REVIEW

Australian Energy Market Commission

FIRST INTERIM REPORT

NEM financial market resilience

4 June 2013

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First Interim Report

Inquiries

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

E: aemc@aemc.gov.au
T: (02) 8296 7800
F: (02) 8296 7899

Reference: EMO0024

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

Executive summary

This report sets out our draft recommendations for measures that will reduce the risks that could arise if a large electricity retailer fails.

While we consider that the likelihood of a large electricity retailer failing is low, the consequences for the market and customers if it occurred could be significant. There is potential for the financial problems of one business to be transmitted to other businesses. We refer to this as financial contagion. In an extreme case, this contagion could mean that the failure of a large electricity retailer could cause other electricity businesses to fail, with widespread consequences for customers.

The National Electricity Market (NEM) currently has arrangements in place to manage the failure of a retailer, including a retailer of last resort (ROLR) scheme. The ROLR arrangements are considered likely to be effective in managing the failure of smaller retailers, but may not be adequate to deal adequately with the failure of a large retailer, particularly one that also has significant generation activities. If a large retailer failed the ROLR scheme could exacerbate the risk of further retailer failures.

This report makes draft recommendations to amend the ROLR scheme to reduce the risk of financial contagion following a retailer failure, and also to consider implementation of a special administration scheme which could be used instead of the ROLR scheme if a large retailer failed.

Context for our draft recommendations

The Standing Committee on Energy and Resources (SCER) has asked the Commission to provide advice on:

- the nature of the risks to financial stability in the NEM arising from financial interdependencies between market participants;
- whether the existing mechanisms to mitigate these risks are adequate; and
- if necessary, options to strengthen those existing mechanisms and minimise the identified risks and their consequences.

Generators, retailers and other businesses that participate in the NEM have complex financial relationships with each other. They adopt a range of risk management strategies to manage the risks arising from their financial interdependency with other market participants. They are also subject to the requirements of financial regulators and external parties such as brokers and exchange operators, which may mitigate some of these risks.

To date there have not been any failures of large retailers or generators in the NEM and the market has proven reasonably robust. However, our issues paper set out examples where an unusual and unexpected series of events could potentially lead to financial contagion in the NEM. Examples from overseas energy markets have shown that even very large businesses can fail in some circumstances. In addition, the global financial crisis demonstrated the potential for high levels of financial interdependency to cause the financial difficulties of one market participant to result in financial contagion that threatens overall market efficiency.

The ROLR arrangements may exacerbate the risk that the financial distress of a large retailer could lead to cascading retailer failure and contagion in the NEM, because the designated ROLR:

- may not be able to secure the substantial increase in credit support required by the Australian Energy Market Operator (AEMO) almost immediately after the ROLR event; and
- would initially be unhedged in relation to the energy consumed by the ROLR customers, so would be exposed to the spot price at a time when prices could be high.

Overview of the draft recommendations

Our draft recommendations to reduce the risk of financial contagion if a large retailer experiences financial distress incorporate two elements:

- Changes to the ROLR scheme and AEMO credit support requirements for the ROLR. These are likely to mitigate some but not all the risks of financial contagion.
- Further development and assessment of a comprehensive special administration regime, supported by interim government funding and a cost recovery mechanism, which could be triggered instead of the ROLR scheme if one of the largest retailers in the NEM encounters financial distress that is likely to trigger a ROLR event.

We also support suggestions by a number of submitters to our options paper to improve operational aspects of the ROLR arrangements that would enhance their smooth operation and mitigate the risk of financial contagion. These operational refinements do not require changes to any electricity sector legislation or rules, and can be implemented independently of our recommendations.

Changes to the ROLR scheme and credit support arrangements

The proposed changes to the ROLR scheme involve changes to the National Electricity Retail Law to:

- give the ROLR greater certainty that it can quickly recover the reasonable costs of undertaking the obligations of being the ROLR. This would improve the financial viability of the ROLR, and enhance its capacity to raise finance and obtain credit support; and

- extend the time available for the Australian Energy Regulator (AER) to appoint the designated ROLR, to allow the AER to make a more considered allocation of customers.

These measures are likely to encourage more retailers to offer to become additional ROLRs, and increase the potential for multiple ROLRs to be appointed. This may reduce the risk of cascading retailer failure and financial contagion by spreading the customers, obligations and risks of the ROLR event between several retailers. Spreading customers across several retailers may also support longer term competition benefits.

The proposed changes to AEMO's credit support requirements involve amending the National Electricity Rules to:

- insert a minimum time before AEMO can require increased credit support from the ROLR, and then ramping it up over a transitional period; and

- allow the Commonwealth government to offer credit support to AEMO.[1]

These proposed changes to credit support arrangements aim to mitigate one of the main risks of financial contagion we have identified - the possibility that the an otherwise solvent ROLR will be unable to provide large amounts of credit support to AEMO almost immediately after the ROLR event.

While we consider these amendments offer significant benefits, they are unlikely to ensure that the failure of a large retailer does not lead to financial instability and contagion in the NEM. For this reason we consider there is merit in considering the introduction of a special administration regime.

Special administration regime

The special administration regime would provide an alternative to the ROLR scheme for large retailers in the NEM. It would not be a process to "rescue" or "bail out" a failing retailer, but rather to facilitate an orderly transfer of customers to new retailers.

This report provides a high level overview of the regime and the issues that need to be considered in its development. Many of the key features of the special administration regime are drawn from precedents in insolvency regimes in Australia and overseas.

Under a special administration regime an administrator would be appointed over a retailer experiencing financial distress where a ROLR event is imminent. The administrator's primary objective would be to maintain continuity of supply of electricity to consumers. This contrasts with most current forms of external administration where the administrator's primary objective is to maximise the return for creditors. Interim government funding would enable the administrator to ensure

1 The purpose of this amendment would be to allow the Commonwealth government to provide credit support on behalf of the ROLR for a transitional period. However, this amendment would not limit the circumstances in which the Commonwealth government could provide credit support.

continued electricity supply to customers and continued payments for energy purchases.

The administrator would seek to sell the retailer's customers contracts to other retailers, with a back-up mechanism to allocate any unsold contracts. Government funding would be recovered from the proceeds of this sale, with any short-fall recovered through a cost recovery mechanism.

The detailed design and implementation of a special administration regime is a complex exercise. Our discussion in this report is intended to provide enough detail for stakeholders to form a view as to the potential merits of such a regime and the key issues that would arise in its design and implementation.

We note that a special administration regime would impose some costs on NEM retailers and potentially other stakeholders. For example, we consider the regime would be most effective if there was ring-fencing of all retailer's NEM electricity retail operations into a separate corporate entity.

The costs of the regime need to be balanced against the low likelihood that a large retailer will fail, but the potentially severe consequences for market participants and consumers if such a failure does occur.

Implementing a special administration regime would require a package of new legislation and legislative changes. The legislative and funding requirements extend beyond the electricity sector. As a result the assessment, design and implementation of the special administration regime is likely to involve a range of parties, both within and outside the electricity sector.

If SCER agrees that further work should be undertaken on the special administration regime following our final report, it should commission an appropriate body to complete that work in consultation with the relevant arms of government.

Responding to this report and next steps

The Commission welcomes stakeholder views on the issues raised in this report, including our draft recommendations. The closing date for submissions is 12 July 2013.

A second interim report will be published in the second half of 2013, focussing on other potential sources of financial contagion in the NEM. A specific issue that we will consider is the potential application of the G20 over-the-counter derivatives reforms to the electricity sector.

We will develop our final recommendations and advice to SCER after consideration of stakeholder views in relation to both interim reports. We expect to publish our final report by the end of 2013.

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1 Introduction and background

1.1 Introduction

This report sets out the Australian Energy Market Commission's (AEMC's or Commission's) draft recommendations for measures designed to reduce the risk of financial instability in the National Electricity Market (NEM). It focusses on risks that could arise if a large electricity retailer experienced financial distress and triggered operation of the retailer of last resort (ROLR) scheme. It is the first stage of our advice to the Standing Council on Energy and Resources (SCER) regarding the resilience of the financial relationships and markets that underpin the efficient operation of the NEM. It also sets out the reasoning underlying these draft recommendations.

The second stage of our advice will examine other potential sources on financial instability and contagion in the NEM. Draft recommendations relating to the second stage will be published in a second interim report in the second half of 2013.

We published an issues paper on 8 June 2012 and invited submissions by 20 July 2012. The issues paper outlined the Commission's initial views on the nature of the relationships and financial interdependencies between NEM participants, the potential risks that could arise from those interdependencies, and the risk management strategies that are currently adopted by generators and retailers to manage those risks.

Based on the analysis contained in the issues paper and submissions to the issues paper, we concluded that the key risks of financial contagion could arise in the event of the financial distress of a large retailer and an associated ROLR event.

We published an options paper on 9 November 2012 that set out a range of options that could mitigate the risks of financial contagion following a large retailer failure and ROLR event. It discussed the potential value of each of the options in mitigating contagion risks and the potential disadvantages of each option. It did not make recommendations as to which, if any, of these options should be implemented.

The options paper recognised that, if the Commission concluded that the existing mechanisms to manage the risks of financial contagion were judged to be insufficient, it was unlikely that any one option would be sufficient on its own to effectively remedy this situation. Accordingly, it recognised that any response to manage those risks is likely to require a package or "toolkit" of several options.

Submissions to the options paper closed on 20 December 2012 and we received 17 submissions. The views expressed in these submissions have been considered by the Commission in developing the draft recommendations set out in this first interim report.

The Commission will consider stakeholders' submissions on both this interim report and the second interim report, before developing final recommendations to SCER. We expect to publish our final report by the end of 2013.

1.2 SCER request for advice

The SCER has requested that the AEMC provide advice on the following issues:

- the risks to financial stability in the NEM arising from financial interdependencies between market participants, and the impacts of those risks if they materialise and result in financial instability;
- the existing mechanisms to mitigate risks to financial stability and manage the consequences in the NEM and whether they are adequate; and
- if they are inadequate, recommendations to strengthen, enhance or supplement the mechanisms for minimising the risks and consequences.

The request for advice provides that the AEMC consider, amongst other things:

- the National Electricity Objective (NEO);
- relevant developments in electricity markets in other jurisdictions;
- approaches to financial stability regulation in other markets;
- relevant developments in the regulation of financial markets in Australia and other jurisdictions;
- relevant work being undertaken by the Council of Financial Regulators;
- the role of the Australian Securities and Investments Commission (ASIC) and obligations on participants under the *Corporations Act 2001* (Cth); and
- transitional mechanisms related to the introduction of a price on carbon.

1.3 Context of this report

The Commission has come to the view that it is beneficial to develop draft recommendations arising from its analysis in two stages, which will be published as two separate interim reports. Once submissions on each interim report have been received and considered, the Commission will publish a final report, incorporating final recommendations relating to both the first and second interim reports.

1.3.1 Scope of the first interim report

This first interim report focuses on measures to mitigate the risks of contagion following the financial distress of a large retailer and ROLR event. This reflects the analysis underlying the issues paper and the options paper, and consideration of submissions to those papers. That analysis demonstrated that a risk of financial contagion could arise if a large retailer failed and triggered a ROLR event, which could potentially lead to a "cascading retailer failure" if the retailer that is appointed as the ROLR is unable to meet its liabilities and also fails. Almost all submitters agreed that this scenario was the most likely to cause a risk of contagion[2] and should be addressed as our first priority.

An important distinction needs to be made in relation to the draft recommendations developed in this paper. These options aim to mitigate the risks of contagion *following* the financial distress or failure of a market participant. They do not aim to prevent an individual market participant encountering financial distress or rescue a participant that is in financial distress.

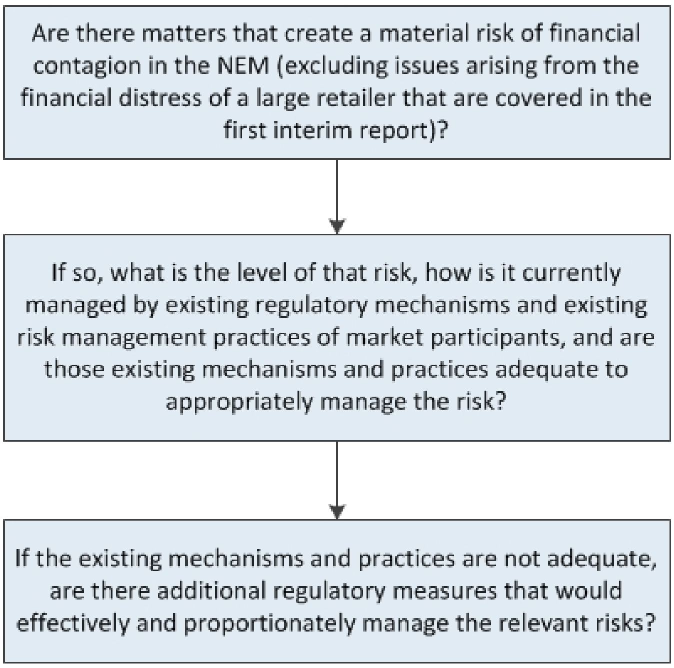
This approach reflects the request for advice made by SCER, which focussed on risks to the stability of the market. It also reflects concern that any mechanisms introduced should aim to minimise moral hazard. In this context moral hazard could occur if the mechanisms introduced were seen to "bail out" market participants who were in risk of failing. If market participants do not bear the full cost of their risk-taking decisions, they could have an incentive to take more than an optimal level of risks.

1.3.2 Scope of the second interim report

This report will be followed by a second interim report, which we expect to publish in the second half of 2013.

This first interim report focusses on financial contagion risks following a large retailer failure. The second interim report will consider other potential causes of financial contagion to assess whether there are other any material risks to market stability arising from financial interdependencies between market participants.

In preparing the second interim report, we intend to undertake a three-step analysis as follows.



2 However, almost all submitters considered that the likelihood of a large retailer failing was very low.

In accordance with SCER's request for advice, our analysis will be limited to risks of financial contagion that could threaten market stability and hinder achievement of the NEO. The scope of our advice will not extend to measures that are designed to prevent the failure of an individual market participant where that failure is unlikely to cause broader financial contagion. Instead, the focus of the second interim report will be on ensuring that the financial distress of one participant does not impact other participants and consumers in a way that could affect market stability and the long term interests of consumers.

If our analysis demonstrates that there is a material risk of financial contagion and that risk is not adequately managed by existing mechanisms, we will consider whether regulatory responses are appropriate and are likely to be effective in mitigating that risk. Potential regulatory responses could involve other agencies taking steps under existing financial sector regulatory arrangements, for example application of the G20 over-the-counter (OTC) derivatives legislation discussed below. Alternatively, an appropriate regulatory response could potentially involve new regulatory arrangements or risk management requirements. This could potentially include some form of prudential oversight of certain electricity market participants if our analysis demonstrates that significant contagion risks exist and that such a response is likely to be effective in managing those risks.

G20 OTC derivatives reforms

A specific issue that we will provide draft recommendations on in the second interim report is the application of the G20 OTC derivatives reforms to the electricity sector.

At the 2009 G20 summit in Pittsburgh, the G20 leaders agreed that:[3]

> "All standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

Australia passed legislation providing a framework for the application of the first three of these commitments in late 2012. Under the *Corporations Legislation Amendment (Derivative Transactions) Act 2012* (Cth), the Minister may prescribe that certain OTC classes are subject to any one or more of the reporting, central clearing or execution requirements. ASIC will then make derivative transaction rules setting out the details of the relevant obligations.

Before the Minister determines that any of these requirements will apply to electricity derivatives, the Minister is expected to seek the written agreement of the Minister for

3 Leaders Statement, The Pittsburgh Summit, 24-25 September 2009. Available at http://www.g20.org/documents.

Resources, Energy and Tourism.[4] Regulations are also expected to require that ASIC must consult with the AEMC before making derivative transaction rules in relation to electricity derivatives.[5]

Treasury proposed in a proposals paper in December 2012 that the Australian Government will consider whether it is appropriate to impose any requirements in relation to electricity derivatives after the completion of the AEMC's NEM financial market resilience advice.[6]

Our second interim report will contain draft advice on which, if any, of the G20 OTC reforms should apply to electricity OTCs.[7]

We will consult with stakeholders in developing our advice on these issues. We will also consider submissions to our issues paper and options paper that raised issues in relation to the G20 reforms.

1.3.3 Final report

We will consider submissions on this first interim report and our second interim report and publish a final report setting out our final recommendations and advice to SCER. We expect to publish the final report by the end of 2013.

1.4 Stakeholder engagement

1.4.1 Working group

In undertaking this work, the Commission has benefited from the input provided by the industry working group, whose experience and technical expertise has been of great assistance.

The working group is made up of representatives from the following market participants:

- AGL Energy;
- Alinta Energy;

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4 Supplementary Explanatory Memorandum to the *Corporations Legislation Amendment (Derivative Transactions) Bill 2012* (Cth), p6.

5 Treasury, *Implementation of Australia's G20 over-the-counter derivatives commitments, Proposals Paper*, December 2012.

6 Treasury, *Implementation of Australia's G20 over-the-counter derivatives commitments, Proposals Paper*, December 2012.

7 If we consider that any of the reforms should apply, we will also provide advice on the form in which they apply. For example, if we consider that trade reporting obligations are appropriate, we will also provide advice on what types of trade information should be reported and who should have access to that information.

- Australian Power and Gas;
- Energy Australia;
- GDF SUEZ Australian Energy; and
- Origin Energy.

However, the views expressed in this report, and the recommendations set out, are the responsibility of the Commission, and do not necessarily reflect the views of members of the working group.

1.4.2 Advisory Committee

In line with SCER's request for advice, the Commission has established an advisory committee, to comment and provide input at each stage of the process, and the Commission has taken account of their views in developing its proposals. The advisory committee is made up of representatives from:

- the Australian Energy Regulator (AER);
- the Australian Energy Market Operator (AEMO);
- ASIC; and
- SCER officials.

1.4.3 Submissions

In developing the recommendations in this report, we have also taken into account the submissions we received on the issues paper and the options paper, and meetings we held with a range of stakeholders.

A summary of submissions to the options paper is contained in Appendix A, together with the Commission's comments in relation to each of the options considered. In some cases the views expressed in submissions are also discussed in the relevant section of the report.

1.5 Responding to this first interim report

The Commission welcomes submissions on the issues raised in this report. In particular, we are interested in stakeholders' views on the Commission's draft recommendations for strengthening and supplementing the mechanisms available to mitigate the risks of financial contagion in the NEM (chapters 4 to 6). This includes the development, further assessment and potential implementation of a special administration regime (chapter 5), and a number of changes to the retailer of last resort (ROLR) scheme and AEMO credit support arrangements (chapter 6).

The closing date for submissions is 12 July 2013.

Submissions should quote project number “EMO0024” and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

1.6 Structure of this report

The remainder of this report is structured as follows:

- Chapter 2 discusses SCER's request for advice and the framework used to develop the Commission's draft recommendations;
- Chapter 3 provides an overview of the financial relationships between participants in the NEM, existing mechanisms to manage the risks arising from those relationships, and the risks of financial contagion resulting from the failure of a large retailer;
- Chapter 4 provides an overview of the Commission's analysis and draft recommendations to strengthen and enhance the mechanisms for mitigating the risks of financial contagion in the NEM;
- Chapter 5 discusses the Commission's draft recommendation for the development of a special administration regime for retailers in the NEM. More detail regarding the issues surrounding the development of a special administration regime for retailers in the NEM is provided in a separate report by Allens Linklaters, which is available on the AEMC's website;
- Chapter 6 outlines the Commission's draft recommendations for changes to the ROLR scheme and credit support arrangements;
- Chapter 7 discusses refinements to the operation of the ROLR scheme that would enhance its operation and reduce the risk of financial contagion in the NEM, but which do not require any changes to the legislation or rules supporting the NEM;
- Chapter 8 discusses implementation issues associated with the adoption of the Commission's recommendations in relation to the introduction of a special administration regime, changes to the ROLR scheme and credit support arrangements; and
- Appendix A provides a summary of the submissions to the options paper, and the Commission's response to the issues raised in submissions. This appendix also summarises the Commission's reasons for not recommending those options that were discussed in the options paper, but have not been adopted as draft recommendations in this report.

2 Framework for developing recommendations

In undertaking this review we have been guided by SCER’s request for advice and the NEO. We also identified a number of principles that have guided our evaluation of the different options. As explained in the following sections, our draft recommendations aim to:

- address the matters set out in SCER's request for advice;
- promote achievement of the NEO;
- ensure that risks are allocated efficiently;
- be well targeted to the problem identified;
- be proportionate to the problem, in that any impact from the introduction of regulatory measures can be justified by the expected benefit in mitigating the risk of contagion; and
- minimise the potential for moral hazard.

2.1 SCER's request for advice

SCER Ministers have requested that the AEMC provide advice on:

- the nature of any risks to the NEM arising from financial interdependencies between market participants;
- whether the existing mechanisms to mitigate these risks are adequate; and
- if necessary, options to strengthen those existing mechanisms and minimise the identified risks and their consequences.

Chapter 3 responds to the first two bullet points above. Our draft recommendations in chapters 4 to 7 to the third bullet point.

As noted in SCER’s request for advice, “market participants need to manage their own financial and commercial positions”. The Commission’s objective is not to prevent an individual firm failing or leaving the market. The entry and exit of individual firms is a natural feature of any competitive market.

The isolated failure of one business may lead to opportunities for new, more efficient businesses to enter the market. However, as noted in chapter 3, there are significant financial interdependencies between market participants in the NEM. Our advice focuses on potential situations where these interdependencies mean that the failure of one firm could lead to a series of events that threaten the financial viability of other firms, cause instability in the NEM and jeopardise the efficient functioning of the market.

Recent events in other markets, in particular the finance sector during the global financial crisis, demonstrate the potential for the financial difficulties in one business to be transmitted to other businesses and cause financial contagion that impacts on the overall efficiency of the market and the long term interests of consumers. These events also demonstrated that costly government intervention may be required to stabilise markets that experience financial contagion if existing regulatory mechanisms are inadequate.

SCER's request for advice recognises that the Commission should take account of any mechanisms that already exist to mitigate the risks arising from financial interdependencies, and whether these are adequate to avoid financial instability and its potential consequences on the achievement of the NEO.

These mechanisms are discussed in chapter 3 and include internal risk management policies, AEMO's credit support requirements, emergency step-in rights and the ROLR scheme. In line with SCER's request for advice, our draft recommendations focus on addressing contagion risks that are not effectively mitigated through existing mechanisms.

2.2 Promoting achievement of the NEO

The NEO, as stated in section 7 of the *National Electricity Law*, 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:

(a) price, quality, safety, reliability and security of supply of electricity; and

(b) the reliability, safety and security of the national electricity system."

SCER's request for advice noted that "financial instability has the potential to result in adverse implications for the secure and reliable supply of electricity, pricing and ultimately, investment, thereby compromising the achievement of the National Electricity Objective".

We have assessed the different options in light of their ability to promote the achievement of the NEO, in particular their ability to alleviate financial instability and its adverse consequences in the NEM.

2.3 Efficient allocation of risk

Efficient risk allocation is achieved where risks are borne by the party that has the greatest control over the risk, is best able to avoid or minimise the risk, and can thus minimise the resulting costs of the risk.

The issues paper provided an overview of the spectrum of risk that energy companies need to manage:

- *market risk*: the risk that the value of an overall market or asset class will change according to economic conditions or other factors, eg, interest rate risk, currency risk;
- *operational risk*: the risk of loss from inadequate or failed internal process, people and systems, driven by internal or external factors, eg, energy trading operations, project management and delivery; and
- *credit risk*: the risk that a debt issuer or counterparty may default on payments.

In the electricity sector, the volatility of the spot market price is a major source of market risk for retailers and generators. As explained in chapter 3, there are a range of strategies to manage this risk, including the use of hedge or derivatives contracts, and through expansion into both generation and retailing (vertical integration) to create an internal or natural hedge.

While hedge contracts are an important mechanism to manage spot price risk, they can lead to increased credit risk. Businesses can manage the allocation of risks through the terms and conditions of the contracts they enter with counterparties.

Managing credit risk is particularly important to avoid flow-on effects to other businesses when a business fails. Liquidity risk is also relevant to the risk of financial contagion, and may increase during the types of events that can lead to financial contagion.

The market and regulatory framework will also affect risk allocation. For example, retail price regulation affects retailers' risks because they may be unable to pass increased input costs through to customers, at least immediately.

The design of the wholesale spot market also affects risk allocation. The NEM prudential framework, including AEMO's credit support requirements, are designed so that generators are largely protected from the risk of default on the payments for electricity they supply to the wholesale spot market. However, in seeking to protect generators, these credit support arrangements transfer significant risks to other market participants, such as the ROLR.

Any changes to the market and regulatory environment in the NEM are also likely to change the allocation of risk between different market participants. In assessing the different options and developing its draft recommendations, the Commission has taken into account the impact of these proposals on the allocation of risk between different parties, including the designated retailer, other retailers, generators, network service providers, customers and government (and ultimately taxpayers).

2.4 Well targeted to the problem

Policies are well targeted if they address the concern identified, while minimising adverse consequences for other participants in the market (including consumers) or the efficiency of the market more broadly.

SCER's request for advice is concerned with the risks to financial instability in the NEM, so our analysis is limited to risks of financial contagion that could threaten market stability and hinder achievement of the NEO. The report focuses on measures to mitigate the risk of contagion following the failure of a large retailer, because our analysis and submissions identified this as a key source of potential contagion. The second interim report will consider other potential sources of financial instability.

In assessing different options we have considered how well they target the causes of financial contagion following the failure of a large retailer. We have weighed this against any associated costs and disadvantages, including their broader impact on NEM participants and the efficient operation of the NEM.

2.5 Proportionate

Recommendations are proportionate if they do not impose costs that are out of line with the likely benefits of the changes. Options that are simple and easy to implement are preferred over more complex solutions, unless there are clear benefits in adopting a more complex solution.

Similarly, options that are well targeted to the problem are preferred to those that have broad unintended impacts on the NEM and its participants.

2.6 Minimise moral hazard

Moral hazard refers to the situation where an individual or business does not bear the full costs of the risks they take. As a result, they may have an incentive or tendency to take on more than an optimal level of risk, knowing that they will not bear the full cost of any detrimental consequences.

For example, moral hazard arises if there is a policy (explicit or implicit) that the government would "bail out" a business in financial distress, using taxpayers money, rather than allowing it to fail. Shareholders may be inclined to take additional risks in the belief that their equity is not at risk.

Avoiding moral hazard is consistent with SCER's request for advice, which identifies the need for market participants to manage their own financial and commercial positions. Our draft recommendations focus on options that address the risk of financial contagion and cascading retailer failure, rather than preventing the failure of an individual market participant or its shareholders.

Where the Commission's draft recommendations require more detailed development, there will be a need to ensure that their design maintains commercial incentives.

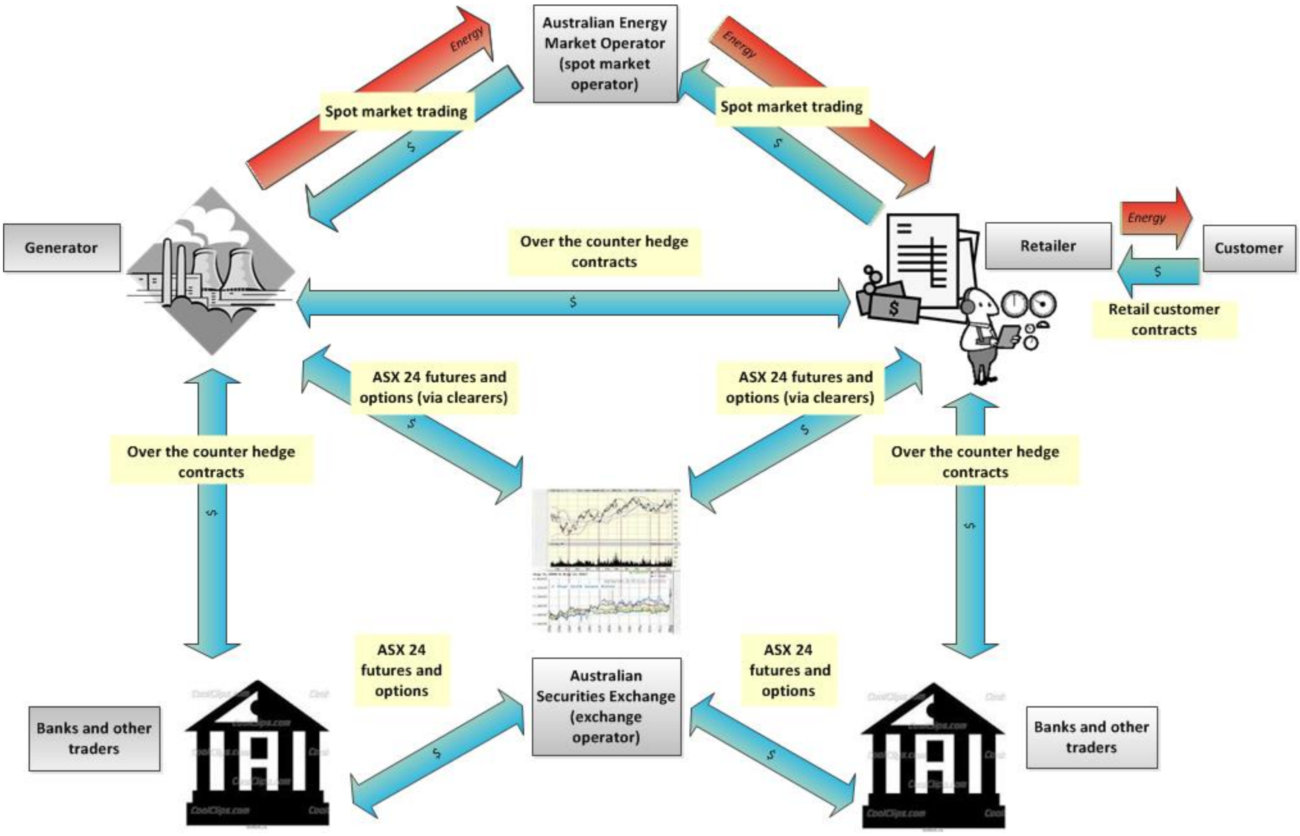
3 Financial relationships and the risk of financial contagion in the NEM

This chapter provides an overview of the main financial relationships in the NEM, the existing mechanisms to manage the financial risks arising from those relationships, and the potential sources of financial contagion, particularly in relation to the failure of a large retailer. These issues have been discussed in more depth in the issues and options papers.

3.1 Financial relationships in the NEM

Generators, retailers and other businesses that participate in the NEM have complex financial relationships with each other. These relationships are summarised in the following simplified diagram.

Figure 3.1 Financial relationships in the NEM



The physical delivery of electricity, shown in red in Figure 3.1, occurs through the wholesale and retail electricity markets. Generators participating in the NEM sell all their electricity through the wholesale spot market, which is operated by AEMO. Retailers buy almost all their electricity through this market, which is supplied to their customers, as shown in the diagram. The electricity is supplied via a network of transmission and distribution wires, connecting generators and customers throughout the NEM.

Apart from the physical delivery of electricity described above, all the other relationships in Figure 3.1 involve financial transactions (shown in blue), and not supply of electricity.

AEMO operates the spot market to balance the demand and supply of electricity in real time. The wholesale spot market price is based on the bids and demand of market participants, with a new spot price determined in each region of the NEM in every half hour. Retailers must pay AEMO for the energy supplied to their customers, and AEMO pays generators for the electricity they supply.

These transactions are shown as "spot market trading" in Figure 3.1. Generators receive the spot price for all electricity they sell on the spot market (subject to some adjustments), and retailers pay the spot price for the electricity their customers use (also subject to some adjustments).

Spot prices in the wholesale market can be highly volatile, depending on supply and demand conditions in each half hour trading interval. The spot price cannot exceed a market price cap of $12,900 per megawatt hour (MWh), and cannot be any lower than the market floor price of -$1,000/MWh in any given half hour.

This spot price volatility creates significant risks for both retailers and generators. While retailers buy electricity in the spot market at a volatile price, they sell it to customers at a fixed price (in some cases this price varies depending on the time of day the electricity is consumed, but the price is not usually linked directly to the spot market price). Similarly, while generators are paid a variable spot price for the electricity they supply, their costs involve large investments in generating capacity, as well as ongoing operating and maintenance costs.

Generators and retailers seek to manage these spot price risks through a range of strategies. One option is to enter into financial relationships with each other and with other market participants, known as "derivative" or "hedge" contracts, which are illustrated in Figure 3.1.

An alternative approach is to develop into a "gentailer", where a company operates both generation and retailing businesses. A gentailer has a natural hedge against movements in the spot price of electricity, because it operates as both a buyer and a seller in the spot market.

The vertical integration of generators and retailers has been a significant trend in the NEM over recent years, so that a significant share of the electricity market is now supplied by gentailers. This trend towards vertical integration has also been a feature of competitive electricity markets in other jurisdictions such as the United Kingdom.

The main purpose of derivative contracts is to provide more certainty about the price a generator will receive and a retailer will pay. They do this by establishing a financial contract where they agree to a certain price for a quantity of electricity. If the spot price turns out to be higher than the agreed price during the relevant period, the generator will make a payment that balances out the difference. Conversely, if the spot price turns out lower than the agreed price, the retailer makes a payment that balances out the difference. This gives generators and retailers more certainty about their future revenue and payment streams.

Figure 3.1 shows the two main types of hedge or derivative contracts used by electricity retailers and generators:

- OTC hedge contracts; and
- futures or options traded on a centralised exchange.

OTC contracts are usually made between generators and retailers, but can also involve other businesses in the financial markets (such as banks or traders). There are a wide variety of OTC contracts including swaps, caps, floors, and options, and they can be standardised or highly individual. The issues paper described the variety of financial instruments used in the electricity sector in more detail.

Currently the only centralised derivatives exchange operating in Australia is the Australian Securities Exchange (ASX). The ASX operates the ASX24 platform, which allows generators, retailers or other financial market participants to trade electricity futures or options. Separate electricity products are currently offered on the ASX for contracts that are priced based on the regional reference prices in each of NSW, Queensland, Victoria and South Australia.[8] No ASX electricity products are currently available for Tasmania or the ACT.

Generators and retailers make trades on the ASX through a bank or other intermediary (referred to as a "clearer") who is a member of the exchange, and often use the assistance of a broker. As a result, generators and retailers do not have a direct have a financial relationship with each other when they use a centralised exchange, but rather with the clearer they use, who in turn has a financial relationship with the exchange.

There are other financial relationships between participants in the NEM that are not shown in Figure 3.1. For example, retailers must pay charges to distribution network service providers (DNSPs) for carrying electricity to their customers.

3.2 Existing mechanisms to mitigate the risk of contagion in the NEM

Generators and retailers use derivatives contracts to manage risks arising from the volatility in the spot price for electricity. However, these financial relationships have the potential to create a high degree of financial interdependency between market participants. As a result, there is a risk that if one participant encounters significant financial difficulties, other participants could also be affected.

These interdependencies could mean that an unexpected or unusual event or series of events could lead to financial contagion that affects several businesses in the NEM, and ultimately the overall stability and efficiency of the market.

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8 Trade volumes for South Australia are significantly lower than in other NEM regions.

3.2.1 Risk management in the NEM

Generators and retailers adopt a range of strategies to manage risk, which are described in more detail in the issues paper. These strategies reflect policies and procedures established within the firm, as well as requirements set by external organisations. Managing credit risk - where a counterparty defaults on a payment - is particularly important to minimise the possibility that financial distress in one business flows through to other businesses, causing financial contagion.

Internally, businesses have corporate governance frameworks that set the policies and processes for assessing the impact of risk, determining the overall risk appetite of the business, and implementing appropriate risk management procedures and controls. For OTC trades, individual businesses set credit requirements and parameters around what level of exposure is appropriate to each counterparty. A business may require credit support from a counterparty, such as a bank guarantee or parent company guarantee, as a condition of trade.

Businesses are also subject to risk management requirements that are set by external organisations. Listed companies have requirements set by the ASX, while entities that deal in OTC electricity derivatives must hold an Australian Financial Services (AFS) licence, and must meet a range of financial requirements established by ASIC. As noted in chapter 1 , G20 leaders have committed to reforms in OTC derivatives markets, and our second interim report will contain draft advice on which, if any, of the G20 OTC reforms should apply to electricity.

In the spot market, credit risk is managed through the AEMO credit support requirements set out in the National Electricity Rules (NER). These requirements are designed to maintain the integrity of the wholesale spot market, and provide confidence that generators will be paid for the electricity they supply. If a market participant cannot meet minimum credit criteria, they must post credit support to AEMO. This credit support is an unconditional guarantee from an acceptable credit support provider, for an amount that reflects the potential exposure of the market to default by the market participant.

Where a NEM participant manages their spot price risk using futures or options (as shown in Figure 3.1), they usually contract with an intermediary ("clearer") who is a member of the ASX (such as a bank). As a result the ASX is exposed to the credit risk of the clearer, while the clearer is exposed to the credit risk of the NEM participant. To manage the risk of counterparty default, the ASX undertakes credit assessments of its members (the clearer). The clearer assesses the credit risk of the NEM participant and assigns appropriate credit obligations, such as cash, letter of credit or bank guarantee.

This structure means that NEM participants using futures and options traded through the ASX are not directly exposed to the credit risk of other NEM participants. Together with the credit obligations imposed by the clearer and the ASX, this mitigates the risk of financial contagion resulting from the failure of one counterparty.

Our second interim report will examine existing risk management procedures and regulatory requirements in more detail.

3.2.2 State emergency powers and step-in rights

Most NEM jurisdictions have legislation which confers powers on either the responsible Minister or a relevant agency, that can be exercised in defined emergency situations. Most NEM jurisdictions also have emergency step-in powers that allow the jurisdictional regulator to step in and take control of an electricity entity in certain defined circumstances. These powers are described in Appendix B of the options paper, which also explains why they are not well-suited for managing financial contagion.

These emergency powers are designed as a last resort measure for threats to physical electricity supply and security issues. It is conceivable that they could be invoked as an absolute last resort following a large retailer failure that led to cascading failure and significant financial contagion. In those circumstances, emergency powers could be used in relation to generators and network service providers to ensure that electricity continued to be supplied.

However, these powers are unlikely to be suitable for use at an earlier stage to prevent financial contagion, for example to prevent the designated ROLR from failing. In addition, they are unlikely to be sufficient on their own even as a last resort and would need to be coupled with other measures such as government funding.

As a result, the Commission has not incorporated the use or enhancement of these existing powers as part of its draft recommendations for mitigating the risk of financial contagion.

3.2.3 Ad-hoc government intervention

If existing mechanisms are not sufficient to avert financial contagion, the government could potentially intervene in an ad-hoc manner if and when concerns arise. The global financial crisis is an example where existing risk management mechanisms were not sufficient, and governments stepped in to prevent further contagion and its adverse consequences in parts of the financial sector.

Ad hoc intervention may be an efficient approach where the probability of an event occurring is remote, and the consequences of that event are minor. However, where an event involves substantial costs, there is likely to be benefit in establishing a comprehensive framework to manage that risk, even where there is a low probability of that event occurring.

The Commission considers there is a low probability of financial contagion in the NEM, but the consequences of that contagion would be severe. Ad-hoc government intervention would need to be designed and introduced at times of high stress, within short timeframes. This is particularly the case in the NEM, where governments may have as little as 24 hours to decide whether and how to act if a large retailer fails and they want to ensure that other retailers that are appointed as ROLRs do not also fail.

Ad-hoc intervention in these circumstances may involve considerable costs, for example the need for substantial government funding, without any clear mechanism for recovering those costs. The long term efficiency of the market will be affected if investors and customers lose confidence in the integrity of the market, to the detriment of the long term interests of consumers.

For these reasons, we consider there is likely to be benefit in developing a framework for government intervention in a last resort role, rather than relying on ad-hoc intervention when a crisis looms.

In addition, businesses may believe that the government will "bail out" a failing business if it is large or there is a risk of financial contagion, even if there is no explicit policy to this effect. This introduces moral hazard, where firms may take greater than optimal levels of risk in the belief that they will not bear the full burden of any adverse consequences. Moral hazard will be reduced where there is a well-defined role for government, within a framework that maintains commercial incentives.

3.3 Risks of financial contagion from failure of a large retailer

There have not been any major failures of retailers or generators in the NEM to date and the market has proven reasonably robust. Two small retailers have exited the market and triggered ROLR events, but those situations were managed by existing market mechanisms without causing financial contagion.

While the Commission considers there is a low probability of financial contagion occurring in the NEM, the issues paper set out examples of potential scenarios where an unusual and unexpected series of events could lead to financial contagion. If such an event occurred, its impacts on the market and the long term interests of consumers would be severe.

A key source of financial contagion risk in the NEM arises if a large retailer experiences financial distress and triggers a ROLR event. The ROLR arrangements could exacerbate the risk of "cascading retailer failure" and financial contagion, as outlined below.

A large retailer could encounter financial difficulty due to a range of circumstances. These include factors such as inadequate hedging during a period of high spot prices, fraud or poor financial practices, external funding constraints, or difficulties experienced by another part of an integrated company (such as generation). It could also arise from the financial distress of a generator, which defaults on payments under hedge contracts with the retailer. The generator's difficulties may have originated because of a major generator or transmission outage, or for myriad other reasons.

Financial contagion may involve other transmission mechanisms. For example, the unwinding of hedge contracts involving a failed retailer could leave some generators highly exposed to volatile spot prices. Alternatively, the failed retailer may be vertically-integrated, and its financial distress may extend to other parts of the business such as generation. This could lead to a reduction in supply and an escalation in spot market prices, placing further pressure on retailers, especially the retailer that is appointed as the ROLR who is likely to suddenly acquire significant unhedged load.

For our advice it is not the initial source of financial distress that causes concern, but the potential for this distress to transmit to other market participants, and ultimately to threaten the achievement of the NEO. Our analysis shows that wherever the initial source of distress lies, it is the potential for this to spread to a large retailer and the subsequent operation of the ROLR scheme that can cause cascading retailer failure and widespread contagion in the NEM.

Box 3.1: The retailer of last resort mechanism

The ROLR scheme is principally designed to ensure that, if retailer failure occurs, arrangements are in place to ensure that customers continue to receive electricity supply and money continues to flow from customers to retailers and from retailers to generators.

The ROLR mechanisms across the NEM are expected to be harmonised under the National Energy Customer Framework (NECF), but to date the NECF has not been adopted in all jurisdictions. Our analysis and draft recommendations have been developed on the basis that the NECF is adopted in all NEM jurisdictions, as discussed in section 6.1.

The National Electricity Retail Law (NERL) requires a "default ROLR" to be appointed by the AER for all electricity connection points. The AER may also appoint "additional ROLRs" in an area. When a ROLR event is triggered, the default ROLR will be appointed as the "designated ROLR" unless the AER provides AEMO with written notice before the ROLR event occurs, appointing another retailer instead.

Retailers can submit an expression of interest to the AER to become an additional ROLR. The AER has established two categories of additional ROLRs - a "firm offer" category where retailers pre-commit to the terms and conditions under which they would be appointed as a ROLR, and a "non-firm" category which registers their interest in being a ROLR but does not commit them to acting in that role.

The designated ROLR is responsible for taking on new customers and facilitating customer transfers from the failed retailer. The AER can appoint more than one retailer as a designated ROLR in any area. If it does so, the customers of the failed retailer will be allocated between the designated ROLRs.

For small customers, a "ROLR deemed small customer arrangement" is taken to apply between the designated ROLR and the small customer. The terms and conditions of this contract are those of the designated ROLR’s standard retail contract. The prices are the ROLR’s standing offer prices, with any variation in accordance with the ROLR cost recovery scheme.

For large customers, the terms and conditions of the "ROLR deemed large contract arrangement" are the terms and conditions published by the designated ROLR on its website, which must be fair and reasonable.

A designated ROLR may apply to the AER to recover certain costs related to the ROLR scheme. Default ROLRs may apply to recover their costs to prepare for a potential ROLR event and designated ROLRs may apply to recover their costs associated with an actual ROLR event.

The issues and options papers explained how the insolvency of a large retailer and associated ROLR event could potentially lead to cascading retailer failure. The key factors leading to this risk are that following the ROLR event, the designated ROLR(s):

- will be required to provide increased credit support to AEMO to cover the potential spot market energy costs of the customers that it acquires from the failed retailer;
- may be required to provide increased credit support to distribution network service providers (DNSPs) to cover the network costs in relation to the acquired customers;
- will likely be unhedged in relation to the acquired customers and will need to obtain additional hedge cover or be exposed to the spot price for the load of the acquired customers;
- may face considerable increased wholesale energy costs, particularly given that a retailer failure may be most likely to occur at a time of high spot prices; and
- may be constrained in its ability to pass these increased costs on to customers due to retail price regulation or competitive pressures.

Where a small retailers fails, these obligations may be absorbed relatively easily by the designated ROLR. In addition, the designated ROLR gets longer term benefits through expanding its customer base. However, if a large retailer fails, these additional obligations could be very large, and require the designated ROLR(s) to access a large amount of funds and credit support.

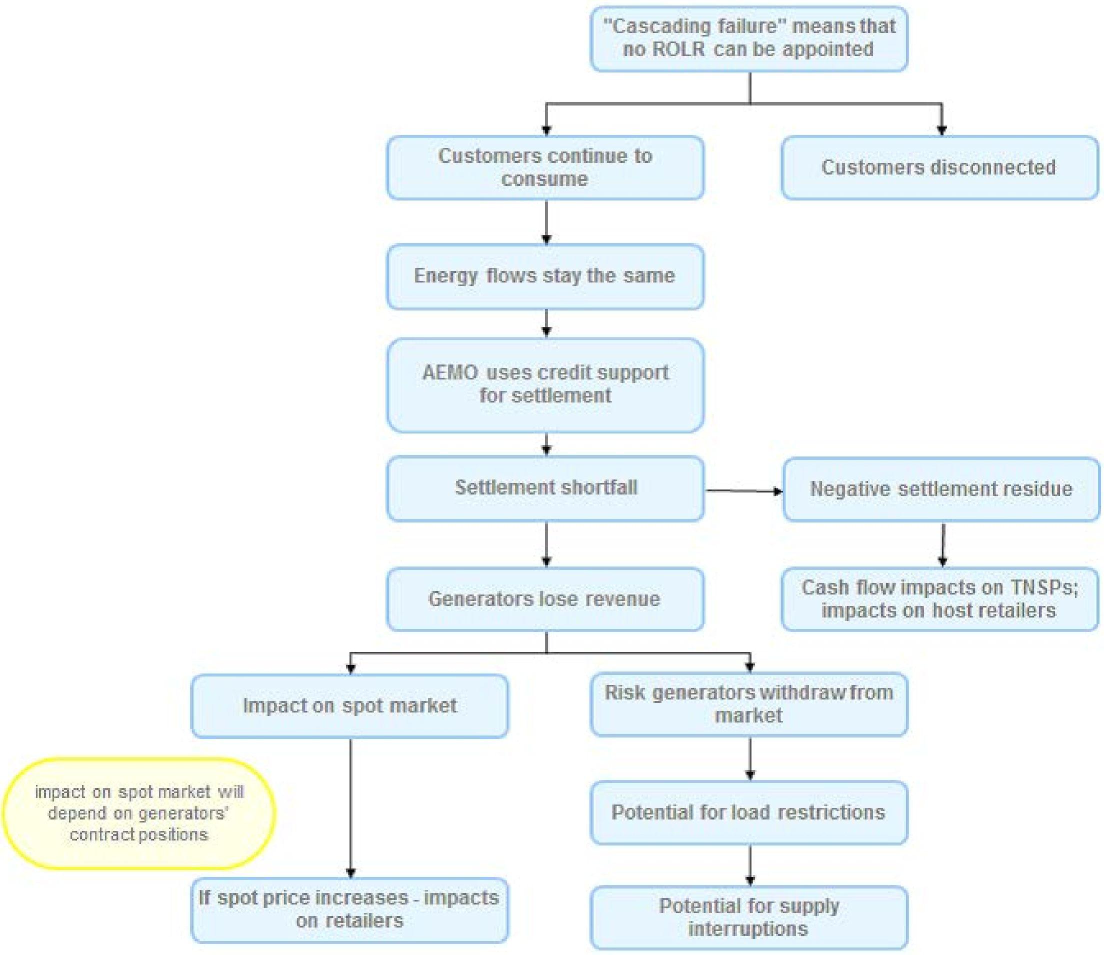
Tight timeframes apply under the ROLR process and AEMO's credit support requirements. These mean that the designated ROLR(s) would need to meet the financial obligations relating to its newly acquired customers very quickly.

If the designated ROLR is unable to meet its increased costs and credit support obligations it may also be suspended from the NEM. This could trigger a "cascading retailer failure", as other retailers are appointed as designated ROLRs and fail for the same reasons.

In these circumstances it is possible that there may be no one that can effectively perform the role of designated ROLR. The potential financial contagion effects of such a situation are shown in Figure 3.2.

The impact on electricity supply in the NEM may occur even more quickly than suggested by this diagram. If a vertically-integrated gentailer fails there is an immediate threat to the continued supply of its generation to the spot market, as explained in AEMO's submission to the options paper. AEMO notes that the ROLR process is designed to manage the transfer of retail customers, and AEMO only has limited discretion in certain circumstances to permit the ongoing operation of the generation side of a vertically-integrated business when its retail operations are suspended or insolvent.[9] The failure of a large retailer with significant generation activities could reduce supply in the NEM, increase spot prices (placing additional pressure on other retailers), and jeopardise continuity of supply to customers.

Figure 3.2 Potential effects of a cascading retailer failure



9 AEMO submission to options paper, p5.

4 Summary of the Commission's analysis and draft recommendations

This first interim report provides our draft recommendations to mitigate the risk that the failure of a large electricity retailer could lead to cascading retailer failure and financial contagion. The draft recommendations incorporate two elements:

- the further development and assessment of a comprehensive special administration regime, which could be triggered instead of the ROLR scheme where the financial distress of a large retailer creates a risk of financial contagion; and
- changes to the ROLR scheme and AEMO credit support requirements for the designated ROLR. These measures mitigate some but not all sources of financial contagion following the failure of a medium or large retailer. They are interim measures that can be implemented relatively quickly while the special administration regime is being developed and implemented.

This chapter provides an overview of our analysis and draft recommendations. Chapters 5 and 6 provide more detail.

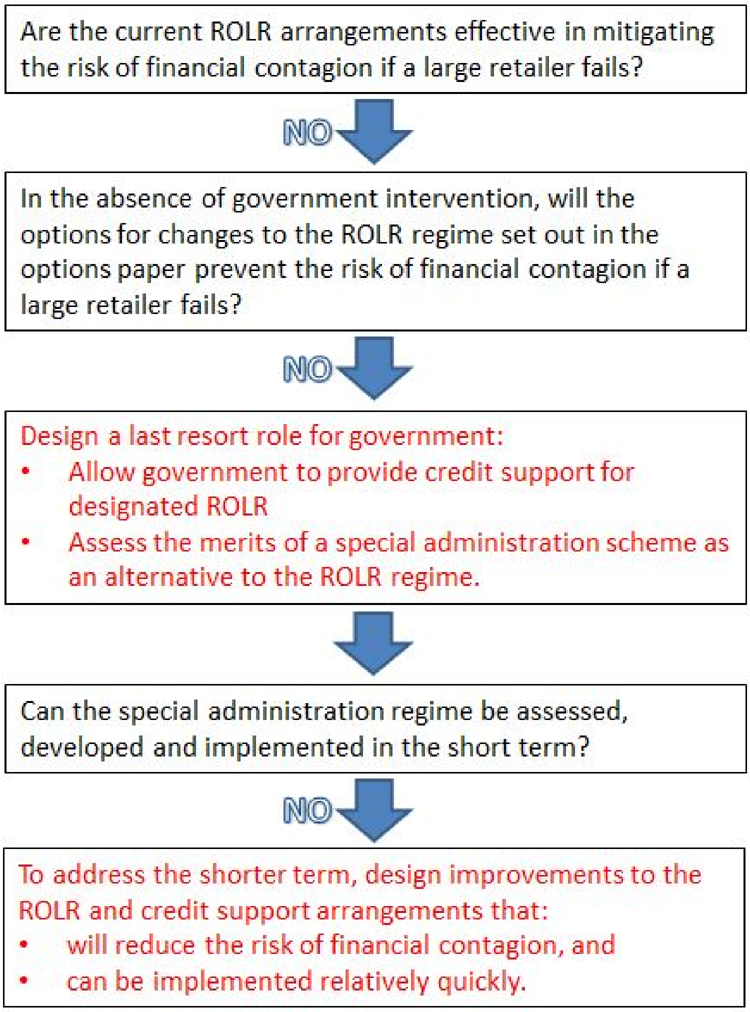
A number of submissions also suggested clarification of, and improvements to, operational aspects of the ROLR arrangements that would improve their smooth operation and mitigate the risk of financial contagion. These refinements do not require changes to any electricity sector legislation or rules, and can be implemented independently of our recommendations. They are discussed in chapter 7.

4.1 Overview of the Commission's analysis of the options

Our analysis has followed the process shown in Figure 4.1. The boxes with black text summarise the questions that guided our analysis.

The two boxes with red text show the outcome of this analysis, being the two elements of the Commission's recommendations - further development and assessment of a special administration regime for retailers in the NEM, and improving the ROLR scheme and credit support arrangements for the designated ROLR.

Figure 4.1 Commission's analysis of the options to mitigate risks following a large retailer failure



4.1.1 Will the current ROLR arrangements mitigate contagion?

The question in the first box of Figure 4.1 was addressed in the options paper. We concluded that the ROLR regimes currently in place in the NEM would be effective in managing the failure of small retailers, as demonstrated in the past. However, we consider there is a risk that the financial distress of a large retailer could spread financial contagion to other energy market participants and, in the extreme case, risk causing a cascading retailer failure. This risk could be exacerbated by the ROLR scheme.

Furthermore, where a large retailer is vertically-integrated, the ROLR scheme does not provide a clear framework for the continued operation of the generation activities when a retailer is suspended from the market. As a result, spot prices could rise, supply could be threatened, and there are likely to be flow-on effects through the NEM.

Therefore our conclusion is that the answer to the question in the top box of Figure 4.1 is "no". Submissions to the issues and options papers supported this view.

4.1.2 Develop options to mitigate the risk of financial contagion

The options paper set out a range of options that were designed to address the potential causes of contagion risk following financial distress in a large retailer. The options are summarised in table 4.1. A more detailed description of each option is provided in the options paper.

Each of the options sought to address one or both of the following potential causes of contagion:

- the increased costs that will be imposed on the designated ROLR in the period immediately following a ROLR event, in particular increased wholesale costs in relation to the customers that it acquires, including the risks that:
  - spot prices could be high following a ROLR event;
  - the designated ROLR will initially not have hedge cover in relation to the acquired customers to manage the risks of high spot prices; and
  - retail price regulation, competitive pressures and delays in billing and receiving payments from customers are likely to limit the designated ROLR's ability to recover these increased costs from the acquired customers, at least in the short term;
- the increased credit support that the designated ROLR will be required to provide to AEMO and DNSPs in relation to the customers that it acquires, and the relatively short timeframes in which that credit support is required to be provided.

These options were grouped as follows:

- amendments to the ROLR regimes;
- options to address the designated ROLR's credit support obligations to AEMO and DNSPs;
- options to address the designated ROLR's increased costs and liquidity challenges in the period immediately following a ROLR event; and
- options for a last resort government response.

We also considered other approaches suggested in submissions to the options paper, such as:

- limiting the ROLR arrangements to small customers, as suggested by AGL and Energy Australia;
- removing the ROLR regime and relying on general insolvency provisions if a retailer fails, as suggested by Alinta, the Energy Supply Association of Australia (ESAA), and Energy Australia;

- regulating the risk management practices of retailers, for example through adoption of the G20 reforms for OTC contracts, supported in the submission by Lorne Franks; and

- removing retail price regulation, as suggested in several submissions.

We note that consideration of the G20 reforms in relation to the electricity sector will be considered as part of the second stage of this review. We also note that the potential removal of retail price regulation is beyond the scope of this review.

Submissions from stakeholders provided valuable input to the Commission in assessing the relative merits of each of the options, and in developing the draft recommendations. Appendix A discusses the main issues raised in submissions to the options paper, and the Commission's assessment of each option.

4.1.3 Assess options involving market mechanisms

The options were assessed in terms of:

- their ability to mitigate the risk of financial contagion in the NEM following the failure of a large retailer;

- the costs and potential disadvantages involved, such as complexity or market distortions; and

- the changes to risk allocation in the NEM and whether these changes are appropriate.

Table 4.1 identifies those options we have recommended. We consider the benefits they offer in terms of mitigating financial contagion outweigh any associated costs or disadvantages. Table 4.1 also identifies those options we do not recommend, for the reasons summarised in Appendix A.

Our analysis initially focussed on answering the question posed in the second box of Figure 4.1. This question asks whether, in the absence of those options involving government support or intervention, a combination of other options would ensure that financial contagion did not occur if a large retailer failed and the ROLR scheme was triggered.

Based on our analysis and the submissions to the options paper, we consider that the answer to this question is "no", because:

- changes to the ROLR scheme are likely to reduce some, but not all, sources of financial contagion risk if a large retailer fails;

- changes to the credit support required by AEMO may avoid cascading retailer failure in some, but not all circumstances; and

- the options seeking to address the designated ROLR's costs and liquidity challenges have a range of drawbacks. These include complexity, far-reaching effects on the design and integrity of the wholesale market, or an undesirable transfer of risk to other market participants. These costs are not balanced by sufficient benefits in preventing the risk of financial contagion.

Therefore we consider it is necessary to design a last resort role for government.

4.2 Last resort role for government

The options paper set out two options for government intervention, shown in the third box of Figure 4.1:

- government credit support for the designated ROLR; and
- a special administration regime that would be triggered as an alternative to the ROLR arrangements where necessary.

Defining the appropriate role for governments can reduce the moral hazard risk that exists if market participants, investors and creditors assume that there will be an implicit government guarantee of the largest retailers. If participants assume that the largest retailers are "too large to fail" and will be bailed out by governments, there is a risk that those participants will not act to minimise the risks of failure.

Moral hazard risks can be minimised if it is made clear in advance that any government role will be limited to the minimum role necessary to mitigate financial contagion. In particular, we consider that any government response should not aim to prevent the first retailer from failing.

Instead, any government assistance should be targeted at the designated ROLR and seek to prevent the contagion that would result if the failure of the first retailer caused a cascading failure of the designated ROLR and other market participants. Furthermore, any government response should have clear boundaries, such as limits on the timeframe for assistance, to ensure the ROLR has appropriate commercial incentives.

This form of limited role for governments will also result in a more targeted and efficient response that minimises the costs to taxpayers (or consumers if the costs are ultimately recovered from the electricity industry) and minimises impacts on the efficient functioning of the market. It also provides comfort to investors that the government will intervene only in limited, specific circumstances, reducing regulatory risk and supporting investor confidence.

4.2.1 Allow the Commonwealth Government to provide credit support

The designated ROLR(s) may need to provide significant levels of credit support to AEMO, and its inability to organise this credit support within a very short timeframe was identified in the options paper as a key source of contagion risk. The option of

Commonwealth government credit support for an interim period would mitigate this risk, and it is included as part of the package of changes proposed in section 4.3 and discussed in more detail in chapter 6.

The designated ROLR's new customer load is likely to be unhedged initially, so the amount of credit support required by AEMO may be much higher than the level applied to the failed retailer.[10]

The NER currently allows state or territory central borrowing authorities to provide credit support to AEMO, as long as they meet certain criteria.[11]

It appears that State and territory central borrowing authorities were listed as entities that are able to provide credit support primarily due to the role of State and Territory governments as owners of some electricity businesses. This provision allows central borrowing authorities to provide credit support for State and Territory government-owned businesses instead of relying on bank guarantees. It is unlikely that the provision of a last resort financing role in the event of the failure of a privately-owned business was contemplated when the relevant provisions of the NER were drafted, but there is nothing that would prevent State and Territory central borrowing authorities performing such a function if necessary.

Although the primary purpose of enabling the Commonwealth government to provide credit support would be different to the reasons why State and Territory central borrowing authorities were originally included in the NER, there does not appear to be any clear reason why the Commonwealth government should not also be able to provide credit support, provided that it meets the same conditions that apply to State and Territory central borrowing authorities.

Making provision for Commonwealth government credit support would *enable* but not *oblige* the government to provide this support. As noted in chapter 6, the credit support provided by the Commonwealth would need to be in a form that is consistent with AEMO's requirements, to ensure that payment could be made quickly if called upon.

4.2.2 Special administration scheme

Assisting the designated ROLR through posting credit support to AEMO on its behalf does not address all the sources of cascading retailer failure and financial contagion. For example, it does not address the issues that arise where a large retailer is vertically-integrated with significant generation activities. Furthermore, this option could involve the government posting extremely large levels of credit support on behalf of the designated ROLR(s), without being assured of a commensurate level of

10 The failed retailer may have benefited from reallocation agreements that allow an off-market financial commitment, such as an OTC hedge contract between participants, to be netted off against pool settlements. This reduces the level of credit support required by AEMO. Similarly, a vertically-integrated gentailer has an internal or natural hedge to the extent that it can offset its own retailing and generation activities.

11 NER, clause 3.3.3.

control over the operations of the designated ROLR(s) or any mechanism for recovery of its costs if the credit support is called on.

The government would also have to decide extremely quickly whether to act and provide a very large amount of credit support - potentially $500 million to $1 billion - within a week or less.[12] The government would also be likely to need to provide additional support, such as loans, to address other sources of contagion, for example to assist the designated ROLR(s) to meet their unhedged wholesale market costs for an initial period.

As a result, we consider there is merit in developing a special administration regime, backed by interim government funding and a cost recovery mechanism. It is discussed in more detail in chapter 5, and in the separate report by Allens Linklaters.[13]

This regime could act as a "circuit breaker" where the imminent failure of a large retailer and subsequent ROLR event raised the prospect of cascading retailer failure, and this could not be resolved via other mechanisms. It would be implemented as an alternative to the ROLR scheme.

Chapter 5 also discusses our draft recommendation that further work be undertaken before a final decision is taken on whether to implement a special administration regime. This work would enable policymakers to balance the potential benefits of the regime in reducing the risk of financial contagion, against the costs it is likely to impose.

4.3 Changes to the ROLR and credit support arrangements

Designing and implementing a special administration regime is complex and is likely to involve the introduction of a package of new legislation with impacts outside the NEM and may require an intergovernmental agreement. It also requires further assessment of the potential benefits against the likely costs, as noted above. Therefore the answer to the question posed in the fourth box of Figure 4.1 is "no".

As a result our draft recommendations include a suite of improvements to the ROLR and AEMO credit support arrangements that can be implemented relatively quickly. They involve reasonably narrow changes to the NERL and the NER, without changes to other legislation or major changes to the design of the electricity market.

While not eliminating the risk of financial contagion in all circumstances, these measures reduce the risks during the interim period until the special administration regime is implemented. They also reduce the risk of financial contagion resulting from the failure of a medium size retailer or gentailer.

12 Section 6.4.3 provides a more detailed discussion of the likely magnitude of the increase in AEMO credit support requirements.

13 Allens Linklaters, *Dealing with Financial Distress in the National Electricity Market: Special Administration Regime for Electricity Retailers*, 10 May 2013.

These draft recommendations involve:

- providing more certainty of cost recovery to the designated ROLR(s) for a ROLR event, in terms of the types of costs that can be recovered, and the timing of cost recovery;
- extending the time available for the AER to appoint the designated ROLR(s), with the aim of giving the AER greater scope to appoint multiple ROLRs;
- increasing the time allowed for a designated ROLR to meet AEMO's credit support requirements in relation to customers acquired in the ROLR event; and
- allowing the Commonwealth government to provide credit support for the designated ROLR(s).

These recommendations are discussed in chapter 6.

Table 4.1 Summary of options and the Commission's draft recommendations

Option from options paper	Description of option	Is this option recommended by the Commission?	Section of report that discusses this option
Options involving amendments to the ROLR regimes			
Revised cost recovery arrangements	The existing ROLR cost recovery provisions would be amended to give the designated ROLR greater certainty that it can quickly recover its costs	Yes	Chapter 6
Enhanced preparation arrangements for a ROLR event	The existing ROLR provisions would be augmented to assist the AER to better prepare for a large retailer ROLR event and facilitate the appointment of multiple designated ROLRs	No	Appendix A
Transfer of hedge contracts to the designated ROLR	The designated ROLR would be granted an option to acquire some or all of the hedge contracts of the failing retailer	No	Appendix A
Amending the ROLR event triggers	The NEM suspension provisions would be amended to delay the triggering of a ROLR event	No	Appendix A
Delayed designation of ROLRs	The ROLR regimes would be amended to delay the time at which the designated ROLR is appointed to allow more time to appoint multiple designated ROLRs. The appointment would be backdated to the time of the original ROLR event	Yes, but in a modified form.	Chapter 6
Options to address the designated ROLR's credit support obligations			
Amendments to AEMO credit support provisions	The increased credit support required to be provided by the designated ROLR to AEMO would be waived or reduced for a short transitional period	Yes	Chapter 6
Amendments to DNSP credit support provisions	The increased credit support required to be provided by the designated ROLR to DNSPs would be waived or reduced for a short transitional period	No	Appendix A

Option from options paper	Description of option	Is this option recommended by the Commission?	Section of report that discusses this option
Options to address the designated ROLR's increased costs			
Spot market price cap	The spot price would be capped at a set price, eg $300/MWh, for a specified period of time following a ROLR event. The cap could potentially apply only to the designated ROLR	No	Appendix A
Initial period where designated ROLR passes through retail prices	Instead of paying the spot price, the designated ROLR would pay AEMO a "transitional ROLR tariff" (which would be calculated based on the wholesale component of retail prices) for an initial period following a ROLR event	No	Appendix A
Delayed settlement period for designated ROLR to pay AEMO	The date for the designated ROLR to pay AEMO for energy would be delayed in relation to the acquired customers	No	Appendix A
Delayed settlement period for designated ROLR to pay DNSPs	The date for the designated ROLR to pay network charges to DNSPs would be delayed in relation to the acquired customers	No	Appendix A
Industry co-insurance fund	Retailers would be required to pay levies into an industry co-insurance fund. Following a ROLR event, the fund could be used to provide loans or grants to the designated ROLR to cover some of its costs, or used to provide credit support to AEMO	No	Appendix A
Options for a last resort government response			
Government posts credit support for the designated ROLR	A government entity would post credit support to AEMO to meet the designated ROLR's increased credit support obligations for an initial period following a ROLR event	Yes, subject to meeting appropriate criteria.	Chapter 6

Option from options paper	Description of option	Is this option recommended by the Commission?	Section of report that discusses this option
Enhanced administration arrangements coupled with interim government funding	A government entity would appoint an administrator to manage the failing retailer to facilitate a trade sale or orderly transfer of the customers to alternative retailers, as an alternative to the ROLR regime. Could potentially be implemented under existing insolvency laws or they could be amended to introduce a new special administration regime. A government entity would provide funding during the administration. This funding could be recovered from the administrators after any sale of the customers, with any shortfall recovered though an industry levy	Yes, subject to further development and assessment.	Chapter 5
Government funding, loans or guarantees	Government funding, loans or guarantees would also potentially be available, but do not require any additional mechanisms to be put in place and are not discussed in this paper	n/a	n/a

5 Special administration regime

This chapter provides an overview of a special administration regime that would provide an alternative to the ROLR scheme for the largest retailers in the NEM. It discusses the objectives and potential benefits of a special administration regime and provides a high-level overview of the regime.

More detail regarding the special administration regime is contained in a separate report from Allens Linklaters, which is available on the AEMC website (Allens Linklaters report).[14]

The purpose of this chapter and the Allens Linklaters report is to inform SCER and other stakeholders on the key features of the special administration regime and the main issues that would arise in designing such a regime. Neither this chapter nor the Allens Linklaters report are intended to provide a detailed and definitive description of how such a regime should be designed and implemented. Instead, they are intended to provide enough detail for stakeholders to form a view as to the potential merits of such a regime and whether to progress to the next phase of developing the detailed design of the regime.

Our draft recommendation is that there is merit in developing a special administration regime as an option for use if a large NEM retailer encounters financial distress that is likely to trigger a ROLR event. In those circumstances, we consider that a special administration regime has significant benefits for mitigating the risk of financial contagion that is otherwise likely to arise.

However, we note that the detailed design and implementation of a special administration regime will be a complex exercise and will impose some costs on NEM retailers and potentially other stakeholders. These costs need to be balanced against the low likelihood that a large retailer will fail, but the potentially severe consequences for market participants and consumers if such a failure does occur. Accordingly, our draft recommendation is that further work is undertaken before making a final decision whether to implement a special administration regime. Our recommended next steps in relation to the special administration regime are discussed in chapter 8.

Box 5.1: Overview of the special administration regime

The special administration regime is intended to facilitate a more orderly transition of customers from the failing retailer to new retailers. It is not a process to "rescue" or "bail out" the failing retailer.

14 Allens Linklaters, *Dealing with Financial Distress in the National Electricity Market: Special Administration Regime for Electricity Retailers*, 10 May 2013.

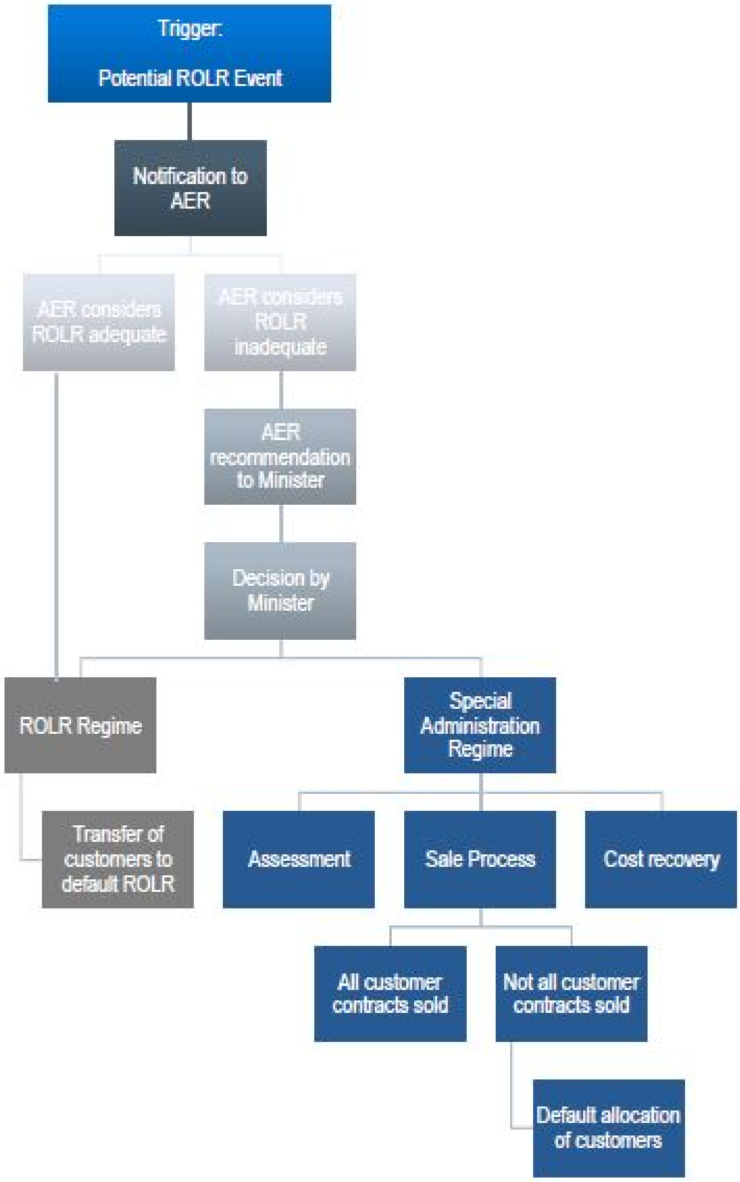
Under the special administration regime:

- an administrator may be appointed over an electricity retailer instead of using the ROLR scheme;
- the government would provide interim funding to the administrator to allow the retailer to continue to operate during the administration process;
- the administrator would seek to sell all of the retailer's customer contracts to other retailers;
- if the administrator could not sell some of the customer contracts, a default allocation mechanism would transfer those customers to other retailers; and
- the government's funding would be recovered from the proceeds of the sale of the customer contracts, with any short-fall recovered through a cost recovery mechanism.

The key steps in the process for applying the special administration regime, including determining whether to invoke the special administration regime or ROLR scheme, are summarised in the diagram on the following page.

As discussed in section 5.2 below, there are several options for the design of this process.

Figure 5.1 Overview of process for special administration regime



5.1 Objectives and principles for the design of the special administration regime

We have developed several objectives and principles that have guided the design of the special administration regime.

Some of the objectives would also be included in the legislation establishing the regime so that they would guide the decisions of the administrator. In particular, a key feature of the special administration regime is that the administrator's objectives should be aligned with the NEO and primarily focus on maintaining continuity of electricity supply to customers. This contrasts with most standard forms of insolvency in Australia, where the insolvency practitioner's overriding objective is to obtain the best financial recovery possible for creditors.

5.1.1 High-level objectives

The high-level objectives of the special administration regime are to:

- support achievement of the NEO;
- reduce the overall risk in the NEM associated with the financial distress or failure of a retailer and to share the remaining risks with those that are best able to manage them; and
- establish a regime under which the costs of implementation are commensurate with the benefits of the regime.

5.1.2 Specific objectives

Building on these high-level objectives, specific objectives of the regime are to:

- maintain continuity of electricity supply to consumers of the failing retailer;
- facilitate the orderly transition of customers from the failing retailer to new retailers;
- reduce the likelihood of financial contagion resulting from the financial distress of a large retailer and act as a 'circuit breaker' in relation to contagion risk following a large retailer failure;
- increase flexibility in potential outcomes compared to the ROLR scheme, for example by providing greater scope to spread customers across multiple retailers;
- provide more scope for other retailers to agree to take on the failing retailer's customers and pay to acquire them, including allowing a variety of sale processes in relation to the customer contracts or potentially a sale of the entire corporate entity to new owners; and
- enable the new retailers to better manage any additional customers that they acquire, for example by allowing them more time to prepare to take on the liabilities associated with those customers.

Importantly, the objectives of the regime do not include "rescuing" the failing retailer. Special administration is not a process for the rehabilitating or restructuring the failing retailer. Instead, the key objective of the regime, and the associated government funding, is to ensure an orderly transfer of customers to new retailers.

The objectives also do not include maximising value for the failing retailer's creditors. This is a key difference compared from standard insolvency processes. It is possible that the special administration regime could result in more favourable outcomes for creditors than the ROLR scheme if the proceeds from the sale of the customers are more than is required to repay the government funding. However, that is not an objective of the regime.

5.1.3 Design principles

Additional principles that have guided our design of the regime to achieve the above objectives are that:

- processes under the regime must be clear to enable:
  - an informed assessment of the situation and decision whether to invoke the special administration regime or allow the ROLR scheme to apply;
  - key trigger points to be identified for the decision whether to invoke the special administration regime or ROLR scheme and for other key decisions by government and the administrator; and
  - the government and administrator to respond rapidly;
- the government's role should be limited to the minimum extent necessary to avoid financial contagion, so as to reduce the moral hazard risk; and
- the special administration regime should involve the least intrusion possible on standard insolvency processes while achieving the above objectives.

5.1.4 Relevant precedents

Many of the key features of the special administration regime are drawn from precedents in insolvency regimes in Australia and overseas.

The main precedent is the energy supply company administration scheme that is currently being implemented for electricity and gas retailers in Great Britain, which was discussed extensively in the options paper. Box 5.9 below summarises the objectives of this scheme. Similar schemes currently apply in Great Britain for electricity and gas networks and several other industries such as rail.

The special administration regime also extensively draws from existing Australian insolvency precedents. As discussed above, one of the design principles is that it should involve the least possible intrusion on standard Australian insolvency processes while achieving its objectives. The design of the regime also draws from specific insolvency regimes that have been established for other industries, in particular the judicial management regime in the insurance sector, which was summarised in the options paper.

Schedule 5 of the Allens Linklaters report provides a summary of the Great Britain special administration regime and the Australian judicial management regime. The Allens Linklaters report also discusses other insolvency precedents that are relevant to specific aspects of the special administration regime.

5.2 Key features of the special administration regime and key issues to be determined

This section summarises the key features of the special administration regime. The Allens Linklaters report discusses each of these key features and others in more detail.

This chapter and the Allens Linklaters report also identify the significant issues that need to be determined in further developing and implementing the regime. In many cases, we present options for the design of important aspects of the regime and discuss the advantages and disadvantages of each option, rather than making specific recommendations.

The boxes in this section summarise the key issues that will need to be addressed if SCER decides to develop the detailed design of a special administration regime after our final report. We are not seeking submissions on the issues raised in the boxes.

5.2.1 Appointment of a special administrator

Over what entity or assets should the administrator be appointed?

A key challenge for the design of the special administration regime arises from the fact that electricity retailers in the NEM adopt a variety of corporate structures. There is currently no requirement that electricity retailers structure their retail operations as separate corporate entities. As a result, some of the large NEM retailers currently have a single company that is registered with AEMO as both a market customer (ie a retailer) and a market generator.[15]

As a result, the following important initial questions for the design of the regime arise:

- Should the administrator be appointed (i) over the company, as is the case for most standard forms of insolvency such as voluntary administrations or liquidations, or (ii) over certain assets such as the retail customer contracts, as is the case for receiverships?
- Should market participants be required to place their NEM electricity retail operations in a separate corporate entity?

The Allens Linklaters paper discusses the advantages and disadvantages of appointment over the company or assets and the main issues that are likely to arise under either option.

If the administrator could be appointed over only the retail customer contracts, that would minimise the complexity and intrusiveness of the regime. However, there would be considerable practical challenges with such an approach. In particular, the administrator will need to continue to operate the retail business during the

15 Examples of current corporate structures of NEM retailers are set out in Schedule 2 of the Allens Linklaters report, based on company searches and other publicly available information.

administration period, including paying AEMO and billing customers. It would also be significantly more expensive to operate the company without the benefit of its existing hedge contracts. Accordingly, appointment over only the retail customer contracts is unlikely to be practical and the administrator would need to be appointed over a broader set of assets.

Appointment over the company would give the administrator greater ability to efficiently operate the retailer during the administration period. We consider that appointment over the company is likely to be more effective in achieving the objectives of special administration. However, it would require the administrator to involve itself in all of the company's operations, including operations that are unrelated to electricity retailing.

Under either approach, we consider that a special administration regime would be most effective if there was ring-fencing of the retailer's NEM electricity retail operations into a separate corporate entity. Such a requirement would also avoid the need for the administrator to operate, and the government to potentially fund, operations in unrelated activities such as electricity generation, gas, or other energy or non-energy businesses.[16]

The Allens Linklaters report discusses potential options for the form of any ring-fencing requirement. To be effective, we expect that ring-fencing would require, as a minimum, that the NEM electricity retail operations were owned by a separate company that does not engage in other businesses. That company would own the relevant assets, including retail customer contracts and hedge contracts. It would also be likely to need to have written contracts with other group companies where it acquires key services from them, including internal hedging arrangements where relevant.

We recognise that a ring-fencing requirement could be a significant obligation for retailers. It would also impose up-front costs that would be incurred at the outset rather than only if and when a large retailer failed. The costs and benefits of ring-fencing should be considered in more detail before deciding whether to implement a special administration regime.

Box 5.2: Key issues to be determined

- Is ring-fencing required in order to implement an effective special administration regime?
- If so, what form of ring-fencing is appropriate?

16 SCER's request for advice is limited to issues related to the NEM. Accordingly, the proposed special administration regime has been designed only to address NEM electricity retail issues. We note that some stakeholders have raised the issue of whether the special administration regime, or a similar regime, should extend to gas retail businesses. Retailer of last resort schemes currently operate in gas markets and it is outside of the scope of this advice to assess whether those regimes are likely to be effective if a large gas retailer failed.

- What are the likely costs of imposing ring-fencing and are they commensurate with the likely benefits?
- If retailers are not ring-fenced, what role, if any, should the administrator play in respect of the company's non-electricity retail assets?
- Should the administrator be appointed over the company or certain assets?

Process and triggers for appointment

The administration process would be commenced by a specified person making a decision whether to invoke the special administration process or allow the usual ROLR process to apply. Certain trigger events would need to have occurred before that person could make such a decision, as discussed below.

Triggers for appointment

Given that the special administration regime is intended as an alternative to ROLR, the triggers should be aligned with the ROLR event triggers in the NERL as much as possible, but structured so that they occur prior to a ROLR event being triggered.

Events that trigger the appointment of a ROLR are:[17]

- the revocation of the retailer's retailer authorisation;
- the suspension by AEMO of the retailer's ability to acquire electricity in the NEM;
- the retailer ceasing to be a NEM registered participant;
- the appointment of an insolvency official in respect of the retailer or any property of the retailer, or the making of an order or the winding up of the retailer or the passing of a resolution for the winding up of the retailer; or
- the retailer ceasing to sell electricity to customers.

Third parties would be required to notify the person with the power to appoint the special administrator before taking any action that would cause a ROLR event to be triggered. For example:

- AEMO must give notice prior to suspending a retailer from the NEM;
- a retailer must give prior notice if it wishes to cease being a registered participant or cease selling electricity to customers.

This notice would be the trigger for the decision whether to appoint a special administrator. The person empowered to make that decision would have a specified

17 NERL, section 122.

period to do so. If it did not make a decision within that period, the normal ROLR process would apply.

The ROLR scheme would need to be amended so that it could not be triggered until the end of this notice period. This period prior to appointment is the key period where parties such as AEMO (and therefore generators) and other creditors will incur additional risks. The retailer may have defaulted on payment obligations to those parties but they will not be able to exercise their usual rights on default during this period and the amount that they are owed may increase during this period. It will therefore be important to make this period as short as possible.

Interaction with standard insolvency processes

The special administration regime would apply instead of traditional forms of insolvency, such as voluntary administration, receivership or liquidation.

Several of the existing ROLR triggers relate to traditional insolvency proceedings, such as the appointment of an insolvency official. Under the appointment process discussed above, any party wishing to appoint an external administrator to a retailer or any of its property would be required to give notice to the AER before making such an appointment. Those parties would be unable to make such an appointment until the end of the notice period for the Minister to decide whether to invoke special administration.

Given that the retailer's directors would be unable to place the company into voluntary administration during this notice period, exemptions from the *Corporations Act 2001* (Cth) would be required to protect the directors from insolvent trading during this period.

If a special administrator is appointed, no other form of external administration could commence during the special administration period. Once all retail customers have been transferred to new retailers and the special administration process has been completed, a liquidator could be appointed to deal with any remaining assets of the company.

Decision-maker for appointment

The decision to appoint a special administrator will involve a government commitment to provide a potentially large amount of funding for the duration of the administration process.[18] Accordingly, we consider that the decision whether to appoint an administrator, or apply to the court for appointment as discussed below, should lie with the relevant Minister that is responsible for providing the funding.

A single Minister should have that power, to enable a decision to be made within the short timeframe that will apply. It appears most likely that this Minister should be a Commonwealth Minister, most probably the Treasurer. This does not necessarily mean

18 This funding will be recovered upon completion of special administration, as discussed in section 5.2.4 below.

that the Commonwealth government should ultimately be responsible for providing all funding. As discussed in section 5.2.5 below, it may be possible for the NEM jurisdictions to agree on a process for contributions by other jurisdictions. However, given the short timeframes, it is unlikely to be practicable for the appointment decision to be made by consensus of all NEM jurisdictions.

Upon occurrence of a trigger event, the AER would be required to form a view as to whether the ROLR scheme is likely to be effective in managing the failure of the retailer or whether there is a risk of financial contagion that may warrant use of special administration. In the event of the failure of a small retailer where the AER was confident that the ROLR process would be effective, the ROLR regime would continue to operate as usual. However, if the failing retailer was large and the AER considered that there was a risk that the ROLR regime may not be effective and may give rise to a risk of financial contagion, the AER would provide advice to the relevant Minister setting out its assessment of those risks. This advice would inform the Minister's decision whether to appoint a special administrator.

The appointment process could be designed so that the Minster makes the final decision to appoint the administrator. Alternatively, the Minister could apply to a court for appointment.

Court appointment is a common feature of many standard insolvency regimes. The main practical benefit is that it reduces the risk of administrative challenges as to the validity of the appointment. If the Minister makes the appointment directly, that decision would be subject to judicial review and the risk of injunctions. However, if the court makes the appointment decision, there would need to be clear criteria to guide its decision and a discretion for the court as to whether or not to make the appointment. Court appointment would also require additional time.

If court appointment is used, the Minister would make an application to the court for appointment. For practical reasons, it may also be appropriate to allow the AER to make the application with the Minister's consent.

Box 5.3: Key issues to be determined

- What should be the triggers for appointment of a special administrator?
- Who should make the appointment decision? If the decision-maker is the relevant Minister, what advice should the Minister receive prior to making a decision and who should provide that advice?
- Should the appointment process involve an application to the court? If so, what are the criteria that the court should apply when deciding whether to appoint a special administrator?
- How much time should the relevant person be given to decide whether or not to appoint a special administrator / make an application to the court?

5.2.2 Consequences of appointment

The administrator would be given broad powers to achieve the objectives of the special administration regime.

As discussed in relation to the objectives above, the primary duties of the administrator would not be to creditors but rather to ensure that the objectives of the special administration regime are met in the most efficient and timely manner possible.

The failing retailer should have the usual protections that apply to companies in standard forms of administration to enable the effective conduct of the administration process, including:

- restrictions or prohibitions on the enforcement of security by secured creditors;
- a moratorium on the commencement or continuation of court proceedings against the retailer or in relation to any of its property; and
- limitations on the ability of owners or lessors of property to recover that property during the course of the administration.

In addition, additional protections are likely to be required to achieve the specific objectives of special administration including:

- prohibitions or restrictions on counterparties to contracts with the retailer exercising rights of termination due to the appointment of the special administrator;
- prohibitions or restrictions on the exercise of other contractual rights such as the acceleration of debt, the closing out of transactions or the repudiation of obligations;
- restrictions on the ability of AEMO to suspend the retailer from the NEM or the ability of the AER to revoke the retailer's retail authorisation due to the appointment of the special administrator; and
- exemptions from *Corporations Act 2001* (Cth) prohibitions on insolvent trading for the duration of the special administration.

An effective prohibition on counterparties to contracts with the retailer exercising rights of termination due solely to the appointment of the special administrator will be particularly critical to ensure that the regime will meet its objectives and be more effective and efficient than relying on ROLR or standard insolvency regimes. Without this prohibition, counterparties could terminate their hedge contracts with the retailer, which may expose it to far higher wholesale market costs and dramatically increase the amount of funding that is required. The ability to keep these hedge contracts on foot is a key advantage of the special administration regime.

Counterparties should retain all of their other rights to terminate, for example if the administrator fails to make a payment when due. However, because the administrator takes over the retailer's contractual obligations and the government has provided funding to allow it to continue to meet those obligations, the appointment of the administrator should not in itself increase counterparties' risks and should not entitle them to terminate those contracts.

The administrator would remain in place until all retailer customers have been sold or transferred to new retailers. It may be possible to include a maximum timeframe, but we do not consider that appropriate as the time required may vary depending on the circumstances. As discussed in section 5.2.4, the government could effectively impose a maximum timeframe through its funding agreement with the administrator.

Box 5.4: Key issues to be determined

- In what respects should the powers and duties of the administrator differ from under standard insolvency regimes?
- What restrictions should apply to contract counterparties' rights during the administration?

5.2.3 Sale/transfer of retail customers to new retailers

Sale process

The special administrator would conduct a sale process in respect of the retailer's NEM electricity customer contracts, and potentially other relevant retail assets.

The main objectives of the sale process would be to:

- maximise the proceeds from the sale;
- avert the risk of financial contagion in the NEM; and
- minimise the amount of funding required to be provided by the government.

There are a number of options for the sale process, including a competitive tender/auction or bilateral sale. The administrator could split the customers into smaller packages to facilitate the sale of groups of customers to a range of retailers. The form of the process could be specified in legislation or left to the administrator's discretion.

The regime could also be structured to allow the administrator the option of selling the entire corporate entity, rather than just its assets. This approach would involve the transfer of the shares of the failing retailer to new owners. Such a process is uncommon in standard insolvency regimes, but has some precedents.

It would be possible to impose requirements for the approval of the sale by the court or Minister. However, we consider that it is preferable for the sale process to be left to the administrator's discretion.

Under the sale process, the administrator would sell the relevant customer contracts to new retailers. Customers would therefore remain on their existing contact terms when they moved to the new retailer. This structure differs from the ROLR process (and the default transfer mechanism discussed below), where the customer's existing contract is terminated and a new contract is formed based on the new retailer's published terms and prices.

It may be appropriate to include a legislative transfer mechanism to assist the implementation of the sale process. For example, customer contracts may contain confidentiality provisions or requirements for third party consents that could hinder or delay the sale process.

The sale would raise competition issues under the *Competition and Consumer Act 2010* (Cth). There are several options to address this issue in the design of the regime. However, it is likely to be appropriate to require the usual process to be followed, including informal clearance from the Australian Competition and Consumer Commission (ACCC) if potential purchasers consider that there is a risk that their acquisition may substantially lessen competition. This ACCC oversight could add time to the sale process, but would bring benefits in terms of ensuring a more competitive outcome.

Default allocation process

A default allocation mechanism would also be required in case the administrator is unable to sell some of the customer contracts.

This mechanism may be required, for example, if one of the reasons for the retailer's failure was that it had agreed to retail contracts at unprofitable prices. In those circumstances, there may be no willing buyers for those customer contracts.[19]

Under this default mechanism, the customers would be transferred to the new retailer's standard or published prices and terms, similar to under the ROLR scheme.

The administrator should decide who to allocate these customers to on the basis of advice from the AER. The AER would have more time for this process than under ROLR and should have more scope to spread the customers between multiple retailers in a manner that will minimise any contagion risk.

The design of the default allocation mechanism will be critical in maximising the incentive for retailers to bid in the sale process. If retailers consider it likely that they will be allocated customers for free under the default allocation mechanism, they are unlikely to pay under the sale process. However, if there are multiple potential bidders

19 An alternative would be to allow negative bids in the sale process - ie to allow buyers to bid how much they would need to be paid to take on those customers.

under the sale process, as seems likely, and they face uncertainty as to how many, if any, customers they will be allocated under the default mechanism, there should be considerable incentives for retailers to pay to acquire customers.

Under both the sale process and the default allocation process, the transfer of customers to new retailers should be designed to minimise contagion risks. For example, there should be a suitable period between the outcome of the sale or default allocation process and transfer date so that the new retailers have sufficient time to arrange for increased credit support and hedge cover.

Box 5.5: Key issues to be determined

- Should the form of the special administration sale process be determined in advance or left to the discretion of the administrator?
- Should any court or Ministerial approval be required as part of the sale process?
- Should a legislative transfer mechanism be established to assist in implementation of the sale process?
- How should competition issues be addressed?
- What form will the default allocation mechanism take?

5.2.4 Government funding and cost recovery

The operation of the special administration regime relies on the government providing funding to the administrator during the administration. This funding would allow the administrator to operate the business for a period while it sells or transfers the retailer's customers to new retailers. Government funding would allow that process to occur in a more orderly and efficient fashion than is possible under the ROLR scheme, therefore avoiding financial contagion.

There would be no express obligation on the government to provide funding. However, in practice an administrator can only be appointed if it has consented to that appointment and it will not do so unless it has an agreement with someone to fund the costs that it will become liable for as administrator. That funding may involve a combination of guarantees, indemnities and loans.

The government's funding agreement with the administrator could include reasonable limitations on the amount of funding that the government agrees to provide or the time during which the government agrees to provide funding. The administrator would then need to ensure that it conducted the administration in a way that allowed it to operate within these limits. Any such limits may affect, for example, the form of sale process used by the administrator.

The regime would be designed to ensure that all funding provided by the government was recovered upon termination of the special administration.

The government should first recover its funding from the failing retailer itself, including the proceeds from the sale of the retail customer contracts and any other relevant assets. A key issue will be whether the government should have any priority over other creditors (in particular secured creditors).

If there is a shortfall, the regime would include a cost-recovery mechanism to recover that shortfall.

Box 5.6: Cost recovery mechanisms under the Great Britain special administration regime

Under the Great Britain special administration regime, the Secretary of State would provide funding to the administrator. This funding would be classed as an expense of the administrator and its repayment would take priority over all other debts incurred prior to the commencement of administration.[20]

If there is a short-fall after the customers are sold and the company is unable to repay the government funding, that short-fall would be recovered under charges that industry participants are required to pay as a condition of their licences. The United Kingdom Department of Energy and Climate Change (UK DECC) is currently consulting on changes to licences to implement this cost recovery arrangement.

UK DECC proposes to amend National Grid's licence to allow the government to direct it to raise any of the charges it levies on electricity suppliers and gas shippers for the transmission of electricity or carriage of gas. Those participants may then pass those charges through to electricity and gas consumers.

UK DECC notes that energy supply company administration "reduces the risk of financial failure spreading across the rest of the industry, which would end up being much more costly for consumers".[21] Given that consumers would benefit from the special administration regime, UK DECC considers that they should meet the costs rather than taxpayers.[22]

The Allens Linklaters report discusses the following options for cost recovery mechanisms:

- cost recovery by the Commonwealth government by means of an industry levy or a taxpayer levy; and

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20 United Kingdom Department of Energy and Climate Change, *A shortfall cost recovery mechanism for energy supply company administration: DECC consultation document*, December 2012, p8.

21 UK DECC, *A shortfall cost recovery mechanism for energy supply company administration: DECC consultation document*, December 2012, p12.

22 UK DECC, *Impact assessment: Modification of gas and electricity licences for the purpose of implementing a cost recovery mechanism for energy supply company administration*, 17 December 2012, p1. Available at www.gov.uk/government/consultations/energy-supply-administration-cost-recovery-mechanism.

- cost recovery under co-operative State laws by means of an industry levy, which could take the form of a levy on network service providers, retailers or consumers.

The report also discusses the issues that would arise with each option, including potential legal issues.

We consider that some form of levy on network service providers under co-operative State laws is likely to be the most effective. This approach has several relevant precedents under which network service providers would pay the levy and their regulated revenues would be adjusted to allow them to recover the levy from electricity consumers over an appropriate period of time. However, it would need to be determined whether this approach is permissible, as there is a question about whether it infringes constitutional limitations on States and Territories imposing excise duties.

Box 5.7: Key issues to be determined

- What mechanism will be used to recover government funding?
- Should the government have any priority over other creditors for repayment of its funding? If so, what form of priority is appropriate?
- If an industry levy is required, how will that levy be allocated amongst participants and how will it be structured to ensure that it is not an excise duty?

5.2.5 Implementation

New legislation would be required to implement the special administration regime.

This legislation would address a range of matters that are discussed in the Allens Linklaters report including:

- the objectives of special administration;
- the means by which the special administration is commenced;
- specific restrictions on third parties taking action to trigger a ROLR event without notice, including by the commencement of a traditional insolvency process;
- restrictions on third party rights during the course of the special administration;
- provisions establishing the default mechanism for allocation of customer contracts;
- provisions in respect of financial support of the special administration; and
- the cost recovery mechanism.

For constitutional reasons discussed in the Allens Linklaters report, it may be preferable for this legislation to be State co-operative legislation (like the NERL, for example), rather than Commonwealth legislation.

Existing *Corporations Act 2001* (Cth) provisions addressing the relationship between Commonwealth and State insolvency laws could be utilised to avoid any conflict between the special administration regime and existing insolvency laws.

Amendments to electricity legislation and rules would also be required to address the interaction between the special administration regime and the ROLR scheme, including:

- amendments to the NERL, National Electricity Law (NEL) and NER in relation to the triggers for a ROLR event and other issues including AEMO's ability to suspend a retailer's ability to acquire electricity in the NEM and the prohibition that a market participant cannot trade in the market while under external administration;
- potential amendments to the AEMO credit support requirements in the NER to address the increased risk of non-payment incurred by AEMO (and therefore generators) during the period where a decision is made whether to invoke the special administration regime or ROLR scheme;
- amendments to the NER and potentially the NEL and other legislation to support the cost recovery scheme, for example to implement specific pass-through arrangements if a network service provider levy is adopted as the form of cost recovery mechanism.

Commonwealth legislation may also be required to support the funding arrangements and confer functions or powers on a relevant Commonwealth officer if the Commonwealth provides the funding and the decision whether to appoint a special administrator is made by a Commonwealth Minister.

An Intergovernmental Agreement, or amendment to the Australian Energy Market Agreement, would also be required to cover aspects of the operation of the regime, such as:

- the process for the AER to make a recommendation to the relevant Minister that a special administrator should be appointed;
- the process and timeframe for the relevant Minister to make a decision whether to appoint a special administrator (or make application to the court for the appointment of an administrator);
- any arrangements between the States, Territories and the Commonwealth in relation to sharing obligations to fund the special administration regime; and
- arrangements to support the cost recovery mechanism.

Box 5.8: Key issues to be determined

- What is the most appropriate legislative mechanism for implementing the special administration regime?

5.3 Benefits of a special administration regime in mitigating contagion

We consider that a special administration regime would have significant benefits in managing financial contagion risks following the financial distress of a large electricity retailer. In particular, it would be significantly more effective in managing contagion risks than relying on either:

- the ROLR scheme, even if the amendments proposed in chapter 6 are implemented; or
- existing insolvency arrangements.

5.3.1 Potential advantages compared with an amended ROLR scheme

As discussed in chapter 3, if the ROLR scheme was invoked following the failure of a large retailer, there would be a risk that the designated ROLR(s) may also fail, risking a cascading retailer failure. The key causes of this risk are that the designated ROLR:

- would need to provide very large amounts of credit support to AEMO almost immediately after the ROLR event; and
- would initially be unhedged and exposed to the spot price in relation to the acquired customers, and therefore be required to pay much higher wholesale costs for the energy consumed by those customers.

In chapter 6, we propose amendments to the ROLR regime that are intended to reduce each of these key contagion risks. However, even with those amendments, there are a number of limitations on the ability of the ROLR scheme to manage the contagion risks that would arise following a failure of a large one of the largest retailers.

The amendments in chapter 6 would allow the designated ROLR more time to provide credit support to AEMO. However, the amount of credit support that is required would not be reduced and could be extremely large.

In section 6.4.3, we set out some estimates of the amount of credit support that a designated ROLR may be required to provide. If one of the three largest retailers failed and its customers were split equally between two designated ROLRs, each of those designated ROLRs could be required to provide increased credit support of between $125 million and $500 million, depending on the level of spot prices.

Under our draft recommendation in section 6.4, the designated ROLRs would each have one week to provide this credit support, instead of potentially as little as one day at present. However, we expect that any retailer would find it very difficult to obtain bank guarantees for such a large amount within a week.

Our draft recommendation in section 6.5 would expand the potential governments that could provide credit support to AEMO on behalf of a designated ROLR. However, we expect that it would also be extremely challenging for any government to provide guarantees for between $250 million and $1 billion in total within a week to support the designated ROLRs.

The size of the unhedged spot market costs of the designated ROLRs could also be overwhelming, depending on the prevailing spot price. The likely level of spot prices following a large retailer failure would be very difficult to predict, but prices could reach exceptionally high levels for a short period following the ROLR event.

If the spot price averaged $1,000/MWh across the NEM, each designated ROLR would accumulate daily payment obligations of about $50 million per day. This level of sustained prices is unprecedented, but well below the market price cap of $12,900/MWh. Under our draft recommendation in section 6.4, the designated ROLRs would have an extended period to provide cash or credit support to cover these obligations, but would still need to do so within one week of being appointed as ROLRs.

These amounts are extremely large mainly because the designated ROLRs will acquire all of the customers of the failed retailer and liability for paying for the energy consumed by those customers. However, they will not acquire any of the hedge contracts of the failed retailer.

In the options paper, we explored an option for transferring the failed retailer's hedge contacts to the designated ROLRs. However, the options paper discussed the problems that would arise in such an approach and considered that it was unlikely to be workable. All submitters opposed implementing this option.

As discussed in section 5.2.2, the legislation establishing the special administration regime would provide that counterparties to contracts, including hedge contracts, would be prohibited from terminating those contracts due to the appointment of the special administrator. This prohibition would be a key benefit of the special administration regime and would allow the administrator to keep the hedge contracts in place during the administration period. This would dramatically reduce the amount of credit support required and the level of spot price exposure.

Under special administration, the new retailers will also have significantly more time than under ROLR to arrange credit support before the new customers are transferred to them. This should also materially reduce contagion risks.

Box 5.9: Great Britain energy supply company administration regime

UK DECC is currently consulting on the implementation of a special administration regime for energy supply companies (ie retailers) in England and Scotland.

UK DECC has summarised the reasons for introducing the special administration scheme as follows:[23]

> "The purpose of energy supply company administration is to ensure that if a large gas or electricity supply company is in financial difficulty, arrangements are in place to allow the company to continue operating normally until it is either rescued, sold, or its customers transferred to other suppliers. This will reduce the risk of financial failure spreading across the energy market, maintain market stability and therefore protect consumers."

This regime is currently being implemented as an alternative to the UK supplier of last resort (SOLR) regime (the UK equivalent of ROLR).

UK DECC has stated that the SOLR arrangements have worked well in relation to failure of small suppliers, but that "experience has shown that it is unlikely that they would be effective in the event of a large supplier becoming insolvent".[24]

UK DECC considers that a failure of one of the six largest UK retailers would involve a transfer of such a large number of customers that it could not take place in an orderly manner in a short timescale and would impose significant financial obligations on the retailer that acquired the customers. UK DECC considers that this would cause cash flow problems for other market participants, putting a strain on the system and threatening the stability of other market participants, risking contagion and reducing consumer and market confidence.[25]

Benefits related to vertical integration issues

A special administration regime would also be more effective than the ROLR scheme in managing the failure of a vertically-integrated business.

23 UK DECC, *A shortfall cost recovery mechanism for energy supply company administration: DECC consultation document*, December 2012, p7. Available at www.gov.uk/government/consultations/energy-supply-administration-cost-recovery-mechanism.

24 UK DECC, *Energy supply company administration rules, Impact Assessment*, March 2012, p3. Available at www.gov.uk/government/consultations/energy-supply-company-administration--2.

25 UK DECC, *Energy supply company administration rules, Impact Assessment*, March 2012, pp3-4.

In its submission to the options paper, AEMO raised concerns about the ability of the ROLR scheme to manage the failure of a vertically-integrated retailer and generator. AEMO stated that:[26]

> "the process of ROLR is only designed to manage the transfer of retail customers, and there is no mechanism in the NEM for ongoing operation of the generation when a business is insolvent or suspended."

A ROLR event in relation to a vertically-integrated business could have significant implications for security of supply in the NEM. As discussed in section 7.3, AEMO has some discretion to partially suspend a market participant, but only in limited circumstances.

If a vertically-integrated business had both its generation and retail operations in a single company and that company became insolvent and was placed in administration, triggering a ROLR event, AEMO would be required to immediately suspend both the retail and generation operations.[27] That could mean that at the same time that a ROLR event is triggered, AEMO may be required to prevent the business from selling any of its generation into the market. If the business operated a large amount of generation, this could potentially cause supply shortages.

Special administration would address this concern. As part of the administration process, the government would provide interim funding to allow the administrator to continue to pay for energy and other purchases. Accordingly, it would be appropriate to amend the NER prohibition on trading in the market while insolvent so that it does not apply to special administration, as there would not be the same level of risk that AEMO may not be paid.

The special administration regime may also involve ring-fencing of a businesses' NEM electricity retail operations from its other operations. That would also address this issue.

Potential competition benefits

Special administration may also have competition benefits compared with ROLR.

An aim of our proposed ROLR amendments is to enhance the ability to appoint multiple ROLRs. In its ROLR statement of approach paper, the AER notes that competition effects are one issue that it will consider when appointing additional ROLRs.[28]

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26 AEMO submission to options paper, p5.

27 Section 3.3.1 of the NER provides that a market participant may not participate in the market while in external administration. The reason for this prohibition is that there would be a serious risk that the participant may not be able to pay AEMO for its energy purchases, which would expose all generators in the NEM to credit risk.

28 AER, *Retailer of last resort statement of approach*, November 2011, p16.

However, even with our proposed amendments, the AER will have limited time to make a decision as to who to appoint as a designated ROLR, and limited information on which to base its decision. As a result, the majority of the customers are most likely to be transferred to the other two largest retailers.

The special administration regime will allow other retailers to compete though an auction or other form of sale process run by the administrator to purchase the customers. That sale process is likely to be subject to oversight by the ACCC under the usual *Competition and Consumer Act 2010* (Cth) provisions.

If all customers cannot be sold, then a default allocation process will apply. That process will allow more time to allocate customers between multiple retailers.

Potential benefits if government involvement is required

Reducing the amount of AEMO credit support required by the designated ROLRs by keeping hedge contracts in place would result in a corresponding reduction in the amount of funding that the government would be required to provide if it posted credit support for the designated ROLR under existing provisions in the NER or the proposal in section 6.5.

The special administration regime also contains a cost recovery mechanism. This mechanism will ensure that any government funding can be recovered, either from the sale of the customers or through a form of levy. In contrast, if a large retailer failed and triggered a ROLR event, and the government chose to provide funding to support the designated ROLR, there would be no mechanism to recover that funding. Taxpayers would therefore ultimately be responsible, unless a special cost recovery mechanism was introduced after the failure.

5.3.2 Potential advantages compared with existing insolvency regimes

The following features of the special administration regime would have benefits over standard Australian insolvency processes in managing the failure of a large electricity retailer.

- **Administrator's objectives:** Under special administration, the administrator's primary objective would be to maintain continuity of electricity supply to consumers. This contrasts with standard forms of external administration, where the primary objective of the insolvency practitioner is to obtain the best financial recovery possible for creditors. If a large electricity retailer becomes insolvent, there is likely to be a conflict between the interests of its creditors and its electricity customers.

- **Government's ability to appoint an administrator:** The decision whether to appoint a special administrator would be made by an appropriate government Minister, either directly or by application to the court. Under standard insolvency processes, the government has no general power to appoint an administrator or other form of insolvency practitioner to a company. In the options paper, we discussed the ABC Learning failure as an example of how governments could potentially use existing insolvency processes. However, that approach relied on a number of unique features of the ABC Learning situation that are unlikely to apply to an electricity retailer. In particular, the Commonwealth Department of Education, Employment and Workplace Relations was a major creditor of ABC Learning, which allowed it to apply to the court for the appointment of a receiver and manager.

- **Vertical integration issues:** The use of standard insolvency processes in relation to an electricity retailer that also undertook other operations within a single company would encounter a number of problems. It may be possible to appoint a receiver and manager over certain defined retail assets, but that may be unworkable in practice, as discussed in the Allens Linklaters report. The alternative would be to appoint an administrator over the entire company, but that would result in the administrator being responsible operating, and the government potentially funding, operations in unrelated markets. A ring-fencing requirement under special administration would address this issue, although it would also be possible to impose such an obligation independently of implementing a special administration regime.

- **NER prohibition on trading while in administration:** As discussed above, the NER currently do not allow a market participant to trade in the market while in administration. It is proposed that this prohibition would be removed under special administration, as the special administration regime and associated government funding would be designed so that the retailer would continue to pay AEMO during the administration period.

- **Default allocation mechanism:** If a standard administrator, receiver or liquidator was appointed to an electricity retailer, it would seek to sell the retail customer contracts to other retailers in a similar manner as under the special administration regime. However, there would be no mechanism to transfer to other retailers any customers that could not be sold, for example because the price under the contract was unprofitable. Those contracts would most likely be disclaimed by a liquidator (ie terminated, with no power for customers to compel the liquidator to specifically perform the contract). The special administration regime contains a default allocation mechanism to address this situation and ensure that all customers can be transferred to a new retailer without any risk of loss of electricity supply.

- **Prohibition on termination of hedge contracts:** The special administration would include a prohibition on counterparties to contracts with the retailer exercising rights of termination due solely to the appointment of the special administrator. This prohibition would allow the administrator to continue to benefit from the retailer's existing hedge contracts during the administration period. Under standard forms of insolvency, the appointment of an administrator would generally entitle hedge counterparties to terminate their contracts under the default provisions of the contract. That would expose the administrator to far higher wholesale market costs. It would also dramatically increase the amount of government funding that is required to support the retailer during the administration period.

- **Cost-recovery mechanism:** Under standard insolvency processes, if the government provided funding to an administrator or receiver and manager, there would be no clear process for repayment of that funding. If the administrator was able to sell the customer contracts, then it may be able to use some of the proceeds to repay some of the government's funding. However, that would depend on how much money was owed to other creditors, particularly secured creditors that ranked ahead of the government. Any short-fall would ultimately be borne by taxpayers, unless a special cost recovery regime was introduced after the failure. Under special administration, there would be a clear process to ensure that all of the government's funding was recovered.

6 Changes to the ROLR scheme and credit support arrangements

Designing and implementing a special administration regime is complex. It is likely to involve the introduction of a package of new legislation with impacts outside the NEM and may require an intergovernmental agreement. As a result, we are recommending a number of other measures that will mitigate the risk of contagion while the special administration regime is being assessed, designed and introduced. They will also mitigate the risk of cascading retailer failure following the failure of a small or medium size retailer.

These measures involve changes to the NERL and NER that can be implemented reasonably quickly, without major changes to the design of the NEM. We consider the recommended changes to be proportionate to the anticipated benefits they offer in terms of the financial stability and competitiveness in the NEM.

These recommendations, discussed in the following sections, involve changes to the ROLR and credit support arrangements as follows:

- revising cost recovery arrangements, to give the designated ROLR(s) more certainty that reasonable costs will be recovered quickly;
- delaying the time at which the AER must notify AEMO of the designated ROLR (if this differs from the default ROLR), so the AER has more time to assess the most appropriate allocation of customers;
- amending AEMO credit support provisions, to allow more time for the ROLR to meet AEMO credit support requirements; and
- making provision to allow the Commonwealth government to post AEMO credit support.

Individually, these changes have a limited effect on the sources of financial contagion, particularly where a large retailer fails, but they have the potential to offer substantial benefits when implemented as a package.

6.1 National Energy Customer Framework

Where relevant, our recommendations have been drafted by reference to changes that would be required to the ROLR scheme under the National Energy Customer Framework (NECF), rather than the changes that would be required to jurisdiction-specific ROLR arrangements. To date the NECF has been adopted by South Australia, Tasmania and the Australian Capital Territory.

In its report to the 7 December 2012 Council of Australian Governments(COAG) meeting, SCER agreed to all jurisdictions commencing NECF as soon as possible and no later than 1 January 2014, subject to the resolution of some jurisdiction-specific issues.

If our recommendations are implemented before the NECF has been adopted throughout the NEM, jurisdiction-specific changes would need to be implemented in the non-NECF jurisdictions, to aim for consistency. However, it would be very difficult to achieve consistency through piecemeal changes to jurisdictional provisions, because the NECF provides for the appointment of multiple ROLRs. This feature is not present in the non-NECF jurisdictions.

We consider the potential for the AER to appoint multiple ROLRs as being very important, to:

- spread the risks imposed on the ROLR, thereby reducing the likelihood that the ROLR will experience financial distress as a result of its appointment, and lead to cascading retailer failure. This is the key objective of our draft recommendations; and
- allow the AER to consider the impact on concentration and competition in the retail electricity sector when deciding which ROLR(s) should be appointed.[29] The competitiveness of the retail sector affects the achievement of the NEO and the interests of consumers in the long term.

6.2 Revised cost recovery arrangements

Box 6.1: Overview of the draft recommendation

The existing ROLR cost recovery provisions should be amended to give the designated ROLR greater certainty that it can quickly recover all reasonable costs associated with a ROLR event.

6.2.1 Overview of the current NECF arrangements

The NECF incorporates a process through which the designated ROLR can apply to recover some of the costs that it incurs as a result of its designation. Differing arrangements apply in those NEM jurisdictions that have not yet adopted the NECF, and these were described in the options paper.

Box 6.2: NECF ROLR cost recovery arrangements

Under the National Energy Retail Law (NERL), a designated ROLR may apply to the AER to recover costs that it incurs on or after a ROLR event.[30] The NERL does not provide guidance as to what costs are recoverable, except that they may include costs paid to an insolvency official of a failed retailer in respect of

29 The AER has stated that it will consider a range of issues in appointing ROLRs, including "changes to market structure which support longer term competition benefits". See AER, *Retailer of last resort statement of approach,* November 2011, p16.

30 NERL, section 166. Applications must be made within nine months of the relevant ROLR event.

anything done under the NERL and costs paid to a distributor for service orders, and which are not recoverable through other means.[31] A default ROLR may also apply to the AER to recover costs incurred in preparing for ROLR events.[32]

Upon receipt of an application, the AER must determine a "ROLR cost recovery scheme". In doing so, the AER may "limit either generally or in particular cases or classes of cases the costs (and the amount of those costs) that are recoverable".[33]

The AER must be guided by the following principles when making its decision:[34]

- the designated ROLR should be provided with a reasonable opportunity to recover the reasonable costs that it incurs;
- the recovery of costs should allow for a return commensurate with the regulatory and commercial risks with respect to the ROLR scheme; and
- the designated ROLR will itself bear some of the costs, in proportion to its customer base.

If the AER approves the cost recovery application, a designated ROLR may recover its costs either from the customers it acquired from the failed retailer or from a broader group of customers in accordance with a "distributor payment determination" made by the AER.[35]

Under a distributor payment determination:

- one or more DNSPs must pay the amount determined by the AER to the designated ROLR; and
- the costs incurred by the DNSP(s) are passed through to all customers in the DNSP's area.[36]

The AER has published a ROLR statement of approach, which provides some

31 NERL, section 166(3)(b).

32 NERL, section 166(3)(a). Preparation costs incurred by a default ROLR do not create a significant contagion risk so are not addressed in the remainder of this section.

33 NERL, section 166(8). However, the AER has stated that limits of this nature will generally not be imposed - see AER, *Retailer of last resort statement of approach*, November 2011, p19.

34 NERL, section 166(7).

35 As explained below, the AER will determine which costs are to be recovered through which mechanism.

36 See section 167 of the NERL. Section 167(2) provides that a distributor payment determination is taken to be both a regulatory change event and a positive change event for the purposes of the NER. This means that the DNSP's regulated revenues and prices will be increased by the amount of the ROLR cost recovery payments without a need for any additional regulatory processes. Those increased DNSP charges will be payable by all retailers with customers in the DNSP's area. Retailers will seek to pass those increased charges on to consumers.

guidance as to how it will assess cost recovery applications.[37]

In this statement of approach, the AER sets out its general principles for cost recovery scheme determinations, and non-binding hypothetical examples of how the AER may exercise its powers. Key points that are made in the statement of approach include:

- To assess whether the costs incurred by a designated ROLR are reasonable, the AER will assess whether the actions of the designated ROLR have been prudent and minimised its costs.
- The statement of approach does not list the types of costs, or provide examples of relevant costs, that may be recovered by designated ROLRs.
- Cost recovery could occur through any one or more of the following mechanisms depending upon the nature of the retailer failure and the type of costs incurred:
  - an upfront fee paid by customers of the failed retailer - but only to the extent that this does not result in onerous price shocks;
  - a variation to the retail tariffs paid by small customers of the failed retailer;[38]
  - a distributor payment determination.
- The ROLR scheme benefits all energy market participants, so the AER considers it appropriate that cost recovery extends beyond just the customers of the failed retailer.
- In the event of a small retailer failure that is unlikely to threaten market security, the AER provides examples that involve the customers of the failed retailer bearing a greater portion of the costs. This could involve an upfront fee covering the administrative costs of the ROLR, with other incremental costs being recovered via a distributor payment determination (limited to distributors in the jurisdiction where the retailer operated). The AER also raises the possibility that in some scenarios, some of the costs could be recovered from small customers of the failed retailer through a retail tariff variation.
- In the event of a large retailer failure, the AER may opt for the entire cost recovery to be managed through a distributor payment determination in order to spread the costs across a wide customer base to minimise the cost

37 AER, *Retailer of last resort statement of approach*, November 2011.

38 Under section 145 of the NERL, the prices applicable to small customers of the failed retailer are the designated ROLR's standing offer prices, subject to any variations made by the AER under the cost recovery scheme. Any variations to prices under this power only last for a maximum period of three months - see section 147(4) of the NERL.

impact of the ROLR event on all market participants. This could involve a combined upfront fee and distributor payment determination.

6.2.2 The draft recommendation in more detail

We recommend that the ROLR regime established under the NECF be amended to provide greater certainty to the designated ROLR(s) that they can quickly recover the reasonable costs that they incur following a ROLR event. This requires amendments to the NERL to:

- remove the reference to the registered ROLR bearing some of the costs, in proportion to its customer base;[39]
- provide a list of specified types of costs that the ROLR has the right to recover in relation to a ROLR event (without limiting cost recovery to the range identified), such as:
  - administration costs;
  - energy costs in relation to the acquired customers (to the extent that they are not recovered in the prices charged to those customers);
  - financing costs in relation to additional credit support that is required to be provided to AEMO or DNSPs in relation to the acquired customers; and
  - financing costs to cover the period from when the costs are incurred and when they are recovered under this mechanism;
- specify a period during which these costs can be claimed, for example three months from the date of the ROLR event; and
- specify clear timeframes for the AER to determine a compensation claim, and for payment of any approved compensation through one of the mechanisms noted in box 6.2 above.

These amendments would not remove the ability for a designated ROLR (other than the default ROLR) to waive the recovery of some or all of the costs of the ROLR event.[40] This leaves open the potential for a retailer to offer to be an additional ROLR on the basis that it absorbs some of the costs of the ROLR event (in return for acquiring the benefit of new customers).

6.2.3 Basis for draft recommendation

Under the NECF regime, the designated ROLR may be able to recover all of its reasonable costs. However, some of the NERL provisions may undermine the

39 NERL, section166(7)(c).

40 NERL, section 167(5).

confidence of the designated ROLR that it can recover all of its reasonable costs. In particular, the NERL:

- allows the AER to "limit either generally or in particular cases or classes of cases the costs (and the amount of those costs) that are recoverable",[41] although the AER has stated that it is unlikely to exercise this power;[42] and
- states the principle, which the AER must follow, that the designated ROLR will itself bear some of the costs, in proportion to its customer base.[43]

Furthermore, the NERL provides little certainty as to what costs are recoverable. Instead, the AER is given very broad discretion.

This recommendation would reduce the financial uncertainty faced by the designated ROLR(s) following the failure of a large retailer. It would have a number of benefits:

- It is likely to increase the appetite among retailers to submit expressions of interest to act as additional ROLRs and be appointed as designated ROLRs. The appointment of multiple ROLRs would reduce the impact of the ROLR event on each designated ROLR, spread the risks of the ROLR among several retailers, and thereby reduce the likelihood that the ROLRs experience financial distress or failure.
- By increasing the potential for multiple ROLRs it may also improve the long term competitiveness of the market by spreading customers across a range of retailers.
- The designated ROLR is likely to have more success in borrowing funds to cover the short-term costs of being a ROLR, since it has more certainty of cost recovery, and the timing of cost recovery. Thus it reduces the risk of cascading retailer failure.
- Similarly, the designated ROLR is likely to have more success in obtaining the additional credit support required for AEMO and for DNSPs, since its future cash flows are more certain.

This recommendation is well targeted because it addresses potential sources of financial distress and cascading retailer failure - uncertain cost recovery and its impact on cash flow, financing and access to credit support.

However, it is unlikely to be sufficient on its own to mitigate contagion risks related to a large retailer failure, due to the high initial costs that could be incurred by a designated ROLR. Although it could assist the ROLR in obtaining financing as discussed above, the current ROLR and AEMO credit support provisions impose a very tight deadline for meeting some of the designated ROLR’s initial obligations and it may not be able to obtain finance within that period.

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41 NERL, section 166(8).

42 AER, *Retailer of last resort statement of approach*, November 2011, p19.

43 NERL, section 166(7).

Nonetheless, this recommendation offers significant potential when combined with the other changes proposed, for example the extension of time for the ROLR to meet AEMO credit support requirements.

There may be concern that this recommendation will reduce the incentives on the designated ROLR to minimise its costs. By being more prescriptive and reducing the discretion for the regulator to decide which costs are recovered, there may be concern that the designated ROLR will recover inefficient costs, and that customers will bear the risk of their inefficient behaviour.

However, the AER maintains the ability to review whether the costs incurred by the designated ROLR(s) are reasonable. In addition, the extent of costs claimed is limited to the period of time that will be specified in the NERL, for example three months from the date of the ROLR event. The AER also has the ability to accept offers from additional ROLRs who advise they are willing to forgo some of the costs of being a ROLR.

Ensuring that the designated ROLR can recover the reasonable costs of performing its functions, and thereby avoiding cascading retailer failures, offers benefits across the NEM, and is consistent with achieving the NEO.

We consider this offers an appropriate balance between prescription and discretion in relation to cost recovery under the ROLR regime.

While this recommendation increases the level of certainty that the designated ROLR will be able to recover reasonable costs, it does not affect the *manner* in which costs are recovered from customers under the NECF.

The AER has flexibility in determining the appropriate mechanism for cost recovery, and whether it should be applied to customers of the failed retailer, or across the NEM more broadly.

In relation to a large retailer failure, the recoverable costs are likely to be significant, while the benefits in terms of avoiding cascading retailer failure are widespread. In its statement of approach the AER provides an example of a large retailer failure where the costs are recovered from a wide customer base.[44] This increases the number of customers bearing the costs of the ROLR event, but reduces the price impact on each individual customer.

6.3 Delayed designation of ROLRs

Box 6.3: Overview of the draft recommendation

The ROLR regime should be amended to delay the time at which the designated ROLR is appointed by the AER, to allow a more considered allocation of customers and greater potential for multiple ROLRs. The designated ROLR's

44 AER, *Retailer of last resort statement of approach*, November 2011, pp22-23.

appointment would still be backdated to the time of the original ROLR event and it would still be held financially responsible for the acquired customers from that date.

6.3.1 Overview of the current NECF arrangements

The ROLR framework under the NECF makes provision for retailers to be appointed ahead of time as "default ROLRs".[45] Retailers can also register voluntarily as firm or non-firm "additional ROLRs", as described in chapter 3.

The ROLR regimes in jurisdictions that have not adopted the NECF do not contain any similar mechanisms for designating multiple ROLRs. As noted at the beginning of this chapter, our recommendations have been developed on the basis that the NECF will be adopted throughout the NEM.

Box 6.4: How is the designated ROLR appointed?

Under the NERL, a "default ROLR" must be appointed by the AER for each electricity connection point.[46] In practice, default ROLRs are generally the original incumbent retailers in the region who previously acted as ROLRs under the existing jurisdictional schemes. It is possible for more than one default ROLR to be appointed in an area.

In addition, the AER may appoint one or more "additional ROLRs" in an area. If there is a ROLR event, the AER will then be able to determine which of the default ROLR(s) or additional ROLR(s) should become the new retailer and take on the customers of the failed retailer in each area, or spread the customers between more than one retailer.

When a ROLR event is triggered, a default ROLR or an additional ROLR will be appointed as the "designated ROLR" for each electricity connection point. The designated ROLRs are responsible for taking on new customers and facilitating customer transfers from the failed retailer.

Under the NERL the default ROLRs will be appointed as the designated ROLR unless the AER provides AEMO with written notice appointing another retailer instead before the ROLR event occurs.[47] Under protocols established between the AER and AEMO, this timeframe has been shortened so the default ROLR will be appointed unless the AER advises AEMO before a default notice is issued.

The AER can appoint more than one retailer as a designated ROLR in any area. If it does so, the customers of the failed retailer will be allocated between the

45 NERL, section 125.

46 NERL, section 125.

47 NERL, section 132.

designated ROLRs.

The AER has provided more guidance on its decision-making process in its statement of approach.[48] It notes that a major factor in its selection of designated ROLRs for appointment will be the length of time it has to make the decision. The more warning the AER has of an impending ROLR event, the more registered ROLRs it will be able to consider.

Where there is less than a few hours notice of a ROLR event, the AER has indicated it is most likely to appoint default ROLRs. With short notice (ie, up to 48 hours), the AER suggests it may also be able to consider additional ROLRs with firm offers. Additional ROLRs with firm offers have agreed not to be consulted prior to being appointed as designated ROLRs (up to the maximum permitted by their terms and conditions). Where the AER has more than 48 hours notice of a ROLR event it may consider (and consult with) other registered ROLRs. This would include non-firm additional ROLRs who have not agreed to be designated without further consultation at the time of an event.

6.3.2 The draft recommendation in more detail

The NERL would be amended to increase the time allowed for the AER to advise AEMO of the designated ROLR(s), to 24 hours after the ROLR event. Protocols between AEMO and the AER should be amended to ensure consistency with this amended timeframe.

The proposed changes to the ROLR timeline are summarised in Figure 6.1.

48 AER, *Retailer of last resort statement of approach*, November 2011, pp11-12.

Figure 6.1 Proposed changes to the ROLR timeline

CURRENT ROLR EVENT TIMELINE

AER has 1 day to advise AEMO of designated ROLR/s

Day	Time	Event	
Day 1		Retailer breaches trading limit	
	before 12pm	AEMO may issue call notice	
		AEMO gives AER notice of call notice	AER assesses potential ROLRs
Day 2	before 11am	Market participant to respond	
	Before 1pm	AER advises AEMO of designated ROLR	
	1pm	AEMO may issue default notice	
Day 3	before 1pm	Market participant to respond	
	after 1pm	Default ROLR may receive notice of response to default notice	
	3pm	AEMO may issue suspension notice	
	midnight	Suspension takes effect, ROLR event triggered	ROLR building up liabilities
Day 4	morning	AER issues ROLR notice - event and designated ROLR ROLR/s informed	
	midnight		

PROPOSED ROLR TIMELINE

AER has 3.5 days to advise AEMO of designated ROLR/s

Day	Time	Event		
Day 1		Retailer breaches trading limit		
	before 12pm	AEMO may issue call notice		
		AEMO gives AER notice of call notice		AER assesses potential ROLRs
		AER negotiates with potential ROLRs		
Day 2	before 11am	Market participant to respond		
	1pm	AEMO may issue default notice		
Day 3	before 1pm	Market participant to respond		
	after 1pm	Default ROLR may receive notice of response to default notice		
	3pm	AEMO may issue suspension notice		AER negotiates with potential ROLRs
	midnight	Suspension takes effect, ROLR event triggered	ROLR building up liabilities	
Day 4	morning	AER issues notice that ROLR event has occurred		
	midnight	AER advises AEMO of designated ROLR		
Day 5	morning	AER issues notice of designated ROLR ROLR/s informed		

The left hand side of the diagram summarises the ROLR timeline under the current protocols between the AER and AEMO. The AER has up to 24 hours to assess potential ROLRs and advise AEMO if a retailer other than the default ROLR should be appointed as the designated ROLR. However, it is possible the AER may not have any time at all to advise AEMO of an alternative ROLR before the default notice is issued, if AEMO does not issue a call notice.[49]

The right hand side of the diagram shows the proposed revision to the ROLR timeline. The AER has an extra two and a half days to advise AEMO of the designated ROLR(s). This gives the AER more time to assess the most appropriate allocation of customers following a ROLR event, to negotiate with different retailers to allocate customers to designated ROLR(s).

As a result of these changes, the AER would issue a notice identifying the designated ROLR(s) 24 hours later than the existing NECF timeframe, and the designated ROLRs would be informed of their appointment 24 hours later than they are at present.

This recommendation would require a distinction to be made between the following dates, which currently occur simultaneously under the NERL ROLR provisions:

- the date that the ROLR event occurs (for example the date of the suspension of the failed retailer from the NEM by AEMO, which constitutes a ROLR event under the NERL); and
- the date that the designated ROLR is appointed.

The designated ROLR would be liable to AEMO for the energy consumed from the date of the ROLR event, while also being entitled to bill customers for energy consumed from that same point in time, as is the case under the current NECF provisions.

The period in which the designated ROLR builds up liabilities, but before it is advised that it is the designated ROLR, is shown in yellow in the above diagram. During this time the ROLR is likely to be unhedged in relation to the energy purchases of the ROLR customers. Our recommendation results in this period increasing by 24 hours, though the designated ROLR is likely to have some knowledge of its potential appointment as part of the AER's process.

6.3.3 Basis for draft recommendation

While the ROLR process under the NERL is a comprehensive set of arrangements, the current provisions make it unlikely that any retailer other than the default ROLR will be appointed as the designated ROLR. Where the retailer in financial distress is large, this is likely to be problematic for the default ROLR, because it acquires the liabilities and credit support requirements relating to a large number of customers. This may put

49 If the retailer breaches its trading limit AEMO will issue a call notice, but if they fail to pay an invoice or provide credit support, AEMO is likely to go straight to a default notice.

the ROLR itself under financial duress, risking cascading retailer failure and instability in the NEM more broadly.

It is also possible that the retailer facing suspension is a default ROLR, and that there are no firm additional ROLRs that can be appointed readily instead. In this case the AER could be forced to make a decision at very short notice with no specific legal structure and limited information to guide it. This situation could require the AER to appoint a retailer as a designated ROLR without its consent and without any prior notification.

Facilitating multiple ROLRs

The main limitation to the AER's ability to appoint multiple ROLRs relates to the tight timing of designation when a ROLR event happens, as described above. The current timeframe makes it highly unlikely the AER will be able to appoint a designated ROLR other than the default ROLR, because:

- there will be a prudent desire not to impede the retailer experiencing financial distress from meeting the default notice and rectifying the shortfall that is specified within it. There might be a concern that broadcasting the impending ROLR event via discussions with non-firm additional ROLRs about whether they are willing to act as a ROLR would damage the prospects of a trade sale of the failing retailer and speed the failure of the business;
- the AER may have very limited information about the financial position and other circumstances of retailers to help it make an informed decision as to who to appoint as the designated ROLR(s). The short timeframe limits the AER’s ability to gather this information after it becomes aware of the failing retailer’s financial problems, and the AER does not have powers to compel potential ROLRs to provide this information; and
- one day or less may not be enough time to decide on the prudent allocation of a large number of customers amongst the potential ROLRs. As noted above, the AER has indicated that if it has more than a few hours notice, but less than 48 hours, it may be able to consider retailers who have made firm offers to be additional ROLRs. However, it is possible few retailers will make firm offers, since they may prefer to negotiate the terms of their offer in light of the specific circumstances of the ROLR event (prevailing spot price, etc).

Extending the time available for the AER to advise AEMO of the designated ROLR(s) would provide greater scope for the AER to appoint multiple ROLRs. In their report to the Ministerial Council on Energy (MCE) as part of the development of the NECF ROLR regime, NERA Economic Consulting and Allens Arthur Robinson noted that while the issue of how to deal with a large retailer failure “appears to be one in which there is no simple answer”, the most effective means of addressing the issue of a large retailer failure was likely to be allocating the failed retailer's customers to more than one designated ROLR.[50]

Spreading customers between a number of retailers may also help maintain the long term competitiveness of the retail market, since it could reduce the concentration of customers in a small numbers of retailers.

More time to consider the optimal allocation of customers

With more time available the AER may be better placed to judge which retailers have sufficient financial resources to meet the obligations of the ROLR. There would be more time for the AER to negotiate terms with potential ROLRs, while also maintaining confidentiality as the retailer tries to remedy the situation or effect a trade sale. There would be greater capacity for the AER to involve retailers who have made non-firm offers to be additional ROLRs. These retailers will have the benefit of knowing more about the extent of obligations they will incur as a designated ROLR (such as the number of customers involved and the current spot market prices).

The optimal allocation of retailers to act as designated ROLRs following a large failure might depend significantly on the nature of the failed business, including its size and spread across the jurisdictions. By delaying the final decision on which retailer(s) to appoint as designated ROLR(s), the AER would have a greater opportunity to determine the allocation that involves the least risk of the designated ROLR failing and causing financial contagion.

No change to billing cycle

Delaying the designation of the ROLR as proposed would not impede the physical billing cycle. Retailers do not pay AEMO for energy consumed by their customers until four to five weeks after the time of consumption. The designated ROLR only assumes rights and liabilities from the date of the ROLR event, so it is only liable to pay AEMO for energy consumed by the acquired customers from that date. All rights and liabilities for energy consumed prior to the ROLR event remain with the failed retailer.

Potential disadvantages

Our recommendation increases the period of time between the ROLR event and the appointment of the designated ROLR by 24 hours. The designated ROLR will inherit an unhedged exposure to the spot price for all energy consumed during this interim period, which could be substantial if the failure occurred during a period of high spot prices. By itself this might increase the risk of the designated ROLR itself failing, which may threaten payments to generators and risk cascading retailer failure. However, this

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50 NERA Economic Consulting and Allens Arthur Robinson, *Retailer of Last Resort – Review of current jurisdictional arrangements and development of a national policy framework, Final report prepared for the MCE retail policy working group*, 29 January 2009, pp66-67.

impact is mitigated when combined with our recommendation to increase the certainty that the ROLR's reasonable costs will be recovered (discussed above).

Furthermore, the proposed changes to the timeline provide an opportunity for the AER to hold discussions with potential ROLRs, so retailers are likely to be aware of their potential appointment and can begin preparations to put hedging contracts into place as soon as possible after appointment.

If no retailer volunteered to act as a designated ROLR, the retailer that was appointed by the AER would have a slightly reduced period of time between its appointment and when it has to pay AEMO and network businesses. This could marginally increase the financial challenges faced by the designated ROLR and the possibility that payments will not be made to generators and network businesses. However, we believe this is outweighed by the potential benefits of the proposed changes, particularly the increased scope for multiple ROLRs to be appointed.

The proposed delay to the designation of the ROLR means that AEMO will need to decide whether to suspend the failing retailer without knowing who will be appointed as the ROLR. AEMO will not have the opportunity to make an assessment of the ability of the ROLR to manage its obligations as the ROLR, or whether there is a risk of cascading retailer failure. We consider the AER is better placed to make this assessment as part of its decision as to which retailer(s) should be appointed as the ROLR(s).

6.4 Amendments to AEMO credit support provisions

Box 6.5: Overview of the draft recommendation

The increased credit support required to be provided by the designated ROLR to AEMO for the new energy volumes of the acquired customers should be waived for a short time, and then ramped up over a transitional period.

6.4.1 Overview of current arrangements

Retailers settle their accounts with AEMO approximately four weeks after the end of the week in which the electricity was supplied. This gives rise to credit risk, because if a retailer fails to pay for the energy consumed, a shortfall will arise between AEMO's incoming payments and its outgoing payments to generators.[51]

If a retailer fails to pay an invoice from AEMO on its due date, AEMO is also exposed to a further period of credit risk between the due date for the invoice and the date on which the retailer is suspended and ceases to purchase energy. This additional period could be up to seven days.

51 Note that under the NER, a payment shortfall from retailers will result in AEMO short-paying generators rather than taking any loss itself.

To address these risks, retailers are required to post credit support to AEMO when they are unable to meet the acceptable credit criteria.[52] This criteria includes having a rating of A-1 or higher as rated by Standard and Poor's (Australia) or P-1 or higher as rated by Moody's Investor Service, for short term unsecured counterparty obligations.[53]

Such a strong rating is not usually met by electricity retailers, and in practice retailers typically need to post credit support, up to a pre-determined value called the maximum credit limit (MCL).

In addition to the MCL requirement, retailers are required at all times to maintain a margin - called the prudential margin - between the amount they owe to AEMO and the total value of all credit support, cash deposits and other offsetting instruments posted with AEMO. The prudential margin is designed to cover the credit risk during the period between when a retailer fails to pay an invoice and the date that AEMO suspends the retailer.

The NER require that the credit support is to take the form of a guarantee or bank letter of credit.[54] If the retailer fails to pay AEMO, the guarantee can be drawn down by AEMO to cover any shortfall arising from the failure to pay.

The NER empower AEMO to revise the minimum level of credit support that it requires of a retailer at any time, provided only that AEMO notifies the party first.[55]

AEMO has published new credit limit procedures, which are due to take effect from 28 November 2013.[56] Under the new credit limit procedures the MCL is calculated so if it defaults, there is a 2 per cent likelihood that a market participant's credit support is not sufficient to cover the amount it owes to AEMO. Each market participant's trading limit is equal to the difference between the total value of credit support it provides, and its prudential margin.

The NER do not specify the time period within which a designated ROLR must provide increased credit support where it acquires new customers as a result of a ROLR event. If a large retailer failed, we understand that AEMO would be likely to determine the required timeframe after discussions with the retailer and may allow a period of up to a week to meet the revised MCL, if this averts the possibility of cascading retailer failure. We also understand that the designated ROLR would be required to provide credit support or cash immediately to ensure its outstandings do not exceed its trading limit.

52 NER, section 3.3.

53 The criteria also require that the business be under the prudential supervision of APRA. This is a condition not met by any electricity retailers.

54 NER, sections 3.3.2. to 3.3.5.

55 NER, section 3.3.6.

56 AEMO, *Credit Limit Procedures*, version 1.0, 29 January 2013.

Since the ROLR acquires responsibility for the acquired customers from the time of the ROLR event, its outstandings to AEMO will increase over the following month as energy is consumed. Nonetheless, it is required to post credit support for the full MCL when notified by AEMO, which as noted above could be immediately, or up to a week after acquiring the additional customers.

6.4.2 The draft recommendation in more detail

The NER would be amended to insert a minimum time before AEMO can require increased credit support from the designated ROLR as a result of its increased customer load, as follows:

- There would be a one week "period of grace" in relation to credit support requirements following a ROLR event. During this time:
  - the designated ROLR would not need to provide additional credit support to meet the revised MCL; and
  - a breach of the revised trading limit, reflecting the increase in customers resulting from the ROLR event, would not trigger a call notice.
- Following the initial period of grace, the MCL would be increased in increments over a period of 4 weeks, until it reaches the level that reflects the addition of customers from the ROLR event. This would more closely reflect the increase in outstandings over this time as energy is consumed and its obligations to pay AEMO increase.

These changes would replace the discretion AEMO currently has in fixing a date by which the extra credit support must be provided. For simplicity, we recommend these changes to credit support requirements should apply to all ROLR events, not just those involving a large retailer failure.

6.4.3 Basis for draft recommendation

If a large retailer failed, the increase in credit support required by the designated ROLR could be very significant. It may be difficult to organise within the timeframe currently required, even if the designated ROLR is otherwise solvent. This is a key factor contributing to the risk that the failure of a large retailer could lead to the subsequent failure of a designated ROLR, and financial contagion in the NEM.

Increase in required AEMO credit support

Precise information about the current level of the MCL for different retailers in the NEM is not publicly available, given the confidentiality of retail market shares. However, if we assume that a retailer supplying 20 per cent of NEM demand fails, the ROLR that acquires all these customers could face an increase in its MCL of

$250 million to $1 billion, depending on the average prices assumed in the MCL calculation.[57]

This means even if customers are split between two designated ROLRs, as is more likely in practice, they may each face an increase in their MCL of up to $500 million, if the failure follows an extended period of high spot prices.

These numbers are particularly high because the designated ROLR will inherit the failed retailer's load but none of its generation or hedging. A retailer's credit support requirements are reduced in light of the load it has hedged through its own generation or hedge contracts with other generators.

The designated ROLR must also post cash or credit support to meet its trading limit. If it acquires an additional 20 per cent of NEM demand following the failure of a large retailer, this could mean it must obtain a substantial amount of credit support in the days following its appointment as designated ROLR.

In an extreme price period the increase in cash or credit support required to cover the trading limit could be close to $100 million per day (or $50 million per day if the load is split between two ROLRs).[58] If spot prices are extremely high for an extended period and the administered price cap of $300/MWh is applied, the increase in credit support required each day would be less, once the administered price cap applies, but still in the region of $30 million (or $15 million each if there are two ROLRs).

It is possible that an otherwise solvent designated ROLR could fail to meet these obligations in the time currently allowed. Should that occur, AEMO is entitled to issue the designated ROLR with a default notice on the same day. Failure to respond to the default notice within 24 hours could result in suspension of the designated ROLR. This outcome would trigger a second ROLR event, and potentially a cascading effect in which retailers are progressively suspended after being designated as ROLRs.

The proposed changes to credit support requirements over a transitional period would allow the designated ROLR to take up its new customers without having to bear the immediate risk or cost of sharply increased credit support requirements, thereby reducing the likelihood of cascading retailer failure.

It would also encourage more retailers to offer to be additional ROLRs, knowing they would have more time to secure additional credit support. This would increase the potential for multiple ROLRs, allowing a spreading of the financial obligations across several retailers and thereby reducing the risk of cascading retailer failure further.

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57 Based on relatively low spot prices over the previous 12 months, the increase in the MCL (using the current methodology to calculate MCL) would be around $250 million, and under more typical spot prices it would be around $500 million. If average prices are high over the previous 12 months ($100/MWh) it would be closer to $1 billion. Under the new MCL methodology to be introduced in late 2013, the increase in MCL for a retailer supplying 20 per cent of NEM demand is likely to be closer to $500 million.

58 This assumes an average spot price of $1,000/MWh. This is an extreme scenario that has never occurred in the history of the NEM, but the failure of a large retailer is unprecedented. The price assumed is well below the maximum price limit in the spot market of $12,900/MWh.

It is also likely to give financiers of default ROLR businesses added confidence that the ROLR framework does not cause a material threat to the ongoing solvency of the business. This benefit would flow from the fact that the designated ROLR would have sufficient time to find a suitable bank guarantee on reasonable terms when called on to provide the last resort service.

Impact on generators

The decrease in the amount of collateral held by AEMO over the transitional period raises the possibility that, if the designated ROLR collapsed and was unable to pay AEMO, generators may be short-paid.

However, this concern needs to be balanced against the following factors:

- Cascading retailer failure would seriously undermine the prospect of generators being fully paid. This recommendation aims to mitigate the risk of cascading retailer failure, so there is a balance between the risk of non-payment due to reduced credit support requirements, and the risk of non-payment due to the sequential failure of several retailers.
- Since generators benefit from measures to mitigate the risk of contagion, it is appropriate that they share some the costs of mitigating this risk.
- The recommended changes to credit support aim to ensure that an otherwise solvent ROLR does not fail simply because it is not feasible to organise a large amount of additional credit support within the very short period of time currently allowed. It does not aim to keep insolvent retailers in business.
- The longer time period allowed to meet credit support requirements would also provide more time to consider alternatives if it became clear that the designated ROLR would not be able to secure additional credit support in the private sector, such as a government entity posting credit support for the designated ROLR (see section 6.5 below).

On balance we consider that these factors support the recommended change to the ROLR's credit support requirements over a transitional period.

6.5 Allowing the Commonwealth government to offer credit support

Box 6.6: Overview of the draft recommendation

The NER should allow the Commonwealth government to post credit support to AEMO for an initial period after the ROLR event, to meet the increased credit support obligations imposed on the designated ROLR.

6.5.1 Overview of current arrangements

Clause 3.3.2 of the NER sets out the requirement that market participants provide credit support from an organisation that meets the acceptable credit criteria, unless the market participant itself meets the criteria. Clause 3.3.3(a) of the NER specifies that an entity that meets the acceptable credit criteria must be either:

- an entity under the prudential supervision of the Australian Prudential Regulation Authority (APRA); or
- a central borrowing authority of an Australian State or Territory which has been established by an Act of parliament of that State or Territory.

In our view neither the Commonwealth Government (eg through the Treasury) nor a Commonwealth Government entity such as the Reserve Bank of Australia could currently provide credit support to a market participant under clause 3.3.2 of the NER, as neither meets the criteria in clause 3.3.3(a).

6.5.2 The draft recommendation in more detail

The NER would be amended to allow the Commonwealth government to provide credit support. While it would *enable* the Commonwealth government to provide credit support, it would not *oblige* the government to provide credit support. It adds another mechanism to the toolbox of possible responses in the event of a large retailer failure and ROLR event.

The NER would be amended to insert a general ability for the Commonwealth government to provide credit support to AEMO, provided that it meets the other conditions for credit support in clause 3.3.2 of the NER.

The terms and conditions of any credit support would be determined at the time. However, we envisage it would:

- be a transitional arrangement until the ROLR could secure credit support from a commercial provider; and
- involve charging the ROLR a commercial rate for this service, to encourage the designated ROLR to transition to commercial credit support as soon as possible.

6.5.3 Basis for draft recommendation

This recommendation provides another option to address the risk that the designated ROLR could not obtain the increase in credit support needed due its increased customer load following a ROLR event, within the timeframe required by AEMO. If the government provided credit support for an initial period, the designated ROLR would have more time to obtain commercial credit support to commence at the end of that initial period. This reduces the likelihood that the designated ROLR would be unable to meet its credit support obligations following appointment and trigger a second ROLR event, and potential cascading failure.

As discussed in section 4.2.1, the NER currently allows State and Territory central borrowing authorities to post credit support. Adding the Commonwealth government provides an additional option for a last resort government response. It may also be more appropriate for the Commonwealth to post credit support where a ROLR event affects customers in several jurisdictions, as would be likely if a large retailer failed.

This recommendation is likely to have most benefit in reducing cascading retailer failure if it is combined with the recommendation to allow a transitional period for ROLRs to meet AEMO's credit support requirements (described in section 6.4). Governments are likely to need time to assess the situation before agreeing to post credit on behalf of a ROLR.

There are a number of requirements under the NER that must be met by an entity providing credit support, which would need to be met by the Commonwealth government. For example, the person providing credit support needs to have an acceptable credit rating.[59]

We note that AEMO requires that any guarantee be provided in the form of the pro forma guarantee prepared by AEMO and published on its website.[60] In particular, AEMO currently requires that 60 per cent of the value of all guarantees posted to AEMO must be able to be called within 60 minutes of a demand from AEMO.[61]

This requirement is necessary due to the need to use the money to pay for settlements to generators on the same day that the call-down is made. The Commonwealth government would need to ensure it had a process in place that allowed them to meet this requirement should they be called on to pay out under the guarantee.

The risk that this government support could lead to moral hazard will be minimised if it is seen as a short-term, transitional measure that is available only until commercial credit support arrangements can be put into place. It is not designed to prop up an insolvent business, but to assist an otherwise solvent ROLR from failing because of its sharply increased obligations immediately after being appointed the ROLR.

This recommendation has the potential to address some but not all the sources of cascading retailer failure. If the ROLR fails despite receiving credit support, this could result in a large liability for the relevant government entity, with no mechanism currently in place to recover the costs from customers. For this reason we do not see this recommendation replacing the role of a special administration regime in some circumstances, as discussed in chapter 5.

59 NER, clause 3.3.2.

60 See http://www.aemo.com.au/en/Electricity/Settlements/Prudentials/AEMO-Credit-Support.

61 AEMO, *AEMO Credit Support Management Guide*, available at http://www.aemo.com.au/en/Electricity/Settlements/Prudentials/~/media/Files/Other/corporate/2530-0001%20pdf.ashx.

7 Operational refinements to the ROLR arrangements

Our review does not encompass a complete evaluation of the ROLR arrangements or the operational functionality of those arrangements, which have been the topic of several studies by other parties in recent years. Nonetheless, several submissions have suggested that refinements to aspects of the operation of the ROLR scheme could have benefits through reducing the risk of an initial retailer failure leading to the failure of other businesses in the NEM. The refinements discussed in this chapter do not require any changes to legislation or the NER, so they can be adopted independently of our other recommendations.

These refinements relate to:

- improvements to the process of transferring customers to the designated ROLR, including the availability of accurate customer data; and
- informing and encouraging large customers to nominate their own back-up retailer in case a ROLR event occurs.

In addition, in its submission to the options paper AEMO discussed the possibility that a market participant could be partially suspended from the NEM, and the potential implications in terms of system security and financial contagion in the NEM. Partial suspension would mean that, for example, the retail activities of a vertically-integrated business could be suspended from the NEM (and initiate a ROLR event) while the generation activities of the business continued to supply energy to the market. We discuss this issue and the inter-related issue of the NER prohibition on trading in the NEM while in external administration in section 7.3 below.

7.1 Improvements to ROLR processes

Box 7.1: Draft recommendation

AEMO and the AER should continue to investigate the scope for further improvements to ROLR processes, including ensuring that updated standardised customer data is available, and that systems are capable of efficiently transferring customers to new retailers if a ROLR event occurs.

The designated ROLR takes on a range of obligations and risks when it is appointed. It must act quickly to arrange additional credit support and put hedges in place so that it is not fully exposed to the spot price in relation to its new customer load. Its ability to negotiate appropriate hedge contracts will depend on its knowledge of the characteristics of the customer load it is acquiring, including the level and pattern of demand. The challenges faced by the designated ROLR are greater if the failed retailer was large, as a large number of customers will be transferred to the designated ROLR(s).

Even though there is likely to be long term value in acquiring the additional customers, the immediate challenges faced be the ROLR cause significant risk. These risks will be reduced if there is an efficient information and transfer process. This would enable the designated ROLR is to assess quickly the characteristics of the customers it has acquired, import the new customers into its internal customer databases, and begin communicating with and billing its new customers.

As noted in Origin Energy's submission to the options paper, the ROLR's ability to efficiently absorb customers will be improved if it has access to standardised customer information. Origin also noted that gas retailers must provide AEMO with an updated data file with customer information each month, which is not required in the electricity sector.[62] There is no central repository for customer information in the NEM, which relies on "B2B" (business to business) transfer of customer information between retailers and distributors.

The smooth transfer of customers to the designated ROLR will also depend on the extent to which AEMO's systems can transfer a large number of customers in a short period of time.

The availability of improved customer information would also assist the AER in its task of deciding which retailer(s) to appoint as designated ROLR(s). This would allow the AER to provide information to potential ROLRs in any auction process. It would also provide better information for the AER in determining which retailer(s) are best placed to manage the obligations imposed by acquiring additional customers.

7.2 ROLR arrangements for large customers

Box 7.2: Draft recommendation

The AER and AEMO should ensure that large customers are informed about their right to "opt out" of the ROLR arrangements and nominate their own back-up retailer in case of a ROLR event, and informed of the potential benefits of doing so.

Under the NERL a large customer can opt out of the normal ROLR arrangements and reach agreement with a retailer (the "nominated retailer") to become its retailer if a ROLR event occurs.[63] The large customer and the nominated retailer agree the terms and conditions of supply, and both the large customer and the nominated retailer must notify AEMO of their arrangement in writing.

The benefit to a large customer of entering such an arrangement is that it can gain greater certainty of the terms and conditions under which it will be supplied, and by whom, if it is affected by a ROLR event. In the absence of an agreement with a nominated retailer, a large customer affected by a ROLR event will be transferred to the designated ROLR.

62 Origin submission to options paper, p9.

63 NERL, section 140(7).

The NERL does not set out specific terms and conditions under which a large customer will be supplied by the designated ROLR, but requires them to be "fair and reasonable".[64] This contrasts with small customers transferred in a ROLR event, who must be supplied under the terms and conditions of the designated ROLR's standard retail contract, at the standing offer price (adjusted for any ROLR cost recovery amount).[65]

While the terms and conditions of supply by the designated ROLR to large customers must be fair and reasonable, there is no certainty as to exactly what this might mean. The designated ROLR must publish the terms and conditions of supply to large customers on its website,[66] but they may not be known very far in advance of the ROLR event. A "fair and reasonable" price could, for example, mean the pass through of spot market prices, plus a margin, as is explicitly permitted under some jurisdictional ROLR schemes. If a ROLR event occurs in an extreme price period, there could be a significant impact on the large customer.

Large customers may benefit from negotiating with a retailer to become their nominated retailer before a ROLR event occurs. They may be able to agree more favourable terms in advance than those that would apply if they are supplied by a designated ROLR, and they can achieve more certainty.

Encouraging large customers to nominate their own ROLR also offers more widespread benefits. By reducing the size of the customer load that is transferred to the designated ROLR, it will reduce the additional credit support required by the designated ROLR, and spread the responsibility for the ROLR customer load among a number of retailers. This reduces the risk of the designated ROLR experiencing financial distress as a result of the ROLR event.

It will also reduce the overall scope of government support required if the government decides to post credit support for the designated ROLR. Depending on the detailed arrangements put in place, it may also reduce the scope of government backing required if a special administration scheme is introduced.

It is likely that most large customers are not aware of the ROLR opt-out provisions in the NERL. We recommend that the AER and AEMO ensure that large customers are made aware of their right to nominate a ROLR, and the potential benefits to them of providing more certainty over the terms and conditions of supply following a ROLR event.

64 NERL, section 146(3).

65 NERL, section 145.

66 NERL, section 146(3).

7.3 Partial market suspension

Box 7.3: Issue for submissions

The Commission welcomes stakeholders' views on the provisions for partial suspension in the NEM, and their potential application following the failure of a large vertically-integrated participant. The Commission would also welcome stakeholders' views on whether there are circumstances where it would be appropriate to allow a market participant to continue trading when it is in external administration.

In its submission to the options paper, AEMO raised concerns about the implications for the NEM of a retailer failing when it is part of a vertically-integrated business that also operates as a generator in the NEM. As AEMO states, "the process of ROLR is only designed to manage the transfer of retail customers, and there is no mechanism in the NEM for ongoing operation of the generation when a business is insolvent or suspended".[67]

As discussed in chapter 5, if a vertically-integrated business with substantial retail and generation activities was suspended from the NEM, it could have a significant impact on the generation side of the market as well as the retail side. The NEM could be affected by a substantial reduction in supply resulting in high prices, and an increased risk of contagion.

The NER give AEMO some discretion to partially suspend a market participant, depending on the circumstances. For example, AEMO could suspend the retail activities of a vertically-integrated business if a default event occurs, but allow its generation activities to continue.[68] However, partial suspension is only possible where allowing the market participant to trade in respect of some of its operations would not be contrary to other provisions of the NER. As a result, it is only possible in some circumstances, and not if the business is in external administration.[69]

Allowing a generator to continue operating while in administration may offer some benefits in the very short term after a ROLR event occurs. It would ensure that the suspension of a retail business would not automatically result in the immediate loss of supply to the NEM.

However, partial suspension of a participant that was in external administration would create significant risks. Usually an administrator is required to act in the best interests of creditors, which may not be consistent with the best interests of NEM customers or

67 AEMO submission to the options paper, p5.

68 Clause 3.15.21(c) allows AEMO to issue a suspension notice and requires that the notice specify the extent of the suspension. Clause 3.15.21(g) provides that a market participant that is suspended is ineligible to trade in the NEM "to the extent specified in the notice". Where a market participant is registered as both a market customer (ie, retailer) and market generator, this clause may allow AEMO to suspend the participant's ability to trade as a market customer but allow it to continue trading as a market generator, depending on the circumstances.

69 NER, section 3.3.1.

the NEO. If a business is in administration there will be a significantly increased risk that it will not pay the full amount for its energy purchases to AEMO. That creates a significant risk of short payment to generators.

We would welcome stakeholder submissions on whether there are any circumstances in which the current NER prohibition on trading while in external administration should not apply. In chapter 5, we note that this provision should not apply to the special administration regime, because the government funding aspect of the regime means that there is not an increased risk that AEMO will not be paid. We are interested in views regarding whether there are other circumstances in which this prohibition may not be appropriate and an exception to the prohibition could provide benefits in mitigating contagion risks.

Due to the limited circumstances in which it is available, we do not believe that partial suspension offers a comprehensive solution to the risk of contagion following the suspension of a large vertically-integrated retailer in the NEM.

We agree with the conclusion reached in AEMO's submission, that the framework designed to mitigate the risk of financial contagion in the NEM must deal explicitly with any generation operated by the failing business. We consider that the most effective way to resolve these complexities is the introduction of a special administration scheme, as discussed in chapter 5.

We would welcome stakeholder views on these issues.

8 Next steps and implementation requirements

This report has focussed on measures that will reduce the risk that the failure of a large retailer and subsequent ROLR event could lead to cascading retailer failure and financial contagion in the NEM. Table 8.1 summarises our draft recommendations to SCER and the action that will be required to implement them, if they are confirmed in our final report and agreed by SCER.

Our draft recommendations involve a range of measures:

- Further investigation of a special administration regime as an alternative to the ROLR scheme for large retailers in the NEM, as discussed in chapter 5.
- Changes to the ROLR scheme and AEMO credit support arrangements, which are discussed in more detail in chapter 6.
- Operational refinements to the ROLR scheme, discussed in chapter 7.

The Commission welcomes stakeholder views on the issues raised in this report, and on the measures proposed in the draft recommendations. We will also seek submissions on a second interim report in late 2013, which will consider other potential causes of financial contagion, as outlined in chapter 1. In light of the analysis undertaken and the input received in submissions to the two interim reports, the Commission will develop its final recommendations and advice to SCER. We expect to publish the final report by the end of 2013.

Following consideration by SCER of the Commission's final recommendations, the next steps required to implement these measures - if they are agreed by SCER - would vary significantly in terms of:

- the extent to which changes would be required to the NER, or to electricity sector legislation, or to broader legislation;
- the degree to which further analysis of the costs and benefits of the draft recommendation needs to be undertaken; and
- the period of time that is likely to be required to implement the recommendation.

Further investigation of a special administration regime is likely to involve a range of parties, both within and outside the electricity sector, as noted in table 8.1. This reflects the complex nature of the proposal, the need for government funding as part of the regime, and the requirement for new legislation that extends beyond the electricity sector.

The proposed changes to the ROLR scheme require amendments to the NERL. They are more straightforward to design and implement than the special administration regime. Nonetheless they may take some time to put into effect, given the need for jurisdictional agreement and the passage of legislative amendments.

We note that the implementation of some of the measures proposed in this report can be initiated by other parties, independently of our review. In particular, the operational refinements to the ROLR scheme discussed in chapter 7 can be progressed by AEMO and the AER as part of their ongoing efforts to improve the effectiveness of the ROLR arrangements.

In addition to seeking stakeholder views on our draft recommendations, the Commission welcomes views on the issues raised in section 7.3 relating to the NER provisions regarding partial suspension and trading while in administration.

Table 8.1 Summary of draft recommendations and implementation requirements

Issue and relevant section of report	Draft recommendation	Implementation requirements following final report
Chapter 5: Special administration regime		
Chapter 5	Further work should be undertaken to assess the costs and benefits of developing and implementing a special administration regime, as an alternative to the ROLR scheme for large retailers in the NEM.	If SCER agrees that further work should be undertaken on the special administration regime following our final report, it should commission an appropriate body to complete that work, in consultation with the relevant arms of government. Further analysis needs to be undertaken into the detailed design of a special administration regime and the costs and benefits that are likely to result from its introduction. Implementing a special administration regime would require new legislation, or a package of legislation. This may include changes to electricity legislation, new State co-operative legislation, Commonwealth legislation and an intergovernmental agreement, as discussed in chapter 5. The legislative changes and funding requirements of a special administration regime extend beyond the electricity sector. For this reason its assessment, design and implementation is likely to involve a range of parties, both within and outside the electricity sector, whose interests are affected by the proposal.

Issue and relevant section of report	Draft recommendation	Implementation requirements following final report
Chapter 6: Changes to the ROLR scheme and credit support arrangements		
6.2: Revised cost recovery arrangements	The existing ROLR cost recovery provisions should be amended to give the designated ROLR greater certainty that it can quickly recover the reasonable costs associated with a ROLR event.	Amendments to the NERL to: • remove the reference to the registered ROLR bearing some of the costs, in proportion to its customer base; • provide a list of specified types of costs that the ROLR has the right to recover in relation to a ROLR event (without limiting cost recovery to the specified items); • specify a period during which these costs can be claimed; and • specify clear timeframes for the AER to determine a compensation claim for the designated ROLR and for payments to be made to the ROLR via the cost recovery mechanisms outlined in chapter 6.
6.3: Delayed designation of ROLRs	The ROLR regime should be amended to delay the time at which the designated ROLR is appointed by the AER, to allow a more considered allocation of customers and greater potential for multiple ROLRs. The designated ROLR's appointment would still be backdated to the time of the original ROLR event and it would still be held financially responsible for the acquired customers from that date.	This recommendation would require a distinction to be made between the following dates, which currently occur simultaneously under the NERL ROLR provisions: • the date that the ROLR event occurs; and • the date that the designated ROLR is appointed. The NERL would need to be amended to specify that the AER must advise AEMO of the identity of the designated ROLR within 24 hours of a ROLR event. Amendments would also be required to AER/AEMO protocols to ensure consistency with NERL timeline.

Issue and relevant section of report	Draft recommendation	Implementation requirements following final report
6.4: Amendments to AEMO credit support provisions	The increased credit support required to be provided by the designated ROLR to AEMO for the new energy volumes of the acquired customers should be waived for a short time, and then ramped up over a transitional period.	Amendments to the NER to insert a minimum time before AEMO can require increased credit support from the designated ROLR reflecting its increased customer load, as follows: • 1 week "period of grace" following a ROLR event, where the designated ROLR would not need to provide additional credit support to meet the revised MCL; and a breach of the revised trading limit would not trigger a call notice; • following the period of grace, the MCL would be increased in increments over a 4-week period.
6.5: Allowing the Commonwealth government to offer credit support	The NER should make provision for the Commonwealth government to post credit support to AEMO for an initial period after the ROLR event, to meet the increased credit support obligations imposed on the designated ROLR.	Amendments to the NER to make provision for the Commonwealth to provide credit support on behalf of the designated ROLR. There are a number of requirements under the NER that must be met by an entity providing credit support, which would need to be met by the Commonwealth government.
Chapter 7: Operational refinements to the ROLR scheme		
7.1: Improvements to ROLR processes	AEMO and the AER should continue to investigate the scope for further improvements to ROLR processes, including ensuring that updated standardised customer data is available, and that systems are capable of efficiently transferring customers to new retailers if a ROLR event occurs.	No changes to legislation or the NER. Action can be taken by AEMO and the AER immediately.

Issue and relevant section of report	Draft recommendation	Implementation requirements following final report
7.2: ROLR arrangements for large customers	The AER and AEMO should ensure that large customers are informed about their right to "opt out" of the ROLR arrangements and nominate their own back-up retailer in case of a ROLR event, and be informed of the potential benefits of doing so.	No changes to legislation or the NER. Action can be taken by AEMO and AER immediately.

Abbreviations

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AFS	Australian Financial Services
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
COAG	Council of Australian Governments
Commission	See AEMC
DNSP	distribution network service provider
DNSPs	distribution network service providers
ESAA	Energy Supply Association of Australia
MCE	Ministerial Council on Energy
MCL	maximum credit limit
MWh	megawatt hour
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Electricity Rules
OTC	over-the-counter
ROLR	retailer of last resort
SCER	Standing Committee on Energy and Resources

A Summary of submissions to options paper and AEMC response

The following table summarises the issues raised in submissions to the options paper, and the Commission's response to each of these issues. The issues have been organised for consistency with the chapters in the options paper.

The submissions are available on the AEMC website at www.aemc.gov.au

Stakeholder	Issue raised in submission	AEMC response
SUMMARY OF RISKS		
AEMO	If a retailer is large, the ROLR scheme is likely to cause financial distress instead of protecting consumers. A last resort government response is needed where the customer base is large. Enhancements to the ROLR scheme are not sufficient. The ROLR scheme doesn't manage the generation part of business.	As noted elsewhere in this report, the Commission considers the risk of a large retailer failing is low, but the consequence for the market and customers if it occurred could be significant. The Commission also agrees that while the ROLR arrangements are likely to be effective in managing the failure of small retailers, if a large retailer failed they are likely to exacerbate the risk of further retailer failures. These considerations underlie the Commission's draft recommendations for changes to the ROLR scheme, and consideration of a special administration scheme. The Commission notes the concerns raised by
AGL	The possibility of retailer failure is remote, but the risk is increased by retail price regulation, which inhibits efficient pass through of costs. Retail prices should be deregulated; smart meters introduced on contestable basis; time-varying tariffs adopted; with safeguards for hardship customers.	
Alinta	The financial relationships underpinning the NEM are robust. Little evidence that financial risks can be removed via regulation. Market shortcomings are driven by regulatory interventions, risks arise from retail price regulation and climate change policies.	
Ausgrid	Considers the AEMC paper underestimated the risk and consequences to DNSPs following the collapse of a large retailer. DNSPs should not assume the commercial risks of retailers - a more appropriate approach would be to embed a framework of risk mitigating strategies in regulation. The most effective way of mitigating the potential credit and cash flow impacts from a retailer failure is through having credit support obligations which can be enforced.	

<table>
<tr><th>Stakeholder</th><th>Issue raised in submission</th><th>AEMC response</th></tr>
<tr><td>Energy and Water Ombudsman NSW (EWON)</td><td>The flow-on effects of retailer failure include increased workload and financial impact on energy ombudsman schemes. Sudden failure of major retailer could put ombudsman schemes at financial and operational risk.</td><td rowspan="6">submitters regarding risks to other parties, such as network businesses and ombudsman schemes, as well as risk management of OTC electricity derivatives.

As noted in chapter 1 of this report, the first interim report focusses on measures to mitigate the risk of contagion following the financial distress of a large retailer and ROLR event. This reflects analysis that the failure of a large retailer and ROLR event, while unlikely, was the most likely scenario to cause a risk of contagion and should therefore be our first priority.

The second interim report will consider other potential causes of financial contagion. In accordance with SCER's request for advice, our analysis will be limited to risks that could threaten market stability and the achievement of the NEO. It will not extend to measures designed to prevent the failure of an individual market participant where that failure is unlikely to cause broader financial contagion.

A specific issue that will be considered is application of the G20 OTC reforms.

The Commission has noted the concerns expressed by EWON in relation to the impact of retailer failures on the energy ombudsman schemes.</td></tr>
<tr><td>Energy Australia</td><td>Financial markets underpinning the NEM are robust. Risks associated with large retailer failure primarily result from ROLR schemes. Contagion risk is exacerbated by transferring costs and risks to other retailers or generators.</td></tr>
<tr><td>Energy Retailers Association of Australia (ERAA)</td><td>Agree that financial relationships underlying NEM are generally robust. Agree that ROLR arrangements could be improved. The ROLR takes on broad responsibilities, not just credit support, eg, billing, debt collection, compliance. The scale involved means the only viable solution if a large retailer fails is for an independent third party to provide public backing to the ROLR.</td></tr>
<tr><td>Energy Networks Association (ENA)</td><td>The key issue for DNSPs is the credit risk and cash flow from supplying a small number of big retailers. ROLR is unlikely to work for large retailer.</td></tr>
<tr><td>Energy Supply Association of Australia (ESAA)</td><td>Since the probability of financial contagion is low, proposed changes should reflect this. Any changes should place a low burden on the sector and not introduce distortions.</td></tr>
<tr><td>GDF Suez</td><td>Agrees that financial relationships in NEM are generally robust, and the risk of financial contagion is low. The NEM has absorbed financial shocks without significant disruption. Recommendations should be commensurate with low risk of occurrence. Financial contagion cannot be mitigated while risks are simply transferred between market participants - government must fulfil this role.</td></tr>
</table>

Stakeholder	Issue raised in submission	AEMC response
Lorne Franks	Concerned about AEMC's view that there is a low probability of financial contagion in the NEM. Other regulators (AER, ASIC) have raised issues about risk management in OTC electricity derivatives market; potential need for G20 requirements. Need to consider regulatory options that reduce risk of crisis, not just 'last resort' options of ROLR or government bailout.	
National Generators Forum (NGF)	Agrees that there is low probability of financial contagion. Any changes to NEM should be proportional to the overall risk of financial contagion and should not place unmanageable risks on market participants.	
Origin	Agrees that financial relationships underpinning NEM are generally robust. Collapse of ROLR following tier 1or large tier 2 retailer is the highest risk for contagion.	
Victorian Department of Primary Industries (DPI)	Agrees that the failure of a large retailer is a low probability but severe impact event. Endorses AEMC focus on failure of a large retailer and ROLR event.	
OPTIONS TO IMPROVE THE ROLR REGIMES: Revised cost recovery arrangements		
AER	Supports the recovery of efficient costs. Notes there is an inherent tension between reducing uncertainty of cost recovery, and ensuring that cost recovery is limited to efficient costs. Considers that regulatory assessment is necessary to determine efficient costs to be recovered.	The Commission has recommended the revision of cost recovery arrangements - see section 6.2 for further information. The Commission's draft recommendation is that existing ROLR cost recovery provisions
AGL	Supports more certain cost recovery arrangements.	

Stakeholder	Issue raised in submission	AEMC response
Alinta	Supports greater certainty that the designated retailer of last resort can quickly recover costs. Believes that greater clarity is required regarding the process for cost recovery applications; the right for recovery of reasonable costs; period for cost recovery, and clear timelines for regulatory determination of recoverable costs. Also concerned about the possibility of lumpy charges for cost recovery, which may be counterproductive. Suggests this may be best managed by locking in customers for 6 months to the ROLR.	should be amended to give the designated ROLR greater certainty that it can quickly recover the reasonable costs associated with a ROLR event. This recommendation would reduce the financial uncertainty faced by the designated ROLR(s). It is likely to increase the appetite among retailers to offer to act as additional ROLRs, which would spread the burden of the ROLR obligations, and thus the risk of cascading failure. Greater certainty of cost recovery is also likely to improve the ROLR's ability to obtain financing and increased credit support. The AER would retain the ability to review whether the ROLR's costs are reasonable. We consider this offers an appropriate balance between prescription and discretion in relation to cost recovery.
Ausgrid	Supports clarity regarding the types of costs that can be recovered through the ROLR scheme, clear timeframes, and consistency across jurisdictions. Considers that AER discretion may undermine confidence in the likelihood of cost recovery. Also, concerned about the operation of the distributor payment determination as a cost recovery mechanism. Suggests that a mechanism be created that would allow a DNSP to adjust its prices before the next annual pricing proposal if it is more than 6 months away.	
Energy and Water Ombudsman Victoria (EWOV)	Concerned about the impact of cost recovery fees on residential customers; concerned about increase in customer complaints to EWOV. Recommends one-off fixed recovery fee set by regulator, to provide incentive to minimise costs.	
Energy Australia	Tariffs should support full cost pass through. ROLR needs certainty of timely cost recovery - critical to support funding. ROLR costs should be recovered from ROLR customers as far as practicable; remaining costs should be recovered through network charges recovered from all customers in that jurisdiction.	
ENA	NECF rules for cost pass-through have created uncertainty regarding cost recovery.	
ESAA	Considers that the ROLR should have clear rights to recover all costs of performing ROLR duties, within defined short timeframe. Considers that retail prices should be deregulated. ROLR costs for large customers should be recovered directly from those customers. Costs for other customers should be recovered over the entire NEM or relevant state customer base.	

Stakeholder	Issue raised in submission	AEMC response
GDF Suez	Supports alignment of state ROLR regulations. Considers that cost recovery for the ROLR remains unclear, and this will make it difficult for a ROLR to raise credit support.	
Origin	Considers that a clear process and right for cost recovery is key to making the ROLR commercially viable and attracting retailers to register as additional ROLRs with the AER. Supports efficient cost recovery for ROLR - AER should determine reasonable costs, with clear timeframes.	
DPI	Supports well-designed cost recovery. Since prevention of contagion benefits the whole NEM, there is an argument for recovering costs from all customers. Retail price regulation is a barrier to cost recovery.	
OPTIONS TO IMPROVE THE ROLR REGIMES: Enhanced preparation for a ROLR event		
AER	The AER has a procedures manual for ROLR events. However, this does not address the fundamental concerns such as cascading failure, practical difficulties for the ROLR to absorb large numbers of customers, and the long term impacts on competition.	The Commission has not recommended this option. The Commission recognises the benefit of the procedures and planning undertaken by the AER and AEMO in preparation for a potential ROLR event, and supports further improvements to ROLR processes. In order to encourage greater potential for multiple ROLRs, the Commission has made draft recommendations for revised cost recovery arrangements (see above) and an extension of the time allowed for the AER to appoint the ROLR(s) (see below).
AGL	Warrants further assessment, but AER should not be able to interrogate retailers to inform preparations for a ROLR event.	
Alinta	Supports AER keeping up-to-date nominations from retailers regarding how many customers they can absorb. Does not support giving AER greater powers to prepare for a ROLR event.	
Ausgrid	Supports proposal to explore possibility to appoint multiple designated ROLRs - would reduce risk of contagion. The 'financial resources criterion' performed by the AER in relation to ROLR should be part of an ongoing assessment as part of the retail licensing regime.	
Energy Australia	Regulatory failures associated with ROLR should not be used to justify new regulatory powers or impositions on retailers. ROLR should be structured so that primary method of determining ROLR is voluntary, market led and based on expressions of interest from retailers.	

Stakeholder	Issue raised in submission	AEMC response
ESAA	Supports AER putting in place arrangements to ensure ROLR event goes smoothly, but does not support increased powers for AER as intrusive. Any DNSP options should allow DNSP to recover costs incurred.	
GDF Suez	Does not support wider powers for AER to compel retailers to provide commercially sensitive information.	
Origin	Does not support enhanced role for AER, eg, power to get retailers to provide information at regular intervals. Market based incentives better than regulatory intervention. Limited justification for AER to mandate retailers to participate in the ROLR framework.	
DPI	Supports provision for multiple ROLRs. However, this is not enough to directly mitigate contagion. Also, need to ensure that only a 'manageable' number of customers are transferred to each retailer.	
OPTIONS TO IMPROVE THE ROLR REGIMES: Transfer of the failed retailer's hedge contracts to the designated ROLR		
AGL	Not supported. Poor hedging likely to be linked to initial retailer failure. Also default by retailer would suspend all hedging contracts in place.	The Commission has not recommended this option. The Commission concurs with the view that it would be difficult to transfer hedge contracts to the ROLR, and would interfere in the commercial transactions of market participants. The cross-default provisions prevalent in hedge contracts are likely to mean that the contracts could not readily be transferred. As discussed in chapter 5, a special administration regime - if introduced - would
Alinta	Not supported. Raises cross-default risk, may involve taking property, requires legislation, and likely to increase risk of cascading default.	
Energy Australia	Not supported - complex and impractical, increases uncertainty and delivers little or no benefit.	
GDF Suez	Not supported - introduces third parties into an already costly process.	
NGF	Not supported. Inconsistent with Corporations Act and a fundamental change to Corporations law. Undermines the integrity of the market and does not support good market governance processes.	

Stakeholder	Issue raised in submission	AEMC response
Origin	Not supported. Imposes obligations on counterparties outside current market frameworks. Hedge contracts unlikely to be in the money. Likely to trigger a credit event that would void the contract. Likely to be in neither parties' interests to have contract transferred.	support the continuation of the failing retailer's contractual obligations such as hedge contracts while the administration is in place, and avoid use of the ROLR scheme.
DPI	On balance not supported. It addresses a key source of contagion, but there are commercial/legal impediments. AEMC should consider an alternative mechanism to provide hedge cover to the ROLR, on a transitional basis, for some or all of the failed retailer's load.	
OPTIONS TO IMPROVE THE ROLR REGIMES: Amending the ROLR event triggers		
AER	If AEMO advises this is feasible, it would be useful to explore further. While some risk may transfer to generators, in the event of a large retailers failure all industry participants will need to bear some risk. Unlikely to change risk profile of generators significantly.	The Commission has not recommended this option. The Commission considers that other options are preferable to manage the risk of cascading retailer failure, such as delaying the designation of the ROLR(s) (see below).
AGL	Not supported. Transfers risk to generators, who may not be able to manage the risk.	
Ausgrid	Agrees with potential benefits of delay but is concerned about operational and customer service implications if delay is greater than 7 days. Transfers risk from the ROLR to DNSPs.	
Energy Australia	May have benefit if it allows a more market driven response, but this needs to be balanced against the costs in relation to prudential requirements - AEMO may need to increase credit support requirements. This option may be more beneficial if combined with options for enhanced use of administration and guarantees.	
GDF Suez	Not supported. Delays the process while transferring risk to generators.	
NGF	Raises market governance issues as a potentially insolvent retailer continues to operate and accrue liabilities, and extends the period of uncertainty for participants. Cross default provisions of ISDA agreements allow parties to close out transactions where a counterparty defaults to third party, so delayed designation of ROLR would not delay actions being taken against retailers under ISDA agreements.	

Stakeholder	Issue raised in submission	AEMC response
Origin	Not supported - extends settlement cycle and increases prudential requirements on retailers. Increases liabilities for ROLR while they cannot hedge for them, and could lead to short payments to generators or credit support via bank guarantees.	
DPI	This option could work for a modest retailer failure but not a large retailer failure, so not supported - would substantially increase risk for other market participants. Would need to be part of a bigger package, eg, credit support guarantees as part of administered arrangement.	
OPTIONS TO IMPROVE THE ROLR REGIMES: Delayed designation of ROLRs		
AER	Worthwhile to explore this option further, in consultation with AEMO. It would be useful for all retailer failures, not just large retailer failures. May reduce likelihood of relying on default ROLR arrangements. However, this may still not help with absorbing large numbers of customers.	The Commission has recommended an extension in the time before the designated ROLR is appointed by the AER, to allow a more considered allocation of customers and greater potential for multiple ROLRs - see section 6.3. The Commission recognises this recommendation has some implications for the allocation of risk, but considers this is outweighed by the potential benefits of the proposal, particularly the increased scope for multiple ROLRs to be appointed. The length of the delay recommended by the Commission is only one day, which would limit the risk allocation implications of the delay and is significantly shorter than the potential delays discussed in the options paper.
AGL	Warrants further assessment. May provide better spread of risks between market participants. Also designating several ROLRs could dilute the burden on ROLR.	
Alinta Energy	Not supported, given related prudential changes that would be required. Could allow better management of failed retailer, but introduces more risk.	
Ausgrid	Ausgrid agrees with potential benefits of delay but is concerned about operational and customer service implications if delay is greater than 7 days. Transfers risk from the ROLR to DNSPs.	
Energy Australia	May have benefit if it allows more market driven response, but this needs to be balanced against the potential costs in relation to prudential requirements, since AEMO may need to increase credit support requirements.	
ESAA	Delaying appointment of ROLR could allow more accurate picture of failed retailer's customers and allow more time to arrange ROLR credit, and facilitate ROLR nomination from other retailers. Alternative to delaying appointment of ROLR could be for AEMO to guarantee the ROLR component of wholesale market payments.	

Stakeholder	Issue raised in submission	AEMC response
GDF Suez	Not supported. ROLR ends up with more risk.	
NGF	Raises market governance issues as a potentially insolvent retailer continues to operate and accrue liabilities, and extends period of uncertainty for participants. Cross default provisions of ISDA agreements allow parties to close out transactions where counterparty defaults to third party, so delayed designation of ROLR would not delay actions being taken against retailers under ISDA agreements.	
DPI	Not supported. Marginal value while adding complexity and uncertain outcomes. Does not support auctioning to allocate customers - complex solution given time constraint.	
OPTIONS TO ADDRESS THE ROLR'S INCREASED CREDIT SUPPORT OBLIGATIONS		
Momentum Energy	Does not support policy options requiring the adjustment of financial settings in the market.	See below.
DPI	Not supported - considers these options are not proportionate. Considers generators will price the risk of reduced prudential quality, resulting in cost impacts in the normal operation of the NEM and financial markets, ie, not well targeted.	
OPTIONS TO ADDRESS THE ROLR'S INCREASED CREDIT SUPPORT OBLIGATIONS: Amendments to AEMO credit support provisions		
AGL	Not supported - transfers risk to generators, who may not be able to manage the risk.	The Commission recommends that the credit support required to be provided by the designated ROLR to AEMO for the new energy volumes of the acquired customers should be waived for a short time, and then ramped up over a transitional period - see section 6.4. The Commission's analysis suggests that if a
Alinta	Does not support waiving or delaying credit support arrangements unless there is complete assurance that short payments can be recovered. Exposes generators to risk and exacerbates risk of cascading default.	
Energy Australia	Not supported - transfers cost and risk to generators, complex to administer. Could be supported if AEMO absorbed credit risk rather than passing on to generators, but AEMO would need to maintain line of credit and be able to recover costs from consumers.	

Stakeholder	Issue raised in submission	AEMC response
GDF Suez	Not supported - risks are transferred to generators. Undermines the purpose of AEMO prudential requirements.	large retailer failed, the increase in credit support required by the ROLR would be significant, particularly in an environment of high spot prices. Given the short timeframe currently allowed to meet AEMO credit support requirements to avoid market suspension, this could contribute to cascading retailer failure. The Commission recognises that this recommendation may imply a transfer of risk to generators, but considers that the risk of cascading retailer failure also poses a potentially greater risk to generators where a large retailer fails.
NGF	NGF sees this as the most effective and practical proposal. Least distorting option for the market. This is a second stage risk as it relates to the ROLR not the failing retailer. Does not impose additional upfront costs.	
Origin	Enabling ROLR to manage costs and risk of supply while minimising credit support requirements over the initial months should be an objective of the ROLR framework. Step change in credit support for ROLR is significant and could have broad consequences on credit rating, licence requirements, counterparties, etc.	
OPTIONS TO ADDRESS THE ROLR'S INCREASED CREDIT SUPPORT OBLIGATIONS: Amendments to DNSP credit support provisions		
AER	Supports further consideration.	The Commission has not recommended this option. The increase in credit support required by DNSPs is not as great as that required by AEMO, and failure to provide this credit support is not an immediate cause of market suspension. For these reasons the Commission does not consider the DNSP credit support provision to be a major driver of cascading retailer failure. The Commission also notes the comments made by Ausgrid regarding the potential size
AGL	Supported as it reduces ROLR's obligations to DNSPs, assisting ROLR to transition customer load.	
Ausgrid	Concerned that the AEMC has understated the risk and potential consequences to DNSPs from a large retailer failing. Significant direct and indirect costs would be borne by the DNSP. Concerned about options that transfer risk from the ROLR to other market participants. More appropriate to embed risk mitigating strategies in regulation.	
Energy Australia	DNSPs could absorb some costs if they have access to secure timely cost recovery.	
ENA	This option would increase risk to DNSPs, especially as they serve a few large retailers.	

Stakeholder	Issue raised in submission	AEMC response
Origin	Step change in credit support for ROLR is significant and could have broad consequences on credit rating, licence requirements, counterparties, etc. Financial risk to ROLR could be reduced if Commonwealth government underwrote credit support guarantee for the ROLR.	of the risks that could be transferred to DNSPs under this option and the implications for DNSPs.
OPTIONS TO ADDRESS THE DESIGNATED ROLR'S INCREASED COSTS AND RISKS		
Alinta	Does not support market distortions like a spot market cap; transitional tariff; or delayed settlement. They distort the market, transfer risk and wealth, are complex to implement, and harm incentives for dubious benefit. Shorter settlement cycle could reduce risk and benefit market.	The Commission has not recommended and of the options suggested in the options paper that aimed to address the designated ROLR's increased costs and risks, as discussed below.
OPTIONS TO ADDRESS THE DESIGNATED ROLR'S INCREASED COSTS AND RISKS: Spot market price cap		
AER	Should be considered further. If properly formulated it would have negligible distortionary impacts and would not affect incentives to invest, as it would only be triggered in extreme events. Would assist in ensuring that the scale of the problem does not escalate rapidly. Places limit on the rapid escalation of financial obligations, and makes trade sale more feasible with limited government cost.	The Commission has not recommended this option. While a spot market cap would have the benefit of capping financial obligations, it represents a major change to market design, and would have a wide-reaching impact on businesses not immediately affected by the ROLR event.
AGL	Not supported. Significant adverse effect on market; reduces revenue to generators that may not have been linked to the failing retailer.	
Energy Australia	Not supported - transfers cost and risk to generators, complex to administer. Short paying generators or reducing credit quality would exacerbate the risk of contagion.	
GDF Suez	Not supported. Suppresses market signals during periods of scarcity which are essential in an energy-only market; leads to settlement deficit with risks transferred to generators; changes the risk position of all parties linked to the wholesale spot price.	
Momentum Energy	Does not support policy options requiring "adjustment of financial settings in market" due to the broader implications for market participants.	

Stakeholder	Issue raised in submission	AEMC response
NGF	Not supported. Puts generators' profitability at risk. Could present cash flow problems for generators, increasing the overall level of contagion for the sector. Affects market efficiency by distorting long-term price signals for new investment. Complex to implement. Exposes generators otherwise not affected by ROLR event.	
Origin	Not supported. Transfers costs from ROLR to generators. High market cap allows generators to recover the capital cost of investment.	
DPI	Not supported. Significant distortion of the wholesale market, poorly targeted.	
OPTIONS TO ADDRESS THE DESIGNATED ROLR'S INCREASED COSTS AND RISKS: Initial period where the designated ROLR passes through retail prices instead of paying the spot price		
AGL	Not supported. Complex, not readily implemented.	The Commission has not recommended this option. This proposal would be complex to implement. It represents a significant change to market design, with the potential for far-reaching consequences that exceed its likely benefits.
Energy Australia	Not supported - transfer cost and risk to generators, complex to administer. Short paying generators or reducing credit quality would exacerbate the risk of contagion.	
GDF Suez	Not supported - could lead to settlement deficit and further contagion; transfers risk to generators who are less able to manage them.	
DPI	Not supported - highly interventionist and complex.	
OPTIONS TO ADDRESS THE DESIGNATED ROLR'S INCREASED COSTS AND RISKS: Delayed settlement period for the designated ROLR to pay AEMO for energy		
AGL	Supported as assists in transition while delaying financial imposts on ROLR.	The Commission has not recommended this option. The existing settlement cycle may make this
Energy Australia	Not supported - transfers cost and risk to generators, and complex to administer. Short paying generators or reducing credit quality would exacerbate risk of contagion.	

Stakeholder	Issue raised in submission	AEMC response
GDF Suez	Not supported - fails to recognise settlement required by generators. AEMO does not have resources to fund one side of the market.	type of mechanism of little marginal benefit. The designated ROLR already gets at least four weeks to pay for the energy consumed by the acquired customers. This provides an opportunity for the ROLR to organise finance as required.
NGF	Not supported. Puts generators' profitability at risk. Could present cash flow problems for generators, increasing the overall level of contagion for the sector.	
Origin	Not supported. Limited benefit. Would increase settlement cycle and therefore require higher prudential requirements from ROLR. Also transfers costs and risks from ROLR to generators and DNSPs.	
DPI	Not supported - complex and would have marginal benefit in containing contagion. Would reduce prudential quality and hence undermine market integrity.	
OPTIONS TO ADDRESS THE DESIGNATED ROLR'S INCREASED COSTS AND RISKS: Delayed settlement period for designated ROLR to pay network charges		
AER	Supports further consideration.	The Commission has not recommended this option. This option would have limited benefit relative to other options, because there is already a delay before retailers are required to pay network charges. Any immediate financial pressures that might trigger cascading retailer default may have been addressed within this time period. Furthermore, non-payment of network charges does not immediately trigger market suspension, so it is less likely to cause cascading failure.
AGL	Supported as assists in transition while delaying financial imposts on ROLR	
Ausgrid	This would impact DNSP's cash flow, revenue and provisioning, which would impact DNSP credit rating. As the failed retailer can continue to operate for some time before being suspended the DNSP may have two months of outstanding network charges before a ROLR event is declared.	
Energy Australia	DNSPs could absorb some costs if they have access to secure timely cost recovery.	
ENA	This option would increase risk to DNSPs, especially as they serve a few large retailers. Additional revenue risk to DNSPs is not consistent with status as regulated monopoly service provider, and would have indirect impacts relating to investment, risk profile and financing costs.	

Stakeholder	Issue raised in submission	AEMC response
Origin	Not supported. Limited benefit. Would increase the settlement cycle and therefore require higher prudential requirements from ROLR.	
DPI	Marginal benefit to contain contagion and complex. Not supported. Reduce prudential quality and hence undermine market integrity.	
OPTIONS TO ADDRESS THE DESIGNATED ROLR'S INCREASED COSTS AND RISKS: Industry co-insurance fund		
AER	Supports further consideration.	The Commission has not recommended this option. Establishing a fund would be complex, as discussed in detail in the options paper. It involves difficult questions regarding the appropriate size of the fund to ensure it prevents contagion, and the criteria for use of the fund. Furthermore, it involves a direct up-front cost on participants regardless of whether a retailer failure actually occurs.
AGL	Not supported. Difficult to determine funds needed; funds may be redirected to another purpose; would increase retailer costs.	
Alinta	Not supported. Likely to tie up capital unnecessarily; provide wrong incentives; has marginal benefit; and would be unwieldy.	
Energy Australia	The proposed model is not supported - costly, inefficient and complex. However, the key functions may have merit. It may be more efficient to establish a smaller fund to borrow if necessary and recover costs over time.	
GDF Suez	Has some merit, but fund would need to be carefully managed and would rely on money from customers. Even with such a fund a risk remains that the amount of money in the fund would be insufficient and settlement deficit risk remains with generators. Could consider what role the Energy Security Council could play.	
Momentum Energy	Additional charge to customer bill won't be well received. Administration of fund difficult; large fund may be used for other purposes. How would fund be distributed if disbanded? Co-insurance unfair to retailers with risk minimisation strategies. Also sets precedent for other co-insurance schemes, eg, hardship funds. Do not create co-insurance fund	

Stakeholder	Issue raised in submission	AEMC response
Origin	Not supported. ROLR could make a case to AER or AEMO where some costs are not recovered from customers. Consistent with compensation provisions in NER clause 3.15.7 for directed generators.	
DPI	Not supported - unwise to crystallise upfront costs from a low probability high impact event; uncertainty about amount needed, may distort behaviour.	
OPTIONS FOR A LAST RESORT GOVERNMENT RESPONSE		
Alinta	Government intervention should be last resort if not entirely avoided, given the nature of interventions and costs to taxpayers. ROLR is a form of government intervention too and the market could function without it (aided by cost recovery measures).	See below.
Ausgrid	Strongly supports amendments to allow a last resort government response, especially enhanced administration plus government funding.	
OPTIONS FOR A LAST RESORT GOVERNMENT RESPONSE: Government entity posts credit support for the designated ROLR		
AEMO	Neither the Commonwealth government or the Reserve Bank of Australia (RBA) meets the acceptable credit criteria defined in the NER, so would not be able to provide acceptable credit support to AEMO without a rule change. Containment of systemic risk should not rely on unclear regulatory decisions, like AEMO discretion.	The Commission has recommended that the NER make provision for the Commonwealth government to post credit support to AEMO - see section 6.5. While this would provide an option for the Commonwealth government to provide credit support, it would not be an obligation. The provision of credit support on behalf of the ROLR on a transitional basis, addresses the contagion risk that would arise if the designated ROLR was unable to meet
AGL	Warrants further assessment. Government will be focussed on customer needs. But government involvement could dilute commercial incentives and socialise costs, and government funding is likely to lead to more intrusive information gathering powers. Any role for Government should be clearly defined and exercised by independent agency, with costs recovered via network charges or customer levies.	
Alinta	If ROLR is maintained this is the least intrusive option for industry, but exposes customers to cost and risk.	

Stakeholder	Issue raised in submission	AEMC response
Energy Australia	Government is unlikely to provide this in a timely manner. Expensive and impractical; likely to complicate negotiations with commercial credit providers.	AEMO's credit support requirements within the required timeframes following a large retailer failure, which is a key cause of contagion risk.
ERAA	Scale involved means only viable solution is for independent third party to provide public backing to the ROLR. Welcome opportunity to workshop options for Government support.	
GDF Suez	Supported. But it would not be reasonable for last resort involvement to be accompanied by unreasonable actions that distort commercial outcomes or increase regulatory burdens. Ideal model is for govt support for ROLR and for ROLR to be able to recover its costs.	
Origin	Support govt credit support via Treasury or Reserve Bank, but only in extreme, low probability high impact scenario.	
DPI	DPI supports this option - for Commonwealth government, as a last resort.	
OPTIONS FOR A LAST RESORT GOVERNMENT RESPONSE: Enhanced administration arrangements coupled with interim government funding		
AER	Considers that the other options are not sufficient to avoid contagion where a large retailer fails, and that an alternative to ROLR is needed. Supports further consideration of UK special administration arrangements. Agrees with AEMC on the key features of such a regime, and that NEM suspension arrangements may need to be changed to accommodate the functioning of a special administration regime. Benefit in determining in advance how respective governments would respond in a special administration situation.	The Commission has recommended that further work be undertaken to assess the costs and benefits of developing and implementing a special administration regime, as an alternative to the ROLR scheme for large retailers in the NEM - see chapter 5 for more details. The Commission's analysis suggests that changes to the ROLR scheme and credit support requirements are likely to reduce some, but not all, sources of financial
AGL	Warrants further assessment. Government will be focussed on customer needs. But government involvement could dilute commercial incentives and socialise costs, and government funding is likely to lead to more intrusive information gathering powers. Any role for Government should be clearly defined and exercised by an independent agency, with costs recovered via network charges or customer levies.	

<table>
<tr><th>Stakeholder</th><th>Issue raised in submission</th><th>AEMC response</th></tr>
<tr><td>Alinta</td><td>Need to ascertain value of allowing normal administration and liquidation processes to run, instead of ROLR. Need to consider whether security of supply for mass customers requires bridging support to allow administrator to trade or on-sell assets. Government appointed administrator is closest to Alinta's preferred position of allowing normal administration arrangements to prevail but with mechanisms to facilitate continued energy supply if threatened. Alinta supports further investigation of existing insolvency arrangements versus special administration for electricity company insolvency.</td><td rowspan="7">contagion risk if a large retailer fails. Therefore we see merit in developing a special administration regime, but recommend that further work be undertaken before making a final decision.

As discussed in section 5.3.2, the special administration regime would have benefits over standard Australian insolvency processes in managing the failure of a large electricity retailer, including:

• the administrator's primary objective would be to maintain continuity of electricity supply;

• the management of vertical integration issues;

• allowing trading in the NEM while in administration;

• a default customer allocation mechanism;

• prohibition on termination of hedge contracts; and

• a cost recovery mechanism.

These features offer significant benefits in terms of meeting the NEO and avoiding contagion, when compared to standard insolvency processes.</td></tr>
<tr><td>Energy Australia</td><td>Has potential merit in preference to ROLR scheme. This is the only option to reduce the risk of contagion. AEMC should explore policy rationale for ROLR and options to utilise existing or modified insolvency laws to manage retailer default.</td></tr>
<tr><td>ERAA</td><td>Open to exploring options under insolvency laws.</td></tr>
<tr><td>ESAA</td><td>AEMC pays insufficient attention to whether ROLR scheme can be justified at all on policy grounds. ESAA supports examining whether there is scope to use insolvency laws instead of the ROLR regime.</td></tr>
<tr><td>GDF Suez</td><td>Supported. But it would not be reasonable for last resort involvement to be accompanied by unreasonable actions that distort commercial outcomes or increase regulatory burdens. Also raises the question of the role of Energy Security Council.</td></tr>
<tr><td>Origin</td><td>Does not support government administrators - it represents an intervention in the normal operation of the market. Retailing requires detailed knowledge of operational risks and challenges that would likely render government administrators ineffectual in mitigating the risks of failure.</td></tr>
<tr><td>DPI</td><td>AEMC should undertake more analysis into this. Design would need to address moral hazard, eg, by quarantining some of the value of the sale of the business for government/taxpayers, rather than failed firm and its creditors. There is tension between managing contagion and maintaining commercial disciplines - avoiding moral hazard.</td></tr>
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