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John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

Submission on NEM Financial Market Resilience First Draft Report

The Australian Energy Regulator (**AER**) welcomes this opportunity to comment on the Australian Energy Market Commission's (**AEMC**) National Electricity Market (**NEM**) Financial Market Resilience First Draft Report. Overall, we consider that both the proposed amendments to the retailer of last resort (ROLR) regime and the introduction of a complementary special administration regime are firmly in the long-term interests of consumers.

The AER welcomes the proposed amendments to the ROLR regime and AEMO credit support requirements. As a package, we consider that these measures are likely to encourage more retailers to offer to become additional ROLRs. By increasing competition in provision of this function, it may reduce the risk of cascading retailer failure by spreading the customers, obligations and risks of the ROLR event between several retailers. Spreading customers across several retailers would also support longer term competition benefits.

As acknowledged by the AEMC, while these amendments offer significant benefits for small and medium retailer failures, they will not assist with large retailer failures. Addressing large retailer failures through the ROLR regime creates a significant risk of cascading failure and would result in unacceptably high market concentration, as the majority of customers are likely to be transferred to the remaining large retailers. Large retailer failures need to be addressed outside the ROLR regime. We therefore support the introduction of a special administration regime and encourage the AEMC to consider further how to take into account competition concerns.

Protecting the interests of consumers lies at the heart of these reforms. We note, however, that there has been limited engagement by consumer organisations on these issues to date. As the costs and benefits of the proposed amendments become more apparent, we encourage the AEMC to proactively seek their views.

The AER has set out its considerations on the recommendations and issues in Chapters 5, 6 and 7 of the draft interim paper below. While our comments only relate to the NEM, we consider that similar

issues would arise from the failure of a large gas retailer. Given all major retailers have a significant gas market presence, not addressing these interactions represents an ongoing major gap in the development of a comprehensive financial resilience framework. We encourage the AEMC to include this in its recommendations pertaining to the development of a special administration regime.

The AER would be pleased to provide further assistance to the Commission on this important area of work. If you would like to discuss any aspect of this submission please contact Tom Leuner, General Manager, Wholesale Markets, on (03) 9290 1890.

Yours sincerely

A handwritten signature in black ink, appearing to read 'A. Reeves', written in a cursive style.

Andrew Reeves
Chairman
Australian Energy Regulator

Chapter 5 - Special administration regime

AEMC Recommendation: *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.*

The AER considers that the National Electricity Retail Law (NERL) ROLR regime is not appropriate for addressing large retailer failures. There are widely accepted practical and systems-related problems associated with transferring large numbers of customers to a new retailer and there is a significant risk of cascading retailer failure. Furthermore, we are highly concerned about the long-term impact on competition of transferring a large retailer's customers to the other retailers.

As such, we agree with the AEMC 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 spreading across the energy market. Such a regime will maintain market stability and therefore protect consumers.

We welcome the AEMC undertaking further work to assess the costs and benefits of developing and implementing a special administration regime as a backstop to the ROLR scheme. The AER considers that there is currently no clarity on what would occur if there were a major retailer failure. If the AER and AEMO comply with their legal obligations without intervention by Governments, it will quite possibly lead to cascading large retailer failure, leading to collapse of the wholesale spot market. In addition, there would be long-term detrimental impacts on the competitiveness of the retail market.

The AER encourages the AEMC to promote the special administration regime. In developing the regime, consideration should be given to ensure that it includes an assessment by the Australian Competition and Consumer Commission (**ACCC**) of any transfer of assets under s. 50 of the *Competition and Consumer Act (2010)*.

Chapter 6: Changes to the ROLR scheme and credit support arrangements

AEMC Recommendation: *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.*

The AER acknowledges that this recommendation may reduce the financial uncertainty faced by the designated ROLR(s) following the failure of a large retailer. This could increase the appetite among retailers to submit expressions of interest to act as additional ROLRs and improve the likelihood of the designated ROLR being able to borrow funds to cover its short-term costs.

We note, however, that there is a tension between providing certainty of cost recovery and limiting that recovery to only reasonable costs. Any revised cost recovery arrangements should not reduce the commercial incentives on the designated ROLR to minimise its costs. Customers will ultimately bear the risk of their inefficient behaviour through higher prices.

The current AEMC recommendation maintains some commercial incentives. For example, a potential ROLR can still waive recovery of some or all of its costs to acquire customers and the AER retains its role in determining whether the costs incurred by the designated ROLR(s) are reasonable. However, we consider that the cost recovery arrangements should preserve the principle in s. 166(7)(c) of the

Retail Law that the registered ROLR will itself bear some of the costs, specifically in relation to smaller retailer failure. While this principle, as currently drafted, is not suited to medium and large ROLR events, we consider that the principle is still appropriate where the number of transferred customers (and their load) is low relative to the ROLR's pre-existing customer base.

AEMC Recommendation: 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.

As we note in our statement of approach¹, a major factor in whether or not the AER will be able to appoint additional ROLRs will be the length of time we have to make the decision. The current timeframe will often make it unlikely that the AER will be able to appoint any additional ROLRs (i.e. the ROLR(s) will typically be the default ROLR(s)). The more warning we have of an impending ROLR event, the more potential there is for the AER to consider appointing additional ROLRs. This would include non-firm additional ROLRs who can only be designated if they provide their agreement at the time of an event.

We note that the recommendation increases the period of time between the ROLR event and the appointment of the designated ROLR by 24 hours. There are costs and benefits to such an approach. The key benefit is that, as noted above, the AER is more likely to be able to appoint additional ROLRs (particularly those who have made a non-firm expression of interest in being a ROLR), which has flow on benefits in terms of limiting the likelihood of cascading failures and promoting a competitive market structure. However, the cost of this approach is that the designated ROLRs 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. Furthermore, customers will not know who the new retailer is for the 24 hour period, potentially creating communication and event management issues.

We support the recommendation for the following reasons:

- The AER is aware of the risks of designated ROLRs inheriting unhedged exposure to the spot price for energy consumed during the interim period, and therefore we would generally try to avoid using the extra 24 hours, particularly if the extra 24 hours is unlikely to change who the designated ROLRs will be.
- Where there is a question mark over the financial viability of the ROLRs after the ROLR event, the extra 24 hours will enable more detailed analysis of financial positions together with AEMO and the potential ROLRs. This may, for example, lead to the AER not choosing to designate a certain additional ROLR if there is a question mark over their viability, or it may leave sufficient time for Governments to intervene if there is a risk of cascading failure of large retailers.
- The default ROLR would know early on the high likelihood that they will be taking on customers. For example, if a retailer with 100,000 customers in a region failed, and the AER had only one firm offer for 5000 customers and was unlikely to get significant interest from potential other additional ROLRs due to high contract prices, the AER would be in discussions early with the default ROLR to let them know the likely result was that close to 100,000 customers would be transferred shortly to the default ROLR. Given this, the default ROLR

¹ AER, Retailer of last resort statement of approach, November 2011

would be able to put hedge contracts in place to protect their greater exposure at an early stage, and would not need to wait until the AER issues the ROLR notice.

AEMC Recommendation: 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.

The AER supports the proposed changes to credit support requirements. We recognise that 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, generators benefit from measures to mitigate the risk of contagion.

Currently, if there is cascading retailer failure, generators face a high risk of not being paid. Lessening the chance of cascading retailer failure is therefore lessening the risk to generators. On that basis, the AER considers it is appropriate that generators take on some additional risk (through changes to credit support requirements) in the context of improving the ROLR regime.

This amendment allows 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. Importantly, 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 being appointed, securing better outcomes for consumers.

Chapter 7: Operational refinements to the ROLR arrangements

AEMC Recommendation: 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.

We strongly support the need for standardised and up-to-date customer data information as well as an efficient transfer process capable of moving large numbers of customers in a short period of time. Although primary responsibility for delivering any changes would rest with AEMO and industry parties, we will support any work to determine the scope for improvements in these areas.

AEMC Issue: Partial market suspension - 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.

We agree 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. As such, we encourage further analysis of this area in the next stage of policy development.