12 July 2013

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Submitted online: www.aemc.gov.au

Dear Mr Pierce

EMO0024 – NEM Financial Market Resilience – First Interim Report

Origin Energy (Origin) appreciates the opportunity to provide comments to the Australian Energy Market Commission (AEMC or Commission) First Interim Report on the National Electricity Market (NEM) financial market resilience. We acknowledge that the First Interim Report provides draft recommendations on measures to mitigate the risk of contagion following the failure of a large retailer under the Retailer of Last Resort (ROLR) framework. A Second Interim Report will assess other risks of contagion and the applicability of the Group of Twenty (G-20) economies reform agenda to the NEM.

Origin agrees with the AEMC that the current ROLR framework may not be able to adequately manage the collapse of a large retailer. An option involving the support or intervention of government, in addition to other draft recommendations in the First Interim Report may be required to mitigate the risk of contagion following the failure of a large retailer.[1]

Origin agrees with the AEMC that "there is a low probability of financial contagion in the NEM."[2] Origin considers a market-based mechanism, enhanced by the AEMC draft recommendations, could adequately manage the risks of a ROLR event and achieve the objectives of the ROLR framework identified by the AEMC. An important recommendation is developing an option – but not obligation - for the Commonwealth Government to provide credit support for the ROLR for an interim period following the ROLR event. We believe this recommendation could significantly reduce the risk of contagion in the unlikely scenario of the failure of a large retailer in the NEM.

Origin does not support the implementation of a new special administration regime proposed by the Commission. We consider the consequences of imposing such a complex regulatory arrangement that intervenes in the normal functioning of the market, and supersede existing external administration regimes, Corporations Law and the National Electricity Rules (NER or Rules) is likely to increase the costs and risks for participating in the NEM rather than reduce them. We expect those resulting costs and increased risk to outweigh any perceived theoretical benefit.

Origin considers the most appropriate way to manage risks associated with the failure of a large retailer is by enhancing market based mechanisms. As such, we support most of the AEMC's other draft recommendations. These include:

- Operational improvements for the provision of customer data; and

[1] AEMC 213, *NEM financial market resilience*, First Interim Report, 4 June 2013, Sydney, p. 24.
[2] Ibid, p. 16.

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- Enhancing cost recovery and certainty for the ROLR.

We consider that, when combined with the option to access interim credit support to help manage the immediate period following a significant ROLR event, the improved ROLR framework would be effective in managing the failure of a large retailer.

We do not support delaying the appointment of designated ROLRs.

The remainder of the submission will be structured as follows:

1. Framework for assessing AEMC Draft Recommendations
2. Identifying and managing the risks of a ROLR event
3. The objective of the ROLR framework
4. Special administration regime
5. Proposed draft recommendations
6. Conclusion

Origin commends the ongoing work of the Commission in conducting the review into the financial resilience of the NEM.

1. Framework for assessing AEMC Draft Recommendations

Origin considers the principle risks that the ROLR will face following the collapse of a large retailer will arise from the following four obligations imposed on the ROLR in relation to the customers that are transferred from the failed retailer:

- Customer transfer and integration through the Market Settlement and Transfer Solution (MSATS) to manage customer transfers;
- Hedging and managing spot market risk for the customers acquired from the failed retailer;
- Obtaining credit support to comply with the Australian Energy Market Operator (AEMO) prudential requirements; and
- The recovery of efficient costs and customer billing.

AEMO raised an additional specific risk of the failure of a large vertically integrated retailer in submission to the AEMC Options Paper. The suspension of the retailer following a default event may result in the company being placed under external administration and this could comprise the operation of the generation assets including the generation of the vertically integrated retailer being turned off.

To adequately manage these risks, Origin supports the high level and specific objectives identified by the AEMC[3] that can be summarised as:

- Maintaining the continual supply of electricity to consumers;
- Managing the transfer of consumers from the failed retailer to designated ROLRs;
- Minimising the risk of contagion; and
- Facilitating the inclusion of additional retailers to participate as ROLRs.

We agree with the AEMC that any solution to amend the ROLR framework should be well targeted, proportionate and minimise the risk of moral hazard with risk allocated to

[3] Ibid, p. 35.

those parties best able to manage the risk. Simpler solutions are also preferable to complex, broad based solutions that may lead to unintended consequences.[4]

To meet these criteria, the AEMC needs to identify a framework where these risks can be adequately managed to achieve the stated objectives in a manner that: allocates the risks to parties that are best able to manage and control the risks; is well targeted; proportionate; minimises moral hazard; and simple.

2. *Identifying and managing the risks of a ROLR event*

As identified by the AEMC, under the existing ROLR framework, a designated ROLR may not be able to adequately manage the risks associated with a ROLR event. To limit the risk of contagion, a role for the Commonwealth Government may be required to provide credit support during the transitional period following a ROLR event. Some of the risks are inherent in the speed of a ROLR event, where a retailer can be suspended from the market within 36 hours following the trigger of one of the 15 default events under the Rules. Given, however, that delaying market suspension could increase the risks to other Market Participants, as noted in the AEMC Options Paper, the most effective way to manage the risks of a ROLR event and limit contagion is, therefore, in the immediate period following the suspension of the failed retailer.

2.1 Transferring the customers of the failed retailer to the designated ROLR

There are several risks arising from the process of transferring the customer of a failed retailer and then integrating them into a designated ROLR. The designated ROLR will require three sets of data to be able to integrate the transferred customers including: standing data; customer data; and a start date for meter readings. Developments with AEMO operating procedures and the passing of the National Electricity Retail Law (NERL) under the National Electricity Consumer Framework (NECF)[5] have enabled this process to be undertaken with more speed and accuracy. In addition, operational improvements, noted by Origin in our submission to the AEMC Options Paper, and one of the AEMC's draft recommendations may enhance the accurate and timely transfer of customers.

AEMO operates under a group hierarchy of operational procedures:

- The MSATS procedure to manage the transfer of customers;
- The Customers Administrative Transfer Solution (CATS) to transfer National Metering Identifier (NMI) data; and
- B2B procedure to manage the transfer of meter data from the Metering Data Provider (MDP) to the retailer.

AEMO has a NEM ROLR procedure and retailers are required to develop a ROLR procedure where they have been selected as the designated default ROLR or where they have elected to register with the Australian Energy Regulator (AER) as a firm or non-firm ROLR under the NECF ROLR framework.

Under NECF, additional customer information is required identifying the consumer as a residential or business consumer. A NMI classification is also required to identify the customer as a small or large customer where the annual usage is less than 100MWh or

[4] Ibid, pp. 10-11.
[5] Origin notes NECF has been implemented in South Australia, Tasmania, the ACT and NSW on 1 July 2013 with COAG announcing on 7 December 2012 with Victoria and Queensland to do so by 1 January 2014 subject to the resolution of issues specific to those states.

greater than 160MWh respectively. The average daily load of each consumer is also required to assess metering requirements. Large customers are able to nominate a ROLR under NECF, which further strengthens the ROLR framework.

These enhancements could make it easier for designated ROLRs to obtain the three sets of data it requires be able to integrate the customers of the failed retailer:

- Standing data;
- Customers data; and
- The start date for metering.

Origin understands there are technical limitations to the volume of customers that can be transferred through MSATS in a single day. In the event of the failure of a large retailer, assuming the failed retailer's customers would be split between two large designated ROLRs, each designated ROLR may acquire an estimated 2 million customers. Under this scenario, it could take several weeks to integrate the customers of the failed retailer.

To adequately manage risks posed by integrating these new customers, a designated ROLR would, during the customer transfer period, need to:

- Estimate the size and shape of the consumer load to be transferred to enable hedging of spot market risk; and
- Establish the start date for metering to allow billing for cost recovery once customer accounts have been established.

To the extent that designated ROLRs are unable to manage the risks posed by integrating new customers, the risk of NEM financial contagion arises. As a means of mitigating these risks, Origin supports the AEMC draft recommendation of operational improvements to enhance the provision of relevant granular data to enable a ROLR to be able to accurately identify the size and shape of any integrated customer load and the needs and status of the customers including life support and hardship classification. These improvements are likely to assist in the customer integration process, following retailer failure, and thereby reduce the risk of contagion.

As noted in the AEMC First Interim Report, there is no central repository for customer information or method for retailers to gain access to customer information other than through B2B procedures. Origin considers there is value in aligning the customer administration requirements for electricity retailers with the requirements for gas retailers and, where appropriate, streamlining the process by which retailers could gain access to this information in certain circumstances, including a ROLR or event. This would further reduce risks associated with customer integration following retailer default.

2.2 Hedging and managing spot market risk from the new customer load

The adequate management of spot market risk arising from the acquired customer load is critical to the financial viability of the designated ROLRs insofar as it may impact the settlement risk of these entities. Where the failed retailer is a large or vertically integrated retailer, the spot market exposure associated with the customers to be transferred is likely to be considerable. In these circumstances, designated ROLRs would need to purchase hedge contracts in order to manage this exposure. Examples of such hedge contracts are over-the-counter (OTC) hedge contracts for swaps and caps and futures traded on the ASX 24. The ROLR framework should, therefore, facilitate liquidity in the hedge contract market, especially where any regulatory response could influence the availability of OTC hedge contracts.

The AEMC has noted in its Options Paper and First Interim Report that retailers have internal risk management frameworks to manage market, credit, operational and other risks. To comply with the risk framework, a retailer could be expected to be required to have a range of hedge contracts to a number of counterparties to effectively manage spot market risk. For a vertically integrated retailer, a hedging strategy could include physical generation assets in addition to swap, caps and futures to hedge the retail load. The hedging strategies of NEM retailers do, to some extent, provide mechanisms for managing default events within the NEM.

For example, the International Swaps and Derivatives Association (ISDA) Master Agreement is a standard industry template for OTC derivative contracts. ISDA Master Agreements have provisions to manage default events that include closing out a contract with the defaulting counterparty or to novate the contract allowing its transfer from the defaulting counterparty to another counterparty by voluntary agreement.

The ability to close out counterparty net positions in light of a default event under the ISDA Master Agreement is critical to managing the consequences of a default event in an orderly manner. It is also important for allowing market participants to reassess their market exposure in light of the default event and adjust their available bids and offers for hedge contracts, which the designated retailer could access to manage its new market exposure.

The level and duration of spot market risk that designated ROLRs might be exposed to will depend on a range of factors, including the availability of OTC hedge contracts and exchange traded derivative products. It is critical for contract counterparties to be able to rely on the default event provisions specified in their contracts. This will ensure that counterparties can calculate their market exposure and respond accordingly, which includes making hedge cover available that designated ROLRs can access in a timely manner, enabling designated ROLRs to manage spot market risk arising from the acquired customer load.

2.3 Credit support for AEMO prudential requirements

Origin considers that the provision of credit support under the current ROLR framework as imposing undue credit risk on designated ROLRs and thereby creates risk of financial contagion. The AEMC has identified the amount of credit support required for a designated ROLR to comply with AEMO prudential requirements as being $125 to $500 million, depending on the level of spot prices at the relevant time.[6] Given existing debt levels and composition, a designated ROLR could require several weeks to obtain credit support to meet AEMO prudential requirements. This creates significant credit risk for a designated ROLR.

Assisting a designated ROLR to meet credit support obligations in the short term could significantly reduce the risk of contagion that could otherwise arise in the initial period following a ROLR event. Under the current framework, the timing to obtain credit support, associated balance sheet implications and timing of exposure to a syndication of lenders imposes significant risk on the designated ROLR.

These risks will subside in the short term, once the designated ROLR can effectively manage the acquired retail load and achieve enhanced cash flow from the recovery of costs arising from the ROLR event. A designated ROLR would be better placed to access credit support and comply with AEMO's prudential requirements once the uncertainty of

[6] AEMC 2013, First Interim Report, p. 49.

the ROLR event is diminished and their risk profile improves. Providing assistance to help a designated ROLR meet credit obligations in the short term could therefore reduce risk of contagion in the NEM.

We support the AEMC's draft recommendation to enable, but not oblige, the Commonwealth Government to provide credit support for the designated ROLRs. We consider this could reduce the risk of financial contagion by providing the designated ROLRs additional time to arrange credit support at a time after the ROLR event when:

- High spot market prices, caused by market stress associated with the ROLR event, may have abated, leading to lower credit support requirements and maximum credit limit; and
- The risk profile of a designated ROLR has decreased as a consequence of increased cash flows from cost recovery associated with the cost of the ROLR event, making it easier to access credit support.

Origin also supports the AEMC's recommendation to phase in the level of credit support to reflect the accrual of actual exposures rather than requiring a lump sum amount to be lodged from the outset. This will further reduce credit risk imposed on designated ROLRs, and thereby reduce the risk of financial contagion in the NEM.

2.4 Cost recovery and certainty for a designated ROLR

Effective cost recovery enhances the cash flow of designated ROLRs and so forms an important component of risk mitigation under the ROLR framework. The ability of designated ROLRs to recover the efficient costs associated with a ROLR event, and thereby, improve their cash flow, will enable these entities to access finance and credit support. This in turn will reduce risks associated with meeting AEMO prudential requirements. However, cost recovery is also linked to integrating the customers of the failed retailer and the ability of designated ROLRs to bill and recover the costs from the customers in a timely manner.

The AER has a role in approving the efficient costs that are recoverable. Providing certainty and guidance on the efficient costs that are recoverable by designated ROLRs is important to minimise the cash flow risk imposed on these entities, and consequently the risk of NEM contagion. Providing NEM retailers with greater certainty regarding the recovery of efficient costs could encourage more retailers to register with the AER in a firm or non-firm capacity to participate in a ROLR event, should one arise.

Origin welcomes the AEMC's draft recommendation to amend the ROLR regime to provide greater certainty that the ROLR could quickly recover the reasonable costs of the ROLR event. We agree with the AEMC that this recommendation could reduce risk imposed on designated ROLRs, and thereby reduce risk of contagion, by enhancing a designated ROLR's cash flow, financing and access to credit support. We recognise that this does not remove the possibility that designated ROLRs will discount some or all costs associated with new customers. It is important for a designated ROLR to determine how costs should be recovered, given the pressure of retail market competition and the value in retaining consumers acquired through the ROLR event.

2.5 Partial suspension and suspension of a vertically integrated retailer

In a submission to the AEMC Options Paper, AEMO noted that the risks under the existing ROLR framework were:

- A designated ROLR being required to integrate the customers of a failed retailer with a large customer base; and
- The possible suspension of a vertically integrated retailer with a generation portfolio.

AEMO has identified that the possibility of loss of available generation, where the market suspension of the vertically integrated retailer resulted in the generation being turned off, may represent a risk to the market. Origin agrees that this possibility poses a risk to the market but does not consider that this risk should be addressed by partial suspension or special administration.

We recognise that AEMO does have some discretion under the Rules to specify the extent of the market suspension.[7] We similarly recognise that an insolvent business under external administration would cease to be classified as a Market Participant[8] and this could occur following a retailer default and suspension from the market. We understand that while a business is suspended from the NEM the registration with AEMO is maintained. In this context, under the NER, the insolvent business would be unable to dispatch generation in the market as it is under external administration and would cease to be classified as a Market Participant. The administrator would also be unable to dispatch the generation as it would still be registered by the owner of the suspended retailer.

We agree with AEMO that there are no explicit provisions for the operation of generation assets where the retail business of a vertically integrated retailer is placed under external administration within the Rules. We recognise, however, that under the NER, each connection point requires a Financially Responsible Market Participant, registered with AEMO as either a Market Customer or a Market Generator. A potential problem within the Rules appears where neither, the suspended retailer or the administrator could act as the Financially Responsible Market Participant at the generator connection point.

Where a gap is identified in the Rules between the suspension of a Market Participant, Registration as a Generator and external administration we recommend the AEMC consider ways to ensure a Financially Responsible Market Participant is maintained over generation assets at a connection point. An option could be an amendment to the Rules to enable the transfer of registration over the generation assets from the suspended vertically integrated retailer to the administrator. This could enable the dispatch of generation through having a Financially Responsible Market Participant at the generator connection point.

3. The objective of the ROLR framework

Origin acknowledges the specific objectives of the special administration regime. We are concerned however that the "objectives do not include maximising value for the failing retailer's creditors."[9] Insofar as it would supersede existing insolvency law, the special administration regime could significantly increase costs and risks associated with transacting in the NEM. We consider that market based mechanisms, operating to facilitate the objectives of the ROLR framework, are more likely to be successful in mitigating risk of NEM financial contagion compared to a broad based and complex regulatory response.

[7] NER clause 3.15.21(c) and (g) state AEMO can determine the extent of a suspension from the NEM.
[8] NER clause 3.3.1(b) states each Market Participant must not be under external administration.
[9] AEMC 2013, First Interim Report, p. 35.

We support the specific objectives of the ROLR framework as stated by the AEMC to:

- Maintain continuity of electricity supply to consumers of the failed retailer;
- Facilitate the orderly transition of customers from the failed retailer to the new retailer;
- Reduce the likelihood of financial contagion resulting from the financial distress of a large retailer;
- Increase flexibility in potential outcomes compared to the ROLR scheme by providing greater scope to spread customers across multiple retailers;
- Provide more scope for other retailers to agree to take on the failing retailers customers and pay to acquire them; and
- Enable the new retailers to better manage any additional retailers that they acquire.[10]

The failure of a major retailer would impose risks on any designated ROLR in relation to the transfer and integration of large numbers of new customers, as discussed above. A targeted market based approach where an incentivised retailer could register with the AER to participate in a ROLR event, consistent with NECF, could more effectively manage this transfer and maintain the continuation of supply to consumers.

We consider the NECF framework, under which retailers can register as a firm or non-firm ROLR with the AER appointing designated ROLR, could provide a mechanism by which additional retailers could participate in the ROLR process. A sales process, as contemplated by the proposed special administration regime, will not necessarily allow more retailers to participate in acquiring customers of a failed retailer or materially reduce the risk of transferring and supplying customers in the event of retailer failure.

On this basis, we do not consider the special administration option will enhance the NEO. The option could diminish the NEO and the long term interests of consumers insofar as the special administrator would not seek to maximise the return to creditors. The additional risk imposed on NEM creditors in the presence of a special administration regime may impose a higher risk premium on NEM transactions and deter investment in the long term.

4. Special administration regime

Origin does not support the special administration regime proposal by the AEMC. We consider the option imposes a broad and complex regulatory arrangement that is disproportionate to the low probability, albeit high impact scenario, of a major retailer failure. We consider that market based mechanisms could provide a simpler, more targeted and more efficient method of adequately managing the risks of a large retailer failure, whilst achieving the objectives of managing the transfer and continual supply to consumers. We do, however, consider a role for government is critical in managing any residual risk of NEM financial contagion through credit support arrangements during the immediate period following a ROLR event.

The special administration option is a complex and broad based proposal that could have unintended consequences. The complexity of the special administration regime is inherent in superseding it existing laws, rules and procedures including:

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[10] Ibid.

- The preference for a court appointed administrator to limit legal recourse of creditors;
- Requirements to ring fence retail businesses;
- Prohibitions or restrictions on counterparties terminating contracts; and
- Prohibitions or restrictions on other creditors from exercising contractual rights.

These regulatory interventions could impose additional risks on the ROLR framework and the NEM more broadly.

In addition, the recovery of costs for funding the special administration regime will impose additional and disproportionate costs on the market as a whole. The longer term consequences of the special administration proposal could be higher risk premiums and costs associated with NEM transactions, the presence of a new regime may function to deter new investment in the NEM. These outcomes could be highly detrimental to the market, would be contrary to the NEO and may constitute a form of sovereign risk.

4.1 Appointment of a special administrator

The AEMC's stated preference is for a court appointed administrator to limit legal recourse and injunctions by third parties in order to remove scope for delays to the sale process. We note, however, that the process of court appointment itself may take some time, as compared with, for example, appointment of an administrator by a qualified person. In this regard, the AEMC has accurately identified that the window prior to appointment of an administrator will expose creditors and other Market Participants to additional risks. We consider these additional risks to be unacceptably high.

The AEMC has accurately identified that the time prior to appointment of an administrator will accrue additional risks for creditors and other Market Participants. The increase and reallocated risk with preferring a court appointed administrator is that, while a sale process may be expedited, the delay in appointing an administrator could result in additional liabilities and risks accruing from the ongoing purchase and supply of electricity to consumers.

As noted above, obtaining metering start dates are important to enable a designated ROLR to bill their newly acquired customers and therein recover costs associated with those new customers. The longer the start date for metering customers is delayed, or put in doubt, the more uncertain recovery of new customer costs becomes for a designated ROLR. A benefit under the NECF ROLR arrangements is the appointment of a designated ROLR enables a clear and rapid metering start date from the suspension of a failed retailer to the transfer to the ROLR. In contrast, a court appointed administrator could increase the risk of cost recovery by creating uncertainty regarding metering start dates.

4.2 Ring fencing

The AEMC and Allens Linklaters have acknowledged that the effectiveness of a special administration regime depends on ring-fencing of retailers' NEM retail operations into separate corporate entities. Allens Linklaters noted that they "would consider legal ring fencing to be the minimum necessary to allow for the benefits sought by the proposed special administration regime."[11] This could include customer contracts, hedge contracts and other intra-group supply agreements, including internal hedging agreements.[12] Insofar as the proposed special administration regime requires ring fencing, it will

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[11] Allens Linklaters 2013, *Dealing with Financial Distress in the National Electricity Market: Special Administration Regime for Electricity Retailers*, 10 May 2013, Melbourne, p. 8.
[12] AEMC 2013, First Interim Report, p. 38.

function to shift the cost of adequately managing risks associated with ROLR events from designated ROLRs all retailers.

Implementation of required ring-fencing under a special administration regime could be either mandated or incentivised through regulation.[13] Such implementation would be likely under a special administration because, without ring fencing, the special administrator could face difficulties in achieving its objectives:[14]

- It could be exceedingly difficult to disentangle the retailer's electricity retail operations from its other business operations;
- An administrator may need to manage the non-retail operations in order to continue trading the company;
- If the non-retail operations are unprofitable, government funding may be used to support non-retail operations; and
- Whether the objectives of an administrator should be expanded to include an objective to attempt to rehabilitate or restructure the retailer.

A regulatory requirement or financial incentive to ring-fence retail operations from other operations could impose a significant, onerous burden on market participants, especially those that have complex supply and hedging arrangements between various business units. Retailers could be expected to incur significant costs in restructuring their businesses to accommodate ring-fencing, with these costs ultimately being passed through to end use consumers in the form of higher prices. Where retail price regulation prevents costs being passed through, the retailer may need to absorb significant additional costs.

Retail businesses in Australia operate under a range of different company structures. The reasons for different company structures can depend on a range of factors including the ownership structure of the business and 'legacy' factors including how the business may have evolved over time, including legal and financing requirements for acquisitions. Company assets including retail hedges, generation assets and the retail portfolio could be held under a single company structure or held under a range of companies within a broader consolidated business. Financial reporting, however, is conducted on a consolidated group basis with the treatment of consolidated earnings, debt and credit ratings for a retailer undertaken on a group basis rather than that of each individual company entity.

Retail and vertically integrated businesses are generally managed and operated on a consolidated group basis.[15] For financial and accounting purposes these operations may be reflected through payments between entities or internal transfer payments but payments between business units support the viability of business as a whole. The retail business of a vertically integrated retailer may make transfer payments to the generation business for available capacity and providing hedge cover, for example but operate under a single management structure. Despite the corporate structure the business is treated as a single entity.

In this context, the issue of whether to ring-fence or place the company as a whole under administration is a moot point; a rapid collapse of the retail section of the business is

[13] Some examples of ring fencing include accounting and financial, functional physical and staffing, legal and ownership separation.
[14] Allens Linklaters 2013, p. 8.
[15] Subsidiaries that function is a niche market may be operated separately however operations that impact the performance in the same market could be expected to be coordinated to enhance performance.

likely to see the business as a whole collapse. While it may be a theoretical, legal consideration, in practice the business units or entities under the corporate structure would be mutually supportive, not withstanding divestment of assets through a trade sale.

4.3 Restrictions on terminating hedge contracts or other financial arrangements

Under the special administration regime, the administrator would be given broad powers to achieve the objectives of the regime and the primary duties of the administrator would be to meet these objectives in the most efficient and timely manner.[16] To the extent that a special administration regime supplants the obligations a retailer would owe to creditors under existing external administration regimes, it imposes increased risk on those creditors. This increased risk is likely to translate into higher borrowing costs, which may reduce the financial resilience of all NEM retailers and thereby fail to mitigate the risk of contagion.

Special administration will also explicitly supersede the right of counterparties to terminate hedge contracts following a default event. This aspect of the proposal will allow the retail portfolio of the failed retailer to retain hedge contracts until the sale process has been completed. The AEMC has contended that the counterparty will not be exposed to significant risk as the government funded administrator should honour all payment obligations of the retailer.

This proposal, however, changes the risk profile for the counterparty. The restriction on the ability to terminate the contract would limit the ability of the counterparty to resell the hedge or another hedge instrument to a solvent counterparty in the market. This could impose a risk on counterparties where they have a restriction on managing counterparty credit risk that could deter investment or liquidity in the contract market as investors seek a higher premium for the additional risk.

The availability of hedge contracts in the NEM is critical to enable retailers to manage spot market risk. Under a ROLR event, specifically involving the failure of a large retailer, it could be expected there would be a number of hedge contracts, including OTC derivative contracts, where the failed retailer is counterparty. The special administration regime proposed would impose a prohibition and restriction on counterparties to hedge contracts from terminating the contracts to minimise the market risk to the administrator. This would be to supersede default provisions under the ISDA Master Agreements.

The immediate and longer terms risks to retailers and designated ROLRs could be reduced and mitigated through counterparties exercising termination or novation provisions under ISDA Master Agreements and terminating the contract with the failed retailer. The market risk to a designated ROLR is reduced to the extent they are able to obtain adequate and timely hedge cover. The longer the termination or novation restrictions are in place, the less likely a designated ROLR would be able to negotiate and execute hedge contracts in a timely manner. This could increase the risk of NEM contagion.

4.4 Cost recovery for special administration

The operation of the special administration regime would rely on the government providing funding to the administrator during the period of administration. This funding would allow the administrator to operate the business while it sells or transfers the retailer’s customers to new retailers with funding provided by the government recovered

[16] AEMC 2013, First Interim Report, p. 42.

upon termination of the special administration regime, either from the retailer itself or via a cost recovery mechanism.[17]

The funding of a special administration scheme will impose indeterminate, and potentially disproportionate, additional costs on NEM participants and ultimately end users. The scope for the government to recover funding from the failed retailer ahead of other creditors will increase creditor risk and therefore retailers' borrowing costs. This will likely increase the cost of energy for end users and may do so in a manner that is disproportionate to the risk that it seeks to mitigate. On top of this, end users will bear the additional expense of a cost recovery mechanism, either in the form of a direct tax through a taxpayer levy or passed through cost from industry participants in the form of an industry levy.

While the mitigation of the risk of financial contagion within the NEM will likely require additional expense, the costs of regulatory changes should be proportionate to the ends sought. The aggregate costs of a special administration regime, being the cost of retailer restructuring in addition to the cost recovery mechanism, would be significant and disproportionate to the objective of the regime.

The duration of the period of administration is critical as the longer the duration of administration and the sales process is undertaken, the greater the cost recovery obligation attached to each customer contract, as consumers will continue consume energy while the special administration is in place. Uncertainty surrounding this growing cost recovery obligation will inevitably diminish the value of the customer contracts that are to be sold. This could lead to a situation where the cost of administration increases while the sales process discounts customer contract values, resulting in diminishing returns to the market as a whole.

5. Proposed draft recommendations

5.1 Targeted role for government

Origin welcomes the draft recommendation from the AEMC to insert a general ability for the Commonwealth Government to provide credit support to AEMO. We consider it appropriate that this proposed amendment enables but does not oblige the Commonwealth Government to provide credit support. Given the number and size of retailers operating in the NEM it could be expected that government intervention and support would not be required where the ROLR event related to a smaller retailer and could be more applicable to the failure of a tier 1 retailer.

We consider it appropriate for the credit support provisions for the Commonwealth government to be a transitional measure. Integrating the customers of a failed retailer into a designated ROLR, especially where the failed retailer is a large retailer, is likely to require significant resource allocation on the part of the designated ROLR. Deferring the obligation to post credit support until a time when the market stress has likely abated, customers have been integrated and cash flows restored, through the recovery of costs from the ROLR event, could reduce the risks to the ROLR and the broader contagion risk to the NEM.

Origin considers the ROLR framework is a regulatory intervention in the operation of the NEM to ensure the supply of electricity consumers. Rights and obligations arising under this framework are not, therefore, commercial arrangements of the designated ROLRs. In

[17] AEMC 2013, First Interim Report, pp. 45-46.

this context, it is inappropriate for a designated ROLR to be subjected to the same credit support and prudential requirements in the immediate aftermath of retailer failure as they would otherwise be required to meet as a Market Participant. A ROLR framework that imposes credit support obligations on a designated ROLR at the time of the ROLR event imposes significant risk on the designated ROLR, and it is this additional and unnecessary risk burden that creates a risk of contagion for the broader market.

5.2 *Delaying the appointment of the ROLR and the AER*

Origin understands the intent of the Commission's draft recommendation to delay the appointment of the designated ROLR by the AER as being to allow for additional ROLRs and to provide the AER more time for consideration as to who to appoint as the designated ROLRs. We understand the obligation of the AER to consider the capacity of the ROLR to manage the ROLR event. As the responsible entity for appointing the designated ROLR, the obligation on the AER to consider the capacity of a potential ROLR is a logical extension of this function. We consider, however, the potential ROLR is best placed to assess its capacity to integrate the customers of the failed retailer.

Successful retailers in the NEM have sophisticated risk management policies, processes and systems. These extend from Board approved risk limits, to structured committees to monitor and manage the exposures of the business and ensure compliance with risk policies, procedures and staff training and accreditation. As managers of risk, retailers are best placed to indicate to the AER the capacity of the business to successfully integrate a given number of customers and avoid financial distress.

There is a natural role for the AER in the ROLR framework under NECF. We consider a large ROLR event could most effectively be managed where ROLRs that have previously registered with the AER as a firm or non-form ROLR or appointed as a designated ROLR, indicate to the AER the capacity of each retail business to take an assessed level of consumers. A cooperative approach to allocating customer load to designated ROLRs is more likely to be successful and minimise financial distress of individual ROLRs and contagion.

6. Conclusion

Origin agrees with the AEMC that under the existing ROLR framework, a designated ROLR may not be able to adequately manage the risks of a ROLR event and limit the risk of contagion without a role for the Commonwealth Government. Origin considers the option but not the obligation for the Commonwealth government to provide credit support as critical to minimise the risks of a ROLR event and contagion risk. The draft recommendations by the AEMC, especially those that enhance the existing NECF framework and cost recovery provision could also assist in minimising risk.

Origin does not, however, support the special administrative regime. We consider the proposed regime as a complex, broad based regulatory intervention that is a disproportionate response to the low probability event of the failure of a large retailer. Superseding existing Corporations Law and provisions of the NER could also lead to unintended consequences and sets a poor regulatory precedent.

We support the objectives of the special administration regime but consider these could be more effectively and efficiently met through existing or enhanced market based mechanisms. Additional risks are imposed on designated ROLRs immediately following a ROLR event, with these risks diminishing over the short term. Under the special administration regime, some of the immediate risks may be mitigated, but at the expense of costs and risks to the market increasing over time. Insofar as it increases the risk of contagion in the long term, a special administration regime cannot support the achievement of the NEO.

Should you have any questions or wish to discuss this information further, please contact Hannah Heath (Manager, Wholesale Regulatory Policy) on (02) 9503 5500 or hannah.heath@originenergy.com.au.

Yours sincerely,

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