RoLR events.

3.6 Should we clarify what happens to contracts that begin or end during directions?

This section describes:

- stakeholder feedback that supported clarifying that contracts that expire during a direction
- our rationale for considering contracts that begin or end during the directions period and questions for consultation.

3.6.1 Stakeholders supported clarifying what happens to contracts that expire

In response to our stage one consultation paper, the AEC outlined that requiring a gas producer to meet a direction for expired contracts would bind the counterparty to a contract it may not be able to support.[55]

The AER supported a requirement for the same terms and conditions to remain in place for the length of the direction.[56] However, this may not be possible if the producer does not have gas available after the contract expires.

3.6.2 We are further considering how to treat contracts that begin or end during directions

The Commission is considering how best to clarify the arrangements for contracts that have been directed for contracts that expire or are due to commence during the directions period. Improved clarity would provide the gas supplier and designated RoLR a consistent understanding of their obligations and ability to access gas supply.

We seek stakeholder feedback on how contracts that begin or end during direction should be treated. We consider:

54 This would be subject to any specific post termination contractual obligations or survival clauses.

55 AEC, Submission to the consultation paper, p. 4. The AEC gave an example that the gas shipper who signed an original contract may have already sold gas contracts for gas supply or pipeline capacity to a third party outside of the original contract's terms. Requiring the expired contract to continue under direction would disrupt the contract with the third party.

56 AER, submission to the consultation paper, p. 9.

- **Directions should cease when a contract expires**. We consider a gas producer's responsibility to comply with a direction should be limited by the period of the directed contract. We agree with the issues raised in the AEC submission that if the responsibility were longer, the gas producer may not have available gas supplies to meet the requirements of the direction. However, contracts may also contain clauses that relate to options to extend the contract. In these circumstances, we consider it may be appropriate for the direction to continue to apply.
- **Directions should include contracts that are due to commence.** We consider a gas producer should be required to comply with a direction to supply gas if that direction period includes contracts that are due to commence. The producer will have planned to supply this gas at the negotiated price, and the gas may be necessary for the designated RoLR to service its new customers.

QUESTION 8: HOW SHOULD WE CLARIFY WHAT HAPPENS TO CONTRACTS THAT BEGIN OR END DURING DIRECTIONS?

1. Should a direction cease when the directed contract expires?
2. How should options to extend contracts be treated under the directions framework?
3. Should contracts that are due to commence in the directions period be subject to direction?

3.7 Should gas storage contracts be considered in the RoLR gas directions framework?

This section describes:

- stakeholder feedback that supported expanding the RoLR gas directions framework to include storage contracts
- our rationale for considering introducing storage contracts in the directions framework and questions for consultation.

3.7.1 Stakeholders supported including storage contracts in RoLR gas directions

In submissions to our stage one consultation paper, stakeholders supported further work to consider expanding the AER's directions powers to include storage contracts.[57]

Stakeholders noted that the storage contracts may have played a key role in the failed retailer's gas supply contracting strategy. Therefore, without the inclusion of storage contracts, there may be no alternative gas supplies available for the designated RoLR to manage the peak demand of the transferred customers.[58]

57 Submissions to the consultation paper, Momentum, pp. 2-3. AEC, p. 4. EnergyAustralia, p. 6. Simply Energy, p. 2. Origin, p. 2. AGL p. 2. AER p. 7.

58 Submissions to the consultation paper, Momentum, p. 3. AEC, p. 4. AER p. 7.

3.7.2 Should storage contracts be included in RoLR gas directions

We are considering including storage contracts in RoLR gas directions. Where a failed retailer's position includes gas storage, extending the RoLR directions to include these contracts would better allow RoLRs to manage the demand from the transferred customers. Storage could be used to manage a range of customer demand and potential peak supply issues and could be particularly important if the RoLR event occurred in a high demand period where the failed retailer's gas supply contracts might not be sufficient to cover demand.

The current RoLR gas directions framework enables the AER to issue a direction for contracts the failed retailer had in place immediately before the transfer of its customers to the incoming RoLR. Directed contracts can include gas held in other jurisdictions such as a Victorian gas contract servicing NSW customers. This can be complex for gas supply in Victoria as the region has a separate RoLR scheme and no mechanism to issue RoLR gas directions.

There are several issues we must consider before forming a draft recommendation, as storage contracts are more complex than supply or transportation contracts. There are specific circumstances to each storage facility including registration requirements. Therefore, we seek stakeholder views on issues that need to be considered before storage facilities can be included in the directions framework.

We also note Victoria has a separate RoLR scheme, and we are actively engaging with the AER and Victorian officials on how the different schemes should efficiently work together.

How should we consider gas already held in storage?

Storage contracts can include contractual rights to inject, withdraw and hold a certain volume of gas. Furthermore, if a retailer injects and holds gas in storage, this gas has already been paid for by the retailer.

The AEMC considers that if the intent is to ensure that the RoLR has the required tools to cover peak demand of their transferred customers then the gas held in storage should be included in the direction. However, given that the gas has already been paid for by the failed retailer it may be appropriate for the RoLR to pay the failed retailer for this gas.

Are there competition issues that need to be mitigated?

The AER raised concerns that directing storage contracts could result in a competitive advantage for the designated RoLR.[59] We seek stakeholder feedback on whether there should be limitations or guidance on how designated RoLRs can use storage contracts during the directions period.

59 AER, submission to the consultation paper, p. 7.

Are there issues with the requirement to be registered in AEMO's systems for the storage facility?

All users of a storage contract must be registered in AEMO's systems for that storage facility. This is needed so the holder of the storage contract can nominate flows to and from the storage facility. We consider that this requirement potentially represents a small delay for the RoLR to be able to utilise the directed storage contract. However, we do not consider this is a material risk as registration should be able to occur reasonably quickly.

QUESTION 9: SHOULD GAS STORAGE CONTRACTS BE CONSIDERED IN THE ROLR GAS DIRECTIONS FRAMEWORK?

1. Should the gas held in storage be transferred to the RoLR?
    a. If yes, should the RoLR be required to pay the failed retailer for this gas in line with the negotiation principles?
    b. If no, can the storage rights alone be transferred to the RoLR?
2. Are there any issues with Victorian gas facilities being included in the RoLR gas directions framework?
3. Do you consider there are competition issues that should be mitigated? If yes, what measures would be appropriate?
4. Are there any issues with the need to be registered in AEMO's systems to use storage facilities?

3.8 How can the benefits or costs of RoLR events be shared with customers?

This section describes:

- stakeholder feedback that supported the benefits of RoLR gas directions being passed to customers
- our rationale for considering both benefits and costs of RoLR events and questions for consultation.

3.8.1 Stakeholders supported the benefits of directions being passed to customers

In submissions to our stage one consultation paper, stakeholders supported introducing a requirement for RoLRs to pass on the benefits of directed contracts to affected customers. The requirement would reduce costs to customers if a designated RoLR received gas at a competitive price through the RoLR gas directions process.

3.8.2 We are further considering how benefits or costs should be shared with customers

When a RoLR event occurs, the impacted customers are automatically transferred to a new contract with the designated RoLR. Residential customers are transferred to the RoLR's standard retail contract, and large customers are transferred to a specific RoLR deemed large customer retail arrangement.[60] Each registered RoLR has a set of applicable rates for large customers in each state.[61]

Where the AER makes a direction for gas supply to be made available to the RoLR, the RoLR receives the benefit of having access to this gas. This gas will usually be priced below the current market spot prices (particularly if the retailer fails in a volatile market period). The intent of the framework is to ensure that the RoLR has access to the supply needed to serve the impacted customers. However, access to these contracts may result in the designated RoLR receiving a commercial gain if it is not required to pass through these lower prices to customers.

Exploring introducing a requirement for designated RoLRs to pass the benefits of a direction to the RoLR-affected customers

AGL suggested that the benefits of a RoLR direction should be shared with the transferred customers in good faith and on a reasonable basis with a requirement to advise the AER of the manner in which this obligation was met. We welcome stakeholder feedback on AGL's proposal or alternatives to achieve this objective.

Clarifying what market costs can be claimed through the RoLR cost recovery

The RoLR cost recovery scheme allows electricity and gas designated RoLRs to claim costs from a RoLR event through a RoLR cost recovery scheme.[62] Currently, the NERL and AER guidelines are not explicit about what market costs are able to be recovered and over what timeframe. In the event of a gas RoLR, the designated RoLR may incur wholesale costs associated with the immediate transfer of customers, even where gas supply is directed to be made available to the RoLR.

Currently, there are no price caps that limit the price gas retailers can charge customers. Therefore, gas retailers could potentially increase the standard retail offers across their customer base to recover any costs associated with a RoLR event.[63] This contrasts with electricity arrangements where the DMO limits the prices charged to customers and creates the risk that the designated RoLR may not be able to recover its costs from customers.

We consider its unlikely that gas designated RoLRs need a mechanism to recover market costs. This is because gas RoLRs can raise prices to cover their wholesale costs and may, in certain circumstances, receive the failed retailer's gas contracts on the terms previously available to the failed retailer.

60 See clauses 145 and 147 of the NERL.

61 AGL classifies a customer as a large customer if it consumes more than one terajoule of gas at a delivery point. AGL, Large Customer Default Rates, 1 January 2023, available here.

62 Section 166 of the NERL and set out in the AER's RoLR guideline, 2011.

63 Gas RoLRs must charge transferred residential gas customers their standard retail offer and cannot charge them a specific gas RoLR rate. See Clause 145(3) of the NERL.

QUESTION 10: HOW CAN THE BENEFITS OR COSTS OF ROLR EVENTS BE SHARED WITH CUSTOMERS?

1. How should the benefit of receiving the gas under direction be passed to the impacted customers? Does there need to be separate benefit sharing arrangements for large and small customers?
2. Should this requirement be principles based or prescriptive?
3. How should compliance with this principle be measured?
4. Should gas RoLRs be able to claim wholesale costs associated with RoLR events given there is no DMO for gas? If so, what costs should a RoLR be reasonably able to claim and over what time frame?

3.9 What information is necessary for the AER and gas RoLRs to fulfil their duties?

This section describes:

- Stakeholder feedback that supported improving the information provided to gas RoLRs
- our rationale for considering what information gas RoLRs and the AER should receive, how this information is collected and questions for consultation.

3.9.1 Stakeholders supported further work to make sure gas RoLRs get the right information

AGL's submission outlined that the designated RoLR should have a clear right to access relevant information in a timely manner.[64] AGL suggested the AER should be able to issue a direction for the designated RoLR to access the following information:

- information about the failed retailer's supply contracts
- a comprehensive summary of the failed retailer's customers and the basis for which they are charged.

3.9.2 We are further considering what information the AER and gas RoLRs should receive

When customers are transferred to the designated RoLR, it only receives limited information about its transferred customers. In practice, this could mean that the RoLR does not have a complete picture of the volume or shape of the new customer demand but must secure physical supply contracts to service them. This incomplete picture represents a risk for the RoLR in determining how much gas they need to meet their customer demand.

Information to the designated RoLR

The Commission considers the designated RoLR should be supplied information about the transferred customers to ensure that they can efficiently service them. We consider that information should include information about the demand profile and location of all the

64 AGL, submission to the consultation paper, p. 2.

transferred customers. The designated RoLR may also require information about prices offered to the failed retailer's large customers who do not shift to standing offers. However, sharing such information could potentially result in a competitive advantage for the designated RoLR. This could be mitigated by limiting how the designated RoLR can use the information to certain parts of the business.

Automating the collection of information to reduce burden on the AER

We are seeking stakeholder feedback on whom the best party would be for collecting and managing the information required to be passed on to designated RoLRs. The AER can use RoLR RINs to obtain and share information with the designated RoLR but this process is burdensome for all parties involved and can take significant time. Furthermore, if a failed retailer has an insolvency official appointed who is not familiar with the company's records this information could be difficult to identify.

The AEMC is exploring alternatives such as AEMO or the gas distribution business having a role in information provision. Following discussions with AEMO after the close of submissions, our initial view is that the gas distribution business is the best party to collect and maintain the consumption data for each gas supply point.[65]

QUESTION 11: WHAT INFORMATION IS NECESSARY FOR THE AER AND GAS ROLRS TO FULFIL THEIR DUTIES?

1. What level of customer information should a RoLR receive to efficiently manage their new customers?
2. Should there be limits on how the designated RoLR uses certain information? Please explain.
3. Who is best placed to hold and then share the relevant customer data with the designated RoLR?

65 AEMO additionally noted that some reports already produced by AEMO could be utilised, such as INT334, which is a monthly report that details the aggregate gas consumption per network per retailer.

4 WE ARE CONSIDERING OBSERVED RETAILER BEHAVIOUR IN VOLATILE CONDITIONS OUTSIDE THIS REVIEW

The Commission analysed the retailer behaviour that occurred in volatile market conditions in 2022. This chapter explores:

- the potential harms of the observed behaviour (section 4.1)
- a summary of our findings (section 4.2)
- analysis and responses to stakeholder feedback for each of our findings (section 4.3 to section 4.5).

4.1 Observed retailer behaviour could result in harm to customers and other retailers

In mid-2022, two retailers reportedly increased the price of market offers, encouraged customers to change retailers, and sold their hedges for a profit.[66]

We consider this behaviour could cause the following potential harms:

- **Financial harm for customers who experience price increases above the default market offer (DMO)**. The DMO protects consumers on standing offers but does not protect customers on market offers. Customers on market offers may face financial harm if price increases mean they pay more than the DMO.
- **Stress and erosion of trust**. Customer trust in markets could be undermined if, in volatile conditions, retailers suddenly raise prices and encourage customers to change retailers.

Despite these potential harms associated with increasing prices and encouraging customers to leave, this behaviour to date has not been widespread. Therefore, we do not consider retailers subsequently selling hedges for a profit as an issue that warrants further investigation.

4.2 We are considering some enhancements to the framework outside this review

The Commission analysed the existing regulatory framework and considered stakeholder feedback specifically in the following four areas:

- we consider the existing framework minimises potential consumer harms (section 4.3)
- we are exploring retail pricing improvements outside this review (section 4.4)
- market bodies are monitoring unusual retailer behaviour (section 4.5)
- we are not considering regulating how retailers trade hedging contracts (section 4.6).

66 Australian Financial Review, *Energy retailers investigated for $100m hedges*, 7 July 2022, http://www.afr.com/companies/energy/energy-retailers-investigated-for-100m-hedges-20220707-p5azvc.

4.3 The existing framework minimises potential consumer harms

Existing frameworks provide a number of protections and mitigate consumer harm potentially associated with the observed behaviour in mid-2022. The existing framework sets out that:

- retailers must provide at least five business days' notice of price changes
- if market prices are too high, customers can change to a standing offer that is capped by the DMO with their current retailer
- customers can compare offers on EnergyMadeEasy
- customers can change retailers in two days if a better offer is available
- false or misleading claims are prohibited.

On 8 May 2023, the ACCC and AER published a compliance bulletin setting out their expectations for retailers communicating price changes.[67]

4.3.1 Retailers must provide at least five business days' notice of price changes

In 2019, the AEMC made a final rule that requires retailers to notify their customers at least five business days before energy price changes with clear and accessible communication.[68] This rule change means customers can find a new offer before their prices increase.

4.3.2 If market prices are too high customers can change to the DMO with their current retailer

Small customers on a market contract can request to terminate their contract and shift to the standing offer.[69] The DMO applies to small customer standing offers but not market offers.[70] Therefore, while prices for market offers can potentially exceed the DMO, customers have the option to change to the standing offer with their existing retailer. This decreases the risk to consumers of financial harm from retailers' rapidly increasing prices. Depending on the terms and conditions that have been agreed between the small customer and retailer, some market offers may attract early exit charges. While exit fees are limited by the NECF, these fees could potentially offset some of the benefit of changing to the standing offer.

4.3.3 Customers can compare offers on EnergyMadeEasy

EnergyMadeEasy is a price comparison website site managed by the AER where customers can find and compare retail contract offers.[71] This service provides customers with an unbiased source of information to help them decide between standing contracts capped by the DMO or market contract offers with their current retailer or an alternative retailer.

67 ACCC and AER, Compliance Bulletin - Communicating price changes, 8 May 2023.

68 The final rule requires retailers to use the customer's preferred form of communication, clearly indicate that the notice is a price change notice, include the date of the change, the customer's existing and new tariffs and provide a prompt that the customer can access their historical billing and usage data if required. AEMC, *Advance notice of price changes*, final determination, 27 September 2018.

69 Section 22(1) of the NERL requires the designated retailer must make a standing offer. The designated retailer is the financially responsible retailer for the premise in a case where there is an existing connection (including where a connection alteration to an existing connection is required).

70 Section 10 of the *Competition and Consumer (Industry Code — Electricity Retail) Regulations 2019*.

71 Section 62(2) of the NERL requires the AER to develop and maintain a price comparison service. http://www.energymadeeasy.gov.au/.

The NERL also requires the AER develop retail pricing information guidelines to assist small customers to consider and compare the products offered by retailers.[72] The AER published the latest version of the guidelines in 2018 which informs retailers about the presentation of standing contract offers and market offer prices.[73]

4.3.4 Customers can change retailers in two days

In 2019, the AEMC made a final rule that reduced customer switching times to two days regardless of meter type.[74] Consequently, if a customer chooses to do so, they can switch to a new retailer in two days.

4.3.5 False or misleading claims are prohibited

The Australian Consumer Law, enforced by the ACCC, prohibits retailers from making claims to customers that are misleading, deceptive or likely to mislead or deceive. This was raised by the AEC, Red Lumo and AGL in their submissions.[75] Infringements of this law can attract civil penalties and helps to address the observed unusual retailer behaviour by requiring retailer communication to be accurate and not likely to mislead or deceive customers.[76]

4.4 We are exploring retail pricing improvements outside this review

This section describes:

- stakeholder feedback supporting further work
- our rationale for considering this option further and questions for consultation.

4.4.1 Stakeholders generally supported further work on minimising consumer harms

Many stakeholders supported further work on the potential consumer harm associated with retailers rapidly increasing offers and assertively encouraging customers to change retailers.[77] However, in supporting further action, some stakeholders considered this should be addressed through a separate review focusing on retailer behaviour and consumer impacts.[78]

Momentum Energy noted that the alleged recent behaviour of a few smaller retailers does not warrant the creation of unnecessary barriers to entry for retail businesses that operate in a highly competitive market.[79] Similarly, Red Lumo asked that the AEMC and other regulatory

72 Section 61 of the National Electricity Retail Law.

73 AER, *Retail pricing information guidelines*, version 5, April 2018. The guideline sets out specific requirements for how retailers:
1. present standing and market offer plan information consistently
2. present standing and market offer plan prices prominently on their websites
3. submit information and data to the AER relating to the presentation of standing and market offer plans that are generally available to classes of small customers.

74 AEMC, *Reducing customers' switching times,* final determination, 19 December 2019.

75 AEC, p. 5; Red Lumo, p. 4; AGL, p. 8, submissions to the consultation paper.

76 Section 18 of the Australian Consumer Law which is legislated in Schedule 2 of the *Competition and Consumer Act 2010*. The ACCC provides guidance on false or misleading claims http://www.accc.gov.au/business/advertising-and-promotions/false-or-misleading-claims.

77 AER, p. 10; PIAC, p. 9; EnergyAustralia, p. 7; AFMA, p. 2; Red Lumo, p. 4; Origin Energy, p. 4 submissions to the consultation paper.

78 EnergyAustralia, p.7; Origin Energy, p. 4 and AFMA, p. 2 submissions to the consultation paper.

79 Momentum Energy, submission to the consultation paper, p. 2.

agencies carefully consider the impact of any new measures which might negatively impact competition.[80]

4.4.2 We support improvements to retail price notifications and the DMO

We consider there are changes that can improve the existing retail customer protection framework in response to the observed behaviour. We support further work to:

- improve the information provided by retailers when they increase prices
- enable the AER to update the DMO in response to significant market changes.

Information provided by retailers when they increase prices

Price change requirements do not require retailers to inform consumers on market offers of their right to move to the standing offer.[81] While retailers must notify their customers of a change in price to their current plan, there is no obligation for retailers to inform the customer of alternate plans that the consumer may access, potentially at lower prices.

We support exploring the merits of enabling the AER to update the DMO in response to significant market changes

We are aware of a range of work in this area and support further analysis on the merits of changing the DMO arrangements. Small consumers' electricity standing offers are capped by the DMO which is set annually by the AER.[82] However, where significant market changes occur during the year it may be necessary for the AER to update the DMO to decrease the likelihood that the DMO is materially different from the cost of supply. In the ACCC's latest inquiry into the NEM, it recommended amending the relevant legislation to provide the AER with the option to adjust the DMO outside of the annual price setting cycle in the event of uncertain or unforeseen circumstances.[83]

4.5 Market bodies are monitoring unusual retailer behaviour

We consider that the observed unusual retailer behaviour, while not desirable, has not been widespread and did not lead to consumer harm (section 4.3). This section describes stakeholder views on the need for work and how market behaviours will be considered.

80 Red Lumo, submission to the consultation paper, p. 4.

81 Price change notification requirements in relation to the terms and conditions of a market retail contract are set out in section 46 of the National Energy Retail Rules.

82 Section 10 of the *Competition and Consumer (Industry Code - Electricity Retail) Regulations 2019*.

83 Recommendation 3. ACCC, *Inquiry into the National Electricity Market*, November 2022 Report, 25 November 2022.

4.5.1 Stakeholders were divided on whether to consider this issue further

Stakeholders provided mixed views on the collective observed behaviour.

- **Market participants cautioned against interventions that could damage competition and efficiency.** Momentum Energy noted that the alleged recent behaviour of a few smaller retailers does not warrant the creation of unnecessary barriers to entry for retail businesses that operate in a highly competitive market.[84] Similarly, Red Lumo requested that the AEMC and other regulatory agencies carefully consider the impact of any new measures which might negatively impact competition.[85]
- **PIAC and the AER supported further work to discourage the observed behaviour.** PIAC considered the behaviour was not in line with the NEO and recommended exploring interventions that require retailers to act in good faith or a windfall tax as seen in the UK.[86] The AER recommended exploring interventions to discourage this conduct and raised several options for further work, such as potentially broadening the AER's powers to revoke retail authorisations.[87]

4.5.2 The ACCC and AER are monitoring the observed behaviour

We acknowledge the AER's focus on this behaviour and ACCC's enforcement priorities and will work with them to develop proportionate solutions if needed.

- The AER's submission to our stage one consultation paper stated they have been closely monitoring the behaviour of retailers in the recent volatile market conditions. They consider that some of the observed behaviour is problematic.[88]
- We have discussed this type of behaviour with the ACCC and note:
  - the ACCC's 2022/23 enforcement priorities include competition and consumer issues arising from the pricing and selling of essential services with a focus on energy.[89]
  - the ACCC reported the volatile market conditions may have placed pressure on retailers leading to the observed behaviour. It noted concerns that this behaviour combined with the six electricity retailer failures, may reduce competition in the retail market over the longer term.[90]

84 Momentum Energy, submission to the consultation paper, p. 2.

85 Red Lumo, submission to the consultation paper, p. 4.

86 PIAC, submission to the consultation paper, p. 8.
The UK government implemented a temporary Public Interest Business Protection Tax for 12 months to 28 January 2023. This is essentially a windfall profits tax to reduce the incentive for retailers to enter into insolvency and profit from the liquidation of 'in-the-money' hedge positions. HM Revenue & Customs, *Public interest business protection tax*, technical note, 28 January 2022.

87 AER, submission to the consultation paper, p. 10.

88 AER, submission to the consultation paper, p. 10.

89 ACCC, *Compliance and enforcement priorities for 2022/23*, found here.

90 Chapter 5 in the ACCC's *Inquiry into the National Electricity Market*, November 2022 Report, 25 November 2022.

4.6 We are not considering regulating how retailers trade hedging contracts

This section describes:

- stakeholder feedback opposing further work
- our rationale for not considering regulations for how retailers trade hedging contracts.

4.6.1 Stakeholders generally opposed additional regulation of contracting behaviour

Submissions provided by AFMA, retailers or vertically integrated market participants opposed any new regulations that would govern how retailers manage their contracting positions. In particular:

- Momentum Energy noted that they do not believe that the alleged recent behaviour of a few smaller retailers warrants undermining the efficiency of the electricity hedge market.[91]
- Stakeholders considered that retailers and other market participants should maintain their right to adopt hedging strategies of their choice, except for the RRO which is designed to support future reliability.[92]

The AER and PIAC supported further work to reduce instances of this behaviour. However, the AER acknowledged the likely challenges in defining conduct in a way that addresses the observed behaviour without impacting legitimate contract trading.[93]

4.6.2 We are not considering regulations for how retailers trade hedging contracts.

We are not considering regulations for how retailers trade hedging contracts. Even if this behaviour became more widespread, we do not consider the appropriate response would be to regulate how retailers trade hedging contracts for the following reasons:

- buying and selling hedging contracts promotes liquidity
- in recent years, the AEMC has only explored interventions to further improve liquidity
- the only energy intervention in contract markets is the RRO which is intended to support reliability.

Buying and selling hedging contracts promotes liquidity

A liquid contract market means buyers and sellers can easily trade hedging contracts at prices reflective of underlying conditions in the spot market. Liquidity supports risk management by generators and retailers alike. Liquidity also supports future investment as contract market prices underpin investment signals in the NEM.

In the context of observed behaviour, we consider contract trading part of the normal operation of the contract market. Speculation, or the buying and selling of hedges for a profit

91 Momentum Energy, submission to the consultation paper, p. 2.

92 AEC, p. 5; Alinta, p. 5; Red Lumo, p. 4; AFMA, p. 2; CS Energy, p. 5. submissions to the consultation paper.

93 AER, submission to the consultation paper, p. 10.

in their own right, provides benefits to market liquidity that can be in the long-term interests of consumers.

In recent years, the AEMC has explored interventions to further improve liquidity

Interventions in the hedging market are rare. In recent years, the AEMC has considered one mechanism to improve price transparency and promote liquidity.[94] However, the AEMC ultimately made no rule because of the recent implementation of the RRO and the ASX's voluntary market making scheme.[95]

The only energy intervention in contract markets is the RRO and this is intended to address reliability

The RRO is the only energy legislation that places requirements on retailers' contracting at certain times.[96]

We note the RRO was not triggered, and reliability was not at risk when the observed behaviour occurred. Therefore, we do not consider that changes to the RRO or other contracting arrangements would be a proportionate response to the observed behaviour.

94 AEMC, *Market making arrangements in the NEM*, final determination, 19 September 2019.

95 The ASX's market maker scheme was introduced on 1 July 2019. Market makers have an important role in ensuring that buyers and sellers can transact in markets. They provide liquidity to the market by providing quotes during the trading day and updating their prices to reflect changes in market conditions.

96 Chapter 4A in the National Energy Rules.

5 MAKING OUR RECOMMENDATIONS

The Commission must make recommendations in the long-term interest of consumers and is applying an assessment framework to do so. We encourage stakeholders to have regard to this assessment framework when providing submissions.

5.1 Our recommendations must be in the long-term interest of consumers

The Commission is bound by the National Electricity Law (NEL), National Gas Law (NGL) and the NERL to only make recommendations if it is satisfied that the recommended changes will, or are likely to, contribute to the achievement of the National Electricity Objective (NEO), National Gas Objective (NGO) and the National Energy Retail Objective (NERO).

The NEO is:

> To promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> 1. price, quality, safety, reliability and security of supply of electricity; and
> 2. the reliability, safety and security of the national electricity system.

The NGO is:[97]

> to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, safety, reliability and security of supply of natural gas.

The NERO is: [98]

> to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to price, quality, safety, reliability and security of supply of energy.

97 Section 23 of the NGL.

98 Section 13 of the NERL.

5.2 We are using an assessment framework to consider policy options

The Commission is using an assessment framework to determine whether any policy recommendations identified in the review promote the long term interests of consumers. The assessment framework includes the following criteria which are explained in the following sections:

1. appropriate risk allocation
2. efficiency
3. incentives
4. predictability and stability
5. simplicity and transparency
6. timing and practicality.

Stakeholders generally supported the proposed assessment framework in submissions to the stage one consultation paper. We have therefore applied this framework for determining areas of work for stage two of the review and encourage future stakeholder responses to have regard to this framework. The following sections describe how each criterion applies to the Review with practical examples of policy issues throughout.

5.2.1 Appropriate risk allocation

Risks should be allocated to those best-placed to manage them. However, the RoLR scheme involves the sudden shift of customers to a designated RoLR to maintain continuity of supply. This results in retailers receiving customers who they can't account for in advance while the failed retailer's customers and associated obligations are taken away.

What insurance mechanisms may be needed to support the designated RoLR to manage the risks and costs associated with participating in the scheme?

We are considering:

- enhancing the RoLR gas directions framework to accommodate both physical and financial market risks for the designated RoLR
- clarifying the wholesale and hedging costs that may be claimed through the RoLR cost recovery scheme
- expanding the cost recovery and directions frameworks to explicitly include price and physical supply risks.

Whether and how costs associated with the RoLR scheme should be paid for by the failed retailer?

We are considering:

- extending the period where RoLR gas directions apply
- exploring issuing a failed retailer a bill for the RoLR cost recovery scheme associated with its failure.

What is the risk period where the RoLR may need support?

- In gas: how long should the RoLR gas directions last for?
- In electricity: what is the appropriate period for a RoLR to claim cost recovery for prudent wholesale and hedging costs?

5.2.2 Efficiency

The regulatory framework should promote efficient market outcomes. Recommended changes should facilitate lower total system costs associated with RoLR events, thereby reducing costs to consumers. Higher costs are likely to arise from the RoLR incurring high wholesale costs without appropriate contracts, hedging instruments or clear cost recovery mechanisms to manage them.

How do changes to the risk allocation reduce total system costs?

We are exploring whether and how the failed retailer can bear the costs of its exit to reduce costs to customers and the RoLR?

How do changes to the risk allocation influence barriers to entry, expansion or the ability to obtain finance?

We are exploring whether and how requiring the failed retailer to bear the costs of its exit may increase the cost of capital, thereby increasing retail barriers to entry, expansion or the ability to obtain finance.

5.2.3 Incentives

The regulatory framework should have incentives that promote efficiency, reflect the appropriate allocation of risk and enhance competition. Recommended changes should enhance competition, improve operational incentives or avoid perverse incentives for the failing retailer, the RoLR or any relevant counterparties to contracts.

How are the failed retailer's incentives influenced by changes to the risk allocation?

The failed retailer will seek to maximise the value it can extract from its failure. If an insolvency official is appointed, it is their duty to do this. We are considering:

- exploring in RoLR gas directions, how the failed retailer's role in negotiations be defined, limited or removed to reduce the ability of the failed retailer to extract value from negotiations
- exploring in making the failed retailer pay for the costs of its exit, what measures can be put in place to prevent the retailer shifting its assets into another company before failing
- exploring what measures may be needed to deter failing retailers from exiting through the RoLR scheme while still solvent (e.g. through the cessation of the sale of energy, or through not meeting AEMO prudential requirements).

How are the RoLR's incentives influenced by changes to the risk allocation?

The default RoLR in each distribution area is required to take on the failed retailer's customers. However, retailers are able to register with the AER to voluntarily take on customers in a RoLR event. We are:

- exploring benefit sharing whereby the RoLR would be required to pass through the benefits of gas contracts from a RoLR gas direction to customers
- considering only allowing prudent costs to be recovered to but not at the expense of discouraging good risk management practices
- considering policy options that encourage broader participation in the RoLR scheme by other electricity and gas retailers.

5.2.4 Simplicity and transparency

The regulatory framework should be easily understood and enforceable. The RoLR scheme manages retailer failure of an essential service and was recently tested in the midst of volatile market conditions. Therefore, recommended enhancements to the RoLR scheme should be easily navigable by all relevant parties in these periods of potential market stress and enforceable by the AER to maintain market confidence.

Are the recommended changes easy to understand?

We are considering:

- amending the trigger for the AER to issue RoLR gas directions
- making explicit the prudent wholesale and hedging costs that can be claimed through the RoLR cost recovery scheme.

Are the recommended changes enforceable?

We are considering:

- exploring what automatic information should be provided to the AER to manage retailer failure
- exploring the necessary functions the AER may need to enforce recommended changes.

5.2.5 Predictability and stability

The regulatory framework should be applied consistently to all classes of comparable contracts in a manner that is predictable and stable. In particular, recommended changes to the RoLR scheme should have consistent policy outcomes across electricity and gas, regardless of the type of RoLR event or contracts held by the failed retailer.

5.2.6 Timing and practicality

Recommended changes should be practical and able to be implemented in a timely manner. The Commission is considering this criterion in the review through the following questions and issues.

Are recommended changes practical and able to be implemented?

Currently, there are two RoLR schemes — one for the NECF jurisdictions and a separate one for Victoria. The RoLR scheme for NECF jurisdictions is the subject of this review but is primarily set out in the NERL and changes must be made through South Australian parliament. Furthermore, retailer failure often interacts with insolvency law, which is set out in the Corporations Act.

The Commission will therefore avoid changes to the regulatory framework that:

- may affect retailers in non-NECF jurisdictions
- require changes outside of the Energy laws and rules.

Are recommended changes likely to achieve the intended benefits in a timely, proportionate and targeted way?

Changes to the regulatory framework should be likely to achieve the benefits including their likelihood to be implemented. The Commission will therefore:

- engage regularly with jurisdictions in line with our terms of reference on potential recommendations to facilitate a smooth implementation process
- consider proportionate policy responses to the risks we are seeking to appropriately allocate.

6 HOW TO MAKE A SUBMISSION

6.1 We encourage you to make a submission

Stakeholders can help shape the recommendations by participating in the review process. Engaging with stakeholders helps us understand the potential impacts of our recommendations and, in so doing, contributes to well-informed, high quality review recommendations.

6.2 How to make a written submission

Due date: Written submissions responding to this consultation paper must be lodged with Commission by **22 June 2023**.

How to make a submission: Go to the Commission's website, www.aemc.gov.au, find the "lodge a submission" function under the "Contact Us" tab, and select the project reference code RPR0016.[99]

We encourage stakeholders to use the stakeholder submission template, which is available on the review project page.

Tips for making submissions are available on our website.[100]

Publication: The Commission publishes submissions on its website. However, we will not publish parts of a submission that we agree are confidential, or that we consider inappropriate (for example offensive or defamatory content, or content that is likely to infringe intellectual property rights).[101]

6.3 Other opportunities for engagement

There are other opportunities for you to engage with us, such as one-on-one discussions with the project team prior to, and following, your formal submission.

6.4 For more information, you can contact us

Please contact the project leader with questions or feedback at any stage.

Project leader:	Sam Markham
Email:	sam.markham@aemc.gov.au
Telephone:	+61 2 8296 7825

99 If you are not able to lodge a submission online, please contact us, and we will provide instructions for alternative methods to lodge the submission.

100 See: https://www.aemc.gov.au/our-work/changing-energy-rules-unique-process/making-rule-change-request/our-work-3

101 Further information is available here: https://www.aemc.gov.au/contact-us/lodge-submission

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.
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Electricity Rules
NERL	National Energy Retail Law
NERO	National Energy Retail Objective
NERR	National Energy Retail Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
Ofgem	UK Office of Electricity and Gas Markets
OTC	Over-the-counter, referring to contracts
PPA	Power purchase agreement
PPSR	Personal Property Securities Register
RoLR	Retailer of Last Resort
STTM	Short term trading market
ToR	Terms of Reference