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Australian Energy Market Commission
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NEM financial market resilience options paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission NEM financial market resilience options paper. The esaa commends the Commission for thoroughly setting out the options available to deal with a large retailer collapse in the National Energy Market (NEM).

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 51,000 people and contribute \$16.5 billion directly to the nation's Gross Domestic Product.

The potential problems associated with a large retailer collapse are primarily due to regulatory failure. The current Retailer of Last Resort (ROLR) schemes limit the ability of the ROLR to recover their costs. This problem is compounded in most jurisdictions by retail price regulation. In other industries a provider is not expected to incur costs to deal with a collapse of a competitor. The cost of electricity provision, like all other services, should be borne by consumers. This should include the short-term costs associated with involuntary transfers. That said, as electricity is an essential service the cost recovery mechanisms should reflect this.

The esaa considers the best way to limit any negative impacts of a large retailer collapse is to deregulate retail prices and give the ROLR's clear rights to recover all of the cost of providing the ROLR service. If the retailer has regulatory certainty that it can recover costs it should make obtaining additional credit in the short-term more likely, avoiding cash flow problems.

Even with certainty around cost recovery, the immediate impact of the Australian Energy Market Operator (AEMO) credit support arrangements could still prove challenging to meet. One option to limit the risk would be to delay the appointment of the ROLR. This would increase the likelihood of gaining a reasonably accurate profile of the failed retailer's customer base and allow more time for a ROLR to organise any necessary credit. It could also facilitate other retailers nominating to provide ROLR services defraying the risk.

Affected customers should be split into two groups – large customers and other customers. The ROLR should be able to directly recover the costs from large customers and recover any costs associated¹ with the other customers indirectly over the entire NEM or the relevant state customer base. The justification for the different treatment is that larger customers are in a position to make a judgment about the relative risk of a retailer and as such should bear the cost of their choice, as opposed to small customers who are ill placed to make an assessment.

While the Commission comprehensively sets out the options to amend the ROLR scheme, insufficient attention is paid to whether the ROLR scheme can be justified at all on policy grounds. Given the ROLR design gives rise to the potential spread of financial contagion, it raises the question whether the ROLR scheme should be removed in favour of another approach. Insolvency laws are the standard approach in other industries to deal with a failed business. The Commission should further explore using insolvency laws to resolve a retailer collapse, in particular whether standalone arrangements would be needed for the energy sector.

The esaa does not believe pushing the ROLR risk onto generators is desirable or practical. There is a risk that if one of the options that achieved this were adopted it could distort the design of the wholesale market. In addition, generators are likely to be poorly placed to manage the additional risk, as they are likely to be unable to access additional capital in a timely manner.

The Options paper highlights the complexity of the multiple ROLR schemes currently being run by jurisdictions. This is further evidence of the need to adopt the National Energy Customer Framework (NECF). The esaa believes that the immediate focus should be on proposals to amend the NECF ROLR arrangements, as by the time any changes are implemented all jurisdictions should have adopted NECF. If any jurisdiction does not implement the NECF by the time any changes are settled, the proposed changes should also be applied to the relevant state scheme.

Our views are set out in more detail in Additional Information.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely



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¹ Except for administrative costs to transfer the ROLR customer.

Additional Information

The Commission notes that the financial arrangements for the NEM are generally robust and that “there is a low probability of financial contagion occurring in the NEM.” As the likelihood of a large retailer collapsing is remote, any proposed changes needs to reflect this; i.e. place a low burden on the sector and not introduce any distortions into the market.

Preferred approach

The risk of financial contagion spreading as a result of a large retailer collapse ultimately boils down to cost recovery. Price restrictions in the retail market and the design of the various ROLR schemes prevent ROLRs from recovering the costs of providing the ROLR service. It is the unrecoverable costs that could spread financial distress. If a ROLR had the flexibility to offer cost reflective prices and certainty that they would be able to recover any costs incurred in providing the ROLR service, this would mitigate most of the risks of a large retailer failing.

There are four dimensions to cost recovery:

- the type of costs that can be recovered;
- who the costs should be recovered from;
- the mechanism that should be used to recover costs; and
- the period over which cost recovery should apply.

A ROLR needs certainty that they will be able to recover the full gamut of costs (credit support, unhedged load, administrative costs etc.) associated with the ROLR event. If the rules were amended to clearly state that all costs were recoverable it should facilitate the ability of the ROLR to obtain any necessary credit to cover short-term cash flow issues. While cost recovery proposals will need to be approved by the Australian Energy Regulator (AER), this will need to be done in a manner that does not undermine confidence as to what can be recovered.

This approach may not address the risk around increased AEMO credit support given the short timeframe in which additional credit support needs to be posted. This risk could be mitigated by delaying the appointment of the ROLR. Delay in assigning a ROLR should allow any potential ROLRs to gain a better understanding of the split of customers and their general geographic location. It could also promote greater interest from other retailers increasing the likelihood of multiple ROLRs. While this approach may reduce the time between when the ROLR(s) are appointed and when some of the costs are incurred, it should increase the amount of time a ROLR has to source additional credit. On a more practical level it may not be possible to transfer all customers from a large retailer immediately. The AER could use an auction to allocate customers, although this does involve risks.

The esaa believes that ROLR costs should be recovered directly from large customers and indirectly for other customers, except for administrative costs. For large customers energy is just another business input containing a degree on contractual risk. As such, it is not unreasonable to expect a sophisticated business to conduct a degree of due diligence. Small customers are not well equipped to make

an assessment of the relative risks of each retailer. As such, it would be unfair to expect them to bear the full costs of a ROLR event. For practical reasons the ROLR should still be able to directly recover the cost of transferring the customer. The remaining costs (increased energy costs etc.) should either be recovered over the entire NEM or the relevant state customer base.

The indirect costs could be recovered through distribution network service providers (DNSPs) or alternatively through AEMO market participant fees. If DNSPs are chosen they will need to be able to pass through all their costs to customers, including any carrying costs. If AEMO is preferred, cost recovery should be limited to retailers, as requiring generators to carry the costs is problematic for reasons set out below.

The period over which costs can be recovered will need to be defined at the outset. The esaa agrees that it should only be for a short period following the ROLR event. The timeframe for the AER to decide on the quantum for cost recovery will also need to be established.

As a starting point, the esaa prefers NECF ROLR arrangements to any of the jurisdictional models. The esaa believes that the immediate focus should be on proposals to amend the NECF ROLR arrangements, as by the time any changes are implemented all jurisdictions should have adopted NECF. If any jurisdiction does not implement the NECF by the time any changes are settled, the proposed changes should also be applied to the relevant state scheme.

Alternative approaches

Given it is the ROLR regime that is the cause of the contagion risk, alternative arrangements warrant consideration. The Commission noted that the UK is examining using a special administrative regime as Government does not believe their equivalent ROLR regime will be able to cope with a large retailer failure. The esaa supports examining whether there is scope to use insolvency laws instead of the ROLR regime. Insolvency is the standard practice in all other industries for dealing with a failed business. While electricity is an essential service it is not clear special insolvency arrangements would be needed.

An alternative to delaying the appointment of a ROLR to mitigate the risk of posting additional AEMO credit support is for AEMO to guarantee the ROLR component of wholesale market payments. These costs would be recovered through higher market participant fees on retailers. AEMO guaranteeing the ROLR would ensure credit risks do not get passed onto generators.

Other options

Other than enhanced preparation and amendments to DNSP arrangements the esaa does not support any of the remaining options. While we believe these three options could be entertained, if they were to be implemented they would need to be amended. While we support the AER putting in place systems to ensure that a ROLR event goes as smoothly as possible, we are not in favour of increased powers for the

AER as there is a risk additional powers may result in unnecessary intrusions on retail businesses. If the DNSP options are pursued, DNSPs should be able to recover any costs they incur due to late payment or retailer default from customers.

We do not think it is appropriate to push risk onto the generators as it goes against the design of the NEM wholesale market. The NEM was designed so that generators would not be required to attempt to increase their spot market offer prices to incorporate an allowance for default risk. While there is a question whether generators would be able to do this anyway, if it is accepted that customers should ultimately bear the cost of ROLR services then passing costs to generators is the least desirable and effective way to attempt to achieve this.