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Mr John Pierce
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Dear Mr Pierce

Submission: NEM Financial Market Resilience First Interim Report

Thank you for the opportunity to make a submission on the Australian Energy Market Commission's (AEMC) First Interim Report on NEM Financial Market Resilience (the report).

AEMO is pleased with the progress that has been made, and continues to be supportive of measures to address potential financial contagion in the NEM. Based on a preliminary assessment we consider the draft recommendations presented in the report to be workable improvements to the existing RoLR process.

However AEMO remains of the view that an improved RoLR process would still be unlikely to prevent financial contagion in the event of failure of a large retailer or gentailer. Although the likelihood of such a failure might be very low, the consequence is very high, therefore recognition by AEMC that development of an alternative to RoLR to deal with such circumstances is an important development. It is important that the AEMC and policy-makers continue to develop an alternative to the RoLR mechanism, recognising that the AEMC's proposal for a special administration scheme is one such alternative.

AEMO acknowledges that the AEMC in its report has raised with stakeholders the matter of failure of vertically-integrated participants – as identified in AEMO's previous submission, the NER does not provide a policy framework for the management of generation following a default event by a gentailer and, in particular, the subsequent decision by AEMO to suspend the business, or portion of it from participating in the NEM. The policy framework needs to balance the risks of having unhedged generation and potentially generation under administration continuing to operate against the risks of potential supply shortfalls in physical and financial markets. AEMO looks forward to supporting the AEMC's continued work in clarifying the policy framework to mitigate these risks.

AEMO has considered the draft recommendations set out in the report, with a particular focus on how they might be implemented The remainder of this submission sets out our initial findings, which are aimed at assisting the AEMC in developing specifications for each of the measures should it decide to take them forward.

Delayed designation of RoLR

The AEMC has proposed that the designation of RoLRs by the AER be permitted to take place up to 24 hours after a retailer is suspended from participation in the NEM. This is intended to mitigate the risk of contagion caused by the RoLR process by allowing an opportunity for a more appropriate allocation of customers to RoLRs.

AEMO agrees this measure may improve the opportunity for additional RoLRs to be considered, thereby supporting a more optimal allocation of customers following a RoLR event. In the case of medium sized retailer, the measure could provide the opportunity for contagion to risk to be mitigated, where additional RoLRs may be better placed to manage the failed retailer's customers than the default RoLR. Based on an initial assessment, the delay in designating a RoLR is not likely to have a material impact on the NEM prudential process. Daily prudential monitoring involves an assessment of outstandings up to the previous day, so the proposed 24 hour delay will accommodate confirmation of the RoLR(s) prior to the consideration of increased trading amounts for those RoLR(s). The delay will also result in the determination and notification of credit limits to be delayed, however this risk has been mitigated by the AEMC's proposed amendments to credit support provisions.

AEMO is concerned however that care should be taken in the implementation of this proposal to ensure that there is certainty that AEMO has sufficient information and authority to execute the RoLR process following a suspension. For example, if no adjustment is made by the AER to default RoLR allocations within the 24 hours, then the mechanism should provide for AEMO to act on the default RoLR allocation. We would be happy to work with the AEMC and the AER to test scenarios as the design is further developed, with the aim of minimising any risks in this regard.

Under the RoLR arrangements prior to the NECF, jurisdictions were responsible for informing customers of the appointment of RoLR(s). This was usually facilitated through media statements and the provision of a contact centre. With the progressive adoption of the NECF, AEMO understands that the AER will be informing customers following the appointment of RoLR(s). However the delay in designation may add to the existing challenge of informing customers, as RoLR allocations might not be completed when calls are being taken. AEMO suggests that responsibility for the management of customer inquiries be made clear, so that public statements such as a suspension notice can communicate a clear contact point for customers to use. In relation to this matter, it is important to note that AEMO is not equipped to operate as a customer call centre, so is concerned to ensure the arrangements are clearly defined and communicated as part of the design.

Amendments to AEMO credit support provisions

The AEMC has proposed that the increased credit support obligations applying to a RoLR be ramped up following the transfer of customers, and relief be provided to the RoLR both in terms of the timing of providing credit support and by not issuing a Call Notice when a sustained breach of the Trading Limit occurs. In making this recommendation the AEMC has acknowledged that relaxation of the Prudential Standard will transfer some risk to generators in the NEM, but argues that this is appropriate when the objective is to mitigate contagion risk.

AEMO agrees that this recommendation, if implemented carefully, can provide some mitigation of financial contagion risk. If the recommendation proceeds, AEMO also considers that its parameters should be clearly set out in the Rules, as this provides certainty to RoLRs following a retailer failure, and may reduce the potential barriers for prospective additional RoLRs.

AEMO has considered the AEMC's recommendations in terms of two separate components:

- Ramping of credit support – the proposed mechanism of ramping provides a more efficient use of collateral, while remaining within the Prudential Standard, effectively recognising that the RoLR's liabilities arising from additional customer load will progressively increase over the outstandings period. Based on an initial assessment AEMO considers this component to be workable, by stepping up the RoLR's Maximum Credit Limit week by week. To avoid triggering of this provision where there is minimal risk of financial contagion, AEMO suggests that a threshold be included.

There is also the potential that a process of ramping credit support obligations within the Prudential Standard may be beneficial to retailers that experience a significant step change in energy patterns other than through RoLR. However this process would not be expected to apply following the sale of a retail business where the new owner immediately assumes financial responsibility for existing liabilities in the outstanding period. A threshold parameter such as a minimum percentage step change in energy could be used to avoid the ramping process being used where the collateral saving is outweighed by the administrative risks and costs to the retailer and AEMO.

- Period of grace – we understand the policy objective of this component is to reduce the collateral requirements for a RoLR following a RoLR event, both in terms of credit support and cash. However the recommendation for providing a period of grace in respect to breaches of "revised trading limit"[1] requires further clarification, to achieve the policy objective in the most practical manner. The mechanism set out in the Report appears to require that separate Trading Limits be maintained for the RoLR for previous and additional customer load - this would add complexity and ambiguity to AEMO's prudential monitoring functions. AEMO therefore suggests that alternative approaches to implementation be considered, preferably using the parameters of the standard prudential process. AEMO's preference would be to specify the new mechanism in terms of changes to the Trading Limit, Maximum Credit Limit, and Prudential Margin. This would provide a means of capping the risk associated with the RoLR, and maximise the use of existing prudential processes. Under such a mechanism, AEMO would still issue a Call Notice if the RoLR's outstandings exceeded its Trading Limit, but the degree of relief provided to the RoLR, and the amount of risk transferred to Generators would be controlled by the policy settings in the Rules rather than being uncapped.

AEMO would be happy to work with the AEMC as it further develops the detail of this proposal, with a view to ensuring the final outcome is practical and workable.

Allowing the Commonwealth government to offer credit support

The AEMC has proposed that the Commonwealth government be able to provide credit support to AEMO, adding another mechanism of possible responses to mitigate financial contagion. AEMO acknowledges that this a sensible and practical compromise from the normal arrangements for the provision of credit support, which can be used as a last-resort to mitigate contagion risk.

AEMO would set out to develop the necessary protocols with Commonwealth departments to ensure that suitable operational arrangements are in place should a call on the credit support be required.

[1] Report, p. 71

Improvements to RoLR processes

The AEMC has proposed that AEMO and the AER continue to investigate further improvements to RoLR processes, including the availability of standardised customer data. AEMO acknowledges that the availability of customer information to the RoLR is unlikely to be a source of financial contagion, and therefore need not be managed as a component of the Financial Market Resilience work.

The availability of customer information to RoLRs is a long-standing issue for the NEM, and AEMO agrees there are potential improvements from introducing a standard approach to this, however AEMO's systems do not currently provide any customer information with the exception of connection point details such as NMI and site address. The current approach of relying on Distribution businesses to maintain customer information has not proven to be reliable to date, and it is not clear at this stage whether refinement of that existing process, or introduction of a new mechanism would be more appropriate. We note that there are currently a range of issues associated with the ownership and access to customer data, and that there are currently B2B processes in place to permit sharing of this information between retailers and the distribution network service provider associated with the customer.

Despite these challenges, AEMO would be in a position to further investigate options to improve access to customer data following a RoLR event. As an initial step, AEMO would propose to address the issue with the Retail Market Leaders Forum, which may wish to consider options such as AEMO being a custodian of customer data similar to the process used in some gas markets.

RoLR arrangements for large customers

The AEMC has proposed that AEMO and the AER promote to large customers that they consider opting out of the centrally managed RoLR process by negotiating their own RoLR arrangement with an alternative retailer. AEMO agrees there are several benefits for large customers being able to opt out of RoLR arrangements, including greater financial certainty for the large customer, and reduced exposure to the spot market for default and additional RoLRs.

As identified in the NERL[2], AEMO can be notified by a large customer of its nominated retailer, and AEMO may transfer the customer to the nominated retailer following a RoLR event. Although AEMO would only use this information at the time of a RoLR event, we understand the AER will need to be aware of the notification to ensure:

- the AER's determination of a default RoLR for each connection point can be performed efficiently; and
- the AER's consideration of additional RoLRs prior to a RoLR event accurately reflects the potential allocation of customers and load.

However, the NERL does not appear to require that the AER be advised by AEMO of what large customers have opted out of the RoLR process. To address this, AEMO will consider with the AER whether the existing operational communication protocols be extended to include the sharing of large customer nominations. In the interests of clarity and certainty however, it is suggested that the AEMC consider making this information sharing a clear obligation in the NERL as part of the other changes being proposed in relation to RoLR.

[2] National Energy Retail Law – Section 140 Transfer of Responsibility, clause 7

AEMO does not currently have a broad operational interface with large customers, and does not consider that the advocacy role proposed by the AEMC fits well with its current operational responsibilities. However, AEMO would be prepared to support the AER in any work they propose to carry out in this regard, as part of their work to ensure that a RoLR is allocated to each NEM connection point.

If you would like to discuss any aspect of the submission, please contact Chris Muffett, Specialist Metering and Settlement on (02) 8884 5317.

Yours sincerely

David Swift
EGM Corporate Development