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Australian Energy Market Commission
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Lodged (online): http://www.aemc.gov.au

NEM financial market resilience – First Interim Report

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission NEM financial market resilience - First Interim Report.

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.

As noted in our previous submission the problems associated with a large retailer failure are due to regulatory failure; the design of the retailer of last resort (RoLR) scheme and retail price regulation, not business practices. As such, any solution should be directed at addressing the regulatory problems, rather than imposing additional costs on businesses.

RoLR is designed to achieve a social policy outcome, maintain continuity of supply of electricity to customers. As the costs under the current design of the scheme are borne by solvent businesses that bear no responsibility for the retailer failure, the aim of policy makers should be to find straight forward solution(s) that aid the RoLR to carry out the desired policy objective.

esaa agrees the aim of any government action is not to support failing retailers, but to ensure the orderly transfer of customers. There are three issues with the current regulatory arrangements that need to be addressed to deal with the low probability of a large retailer collapse causing a cascading retailer failure: allow a RoLR to recover their costs associated with the RoLR event, ensuring short-term credit access does not cause a collapse of an otherwise viable business and ensuring all RoLR customers are viable over the longer term.

The esaa preferred approach to addressing these three issues is:

- retail price deregulation;
- implementation of the proposed amendments to the RoLR scheme; and

- reliance on the combination of short term government credit support and general insolvency to manage any large retailer collapse.

This approach deals directly with the current regulatory issues without imposing unnecessary additional burdens on businesses. In comparison the proposed special administration regime is highly intrusive, complex, and would require changes to nearly every aspect of running an energy business; directors and administrators duties, creditor rights (particularly under hedge contracts), prudentials etc. The material costs borne immediately due to the introduction of the special administration are not proportionate to the uncertain future benefits. Further, the proposal is not well targeted as it will have an impact on many aspects of energy sector beyond the root causes of any potential cascading retailer failure

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

Any questions about our submission should be addressed to Fergus Pope, by email to fergus.pope@esaa.com.au or by telephone on (03) 9205 3107.

Yours sincerely

Andrew Dillon
General Manager Corporate Affairs

Additional Information

The esaa preferred approach to addressing the three issues with the current regulatory failure is:

- retail price deregulation;
- implementation of the proposed amendments to the RoLR scheme; and
- reliance on the combination of short term government credit support and general insolvency to manage any large retailer collapse.

If customers are viable and retailer has certainty they can recover costs incurred as the RoLR, they should be able to secure the necessary credit given sufficient time. This would only leave the timing of accessing additional credit as a risk of RoLR collapse.

The changes proposed by the Australian Energy market Commission (AEMC) clarify cost recovery arrangements for a RoLR and reduce the risk of short term credit causing a collapse. esaa believes the use of government credit support should remove the risk of the collapse of a RoLR following a large retailer failure.

Deregulation

One possible barrier to the viability of customers is retail price regulation. If prices are deregulated it would remove this risk. Victoria and South Australia have deregulated, Queensland has committed to deregulation in 2015, subject to the state of competition and NSW is currently conducting a process to assess whether the retail market can be deregulated. If retail price regulation is ultimately removed in NSW as a result of the current process and the Queensland Government follows through on its commitment, it would remove the risk the RoLR customers could be unviable.

Government credit support

Short term government credit support should ensure a RoLR does not collapse, causing a cascading failure. The government offering credit support should provide the RoLR sufficient time to secure private credit, given the customers should be ultimately profitable. The length of time the credit support would be available for, and the conditions (commercial terms etc) it is provided under would need to be established prior to any RoLR event to ensure it can be activated in a timely manner. There would also need to be a materiality test so that support was only available if there was a risk of cascading retailer failure.

The AEMC suggests government credit support “has potential to address some but not all the sources of cascading retailer failure”. esaa disagrees with the AEMC analysis. We do not think any of the issues identified by the AEMC would affect government credit support mitigating the risk of a cascading failure and the risks to government of providing support can be adequately managed. The AEMC’s issues with relying on government credit support include:

- does not address the issue where the retailer is part of a vertically integrated business with generation assets – this can be addressed in a straight forward manner by allowing partial suspension (see discussion below);

- unsecured risk to government if the RoLR failed – the rules could allow the government to recover any costs from all electricity customers, possibly through network charges. Although it seems unlikely this scenario would arise;
- the government would need to make a decision about posting credit support in a short period of time – under the special administration arrangements the government would still need to make a decision in a short period of time; and
- the government posts credit support without commensurate control over the operation of the RoLR - the RoLR is best placed to deal with the impact of a large influx of customers. The retailer has a greater understanding of their business and the sector more generally than the government. The incentives of the RoLR and the government are aligned, given the business' aim is to successfully integrate the RoLR customers while maintaining profitability. Government control is likely to create problems and the need for it is further reduced as any credit would be provided on commercial terms.

Insolvency

The AEMC has not made a convincing case why standard insolvency practices would not be sufficient for detailing with the failed retailer. While the AEMC specifies that the special administrator would focus on continuity of supply, in all but a narrow set of cases securing supply and getting the best deal for creditors would appear to be aligned.

The customer base is the major retailer asset. An administrator would attempt to sell the assets to recover money for the creditors, hence maintain supply. While the majority of the customers should be able to be sold, there could be a minority that are not attractive. However, the special administration arrangements also envisage having unsold contracts. Similar to the ABC Learning insolvency where the viable centres were sold off, while the unviable ones were hived off and treated differently, the process for dealing with unsold customers proposed for special administration could be used for the residual customers that could not be sold.

Reduce size of problem

A key driver of the risk of a cascading collapse from the failure of large retailer is the volume of load that would be transferred at one time. If the RoLR scheme was limited to small business and households, this would substantially reduce costs and the potential for financial contagion to spread.

Partial suspension

esaa supports allowing the generation assets of a vertically integrated business to continue trading after the suspension of its retail arm. From our perspective any other approach would be counterproductive and against the objectives of the National Electricity Objective, as suspending generation assets would worsen market conditions without any possible upside.

Allowing generation assets to keep trading would present no risk to the Australian Energy Market Operator, as generators receive payments from the wholesale market. Continuing to run generation assets under external administration, due to a retailer collapse, would also maximise the return to the creditors. Given generation assets would be producing income, especially under wholesale market conditions that would bring about the collapse of a large retailer, an administrator would invariably continue to operate them. This is a much more straight forward way to deal with one of the issues arising from a large retailer collapse than introducing a whole new burdensome regulatory regime.

Hedges

Under either our preferred approach or the special administration arrangements the RoLR will face similar issues obtaining hedges for their new load, as ultimately they will need to put in place hedges for new customers, most likely under unfavourable circumstances. There may be minor differences in timing, but this is unlikely to have a material impact on the cost. As the RoLR will be able to recover this cost and financing for the first wholesale payment is not due for four weeks, it should be able to arrange private finance in time. The only impact the special administration regime will have hedging arrangements is for the failed retailer and their original counter parties. We would note that the proposal to prevent counter parties terminating hedge contracts under special administration will increase the risk of contracting.

<u>Special administration</u>

The proposed special administration regime is highly intrusive, complex, and would require changes to nearly every aspect of running an energy business; directors and administrators duties, creditor rights (particularly under hedge contracts), prudentials etc.

esaa believes special administration is not a proportionate response as it would impose certain material costs and inefficiencies now, out of line with the uncertain future benefits. A low likelihood that the design of RoLR creates a risk of contagion in the event a large retailer fails does not justify fundamental changes to Australia's insolvency laws altering the rights and responsibilities of lenders, owners, directors and administrators. Further, the proposal is not well targeted as it will have an impact on many aspects of energy sector beyond the root causes of any potential cascading retailer failure.

The use of ring fencing would undermine the use of a range of legitimate corporate structures currently used by various energy businesses as part of their risk management practices. Under the special administration proposal companies would have to organise their businesses in a manner that best suits a potential future administration approach rather than the day to day running of the business. Ring fencing will impose costs that will need to be met by consumers.

In the event the AEMC wants to further pursue the special administration arrangements, we would recommend a thorough cost benefit analysis to see if it can be justified given the obvious material costs. We would note that there is ample time to undertake such analysis as it is unlikely there would be a large retailer collapse any time in the near future, due to the prevailing wholesale market conditions. As a large retailer collapse is only likely to occur during high price event, the current oversupplied wholesale market is unlikely to produce this. The increasing penetration of renewables, driven by the Renewable Energy Target could increase volatility in the

National Energy Market (NEM), but again this is not likely to happen for a few years. Further, volatility would need to be widespread to bring about a large retailer collapse, as they operate across the NEM.