



EnergyAustralia

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Dear Commissioners

NEM Financial Market Resilience – First Interim Report

EnergyAustralia welcomes the opportunity to make a submission on the 'NEM Financial Market Resilience First Interim Report' (the interim report).

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.7 million household and business customer accounts. We own and operate an integrated portfolio of energy generation and storage facilities across Australia.

The interim report sets out the Commission's recommendations for measures to reduce the risk of financial contagion that could arise if a large retailer fails. The report notes that risk of failure is low but that the consequences for the market if it occurred could be significant and that the retailer of last resort (RoLR) arrangements may exacerbate the risk of financial contagion.

The objectives of the RoLR arrangements are to maintain continuity of supply to electricity customers and reduce credit risk for participants. The arrangements create financial stress in an otherwise well managed retailer as they impose immediate costs on the RoLR to fund the electricity purchases of the failed retailer's customers.

The costs of RoLR schemes are imposed on retailers that bear no responsibility for the failure of the initial retailer. The risk of financial contagion arising from the failure of a large retailer is a result of regulatory failure, not poor business practices in the remaining retailers. Mitigation should therefore focus on reform of RoLR arrangements, complemented by broader reforms to facilitate the long term sustainability of the electricity market - such as the removal retail price regulation.

The draft recommendations in the interim report incorporate two elements:

1. **Changes to the RoLR scheme and AEMO credit support requirements to mitigate the risks of financial contagion.**

We generally support these recommendations and believe there is scope to further mitigate contagion risk by improved market lead allocation of the failed retailer's customers, including making large customers responsible for establishing their own arrangements.

2. **Development and assessment of a special administration regime for retailers.**

We do not support this recommendation. It is not well targeted or proportionate. Implementation of this option would have far reaching consequences well beyond the operation of RoLR arrangements and would be complex, costly and risky to implement.

The policy objectives in responding to the failure of a retailer should be to ensure an orderly, market-driven response and to enable customers of the failed retailer to enjoy continuity of supply. We recognise that Government has a legitimate interest in protecting consumers and market stability. We agree that any Government response should not seek to prevent the failure of individual businesses.

The risks associated with RoLR arrangements are primarily short term in nature and the key issues that need to be addressed relate to cash flow, working capital, and secure, timely recovery of costs. We support the draft recommendations in the interim report that seek to address these risks, particularly improved cost recovery for the RoLR. In addition, it is vital that the RoLR can access timely and accurate information about the customers allocated to them and we support operational improvements to facilitate this.

Contagion risk is exacerbated by transferring costs and risks to other retailers or generators. It may be possible for Distribution Network Service Providers (DNSPs) to temporarily absorb some costs and reduce contagion risk, provided they have access to secure and timely cost recovery under the National Electricity Rules (NER). DNSPs are typically able to secure additional credit at competitive rate where it backed by effective regulated cost recovery arrangements, they may be able to delay network billing to retailers to offset cash flow implications and credit support arrangements that now exist under the NECF. The AEMC should reconsider options to facilitate this in preference to the relatively complex and far reaching option of establishing a special administration regime for retailers.

Further comments on specific recommendations in the interim report follow.

➤ **Special administration regime (chapter 5)**

We do not support the draft recommendation to develop a special administration regime for electricity retailers.

The proposed regime is not well targeted or proportionate to the identified problem (financial contagion arising from RoLR arrangements). The special administration regime would require significant changes to established, economy wide insolvency laws and directors duties. It would have far reaching consequences and affect the rights and obligations of all businesses with electricity retail licences, their creditors and trading partners.

The implementation of the scheme would impose significant upfront costs, and ongoing risks, to achieve uncertain benefits. A key difference from standard insolvency processes is that the administration objectives would not include maximising value for the failed retailer's creditors. This would increase the inherent credit risk of electricity retailers and funding costs across the industry.

The proposed requirement that a retailer's electricity retail operations be ring-fenced into a separate corporate entity, together with relevant assets including hedge contracts, would distort business models and crystallise costs upfront.

The special administration scheme would explicitly prohibit counterparties from exercising their termination rights under hedge contracts in order to provide the administrator with the right to determine how and when the hedge book of the failed retailer is unwound. This prohibition would increase the riskiness of contracting with retailers and reduce the ability of the market to efficiently adjust to the failure of a retailer.

The potential benefits of the proposed scheme are not clear. It does not resolve the most difficult issues that arise from the failure of a very large retailer. The circumstances under which Government would intervene still need to be defined and a default allocation method established in case the administrator is unable to sell some customers. All very large electricity retailers

currently own significant generation portfolios. It is counter-intuitive to expect that separating the administration of the retail assets from the generation assets would decrease the cost and risk associated with a Government intervention if spot market prices are anticipated to be high and volatile.

If the AEMC determines to recommend that Government define a last resort role to intervene to prevent the operation of RoLR arrangements then, consistent with the objectives outlined in the interim report, we encourage the AEMC to consider more proportionate, better targeted and less intrusive options.

The precedents identified in the interim report do not demonstrate a need for a special administration scheme, or that it would be effective and provide net benefits if implemented. The AEMC should undertake more detailed analysis to identify and quantify the potential costs, risks and benefits before recommending such a significant and far reaching change.

The costs associated with servicing the failed retailer's customers are real. Increasing the complexity and uncertainty of administrative arrangements will not reduce them. If Government determines that it should have a role to support the orderly liquidation and transfer of customers then this is likely to have cost. If the total net value of a retailer's customers significantly exceeded their liabilities then it is likely that commercial arrangements would have been found to avoid a default event that would trigger RoLR.

Government should be able to negotiate with an administrator to achieve its policy objectives without significant changes to insolvency law if it is prepared to meet the associated costs.

Cost recovery arrangements for Government can be considered separately, and could in theory be established before or after the event. Given that the failure of a very large retailer is highly unlikely, it may be more appropriate for Government to consider whether and how to recover costs after the event, if such an event ever occurs.

➤ **Changes to the RoLR scheme and credit support arrangements (chapter 6)**

The recommendations in the interim report involve four broad changes to RoLR and credit support arrangements.

- a) Amended Cost recovery (box 6.1). We support revised RoLR cost recovery provisions to give the RoLR greater certainty that it can quickly recover all reasonable costs associated with the event.

The RoLR needs certainty that they will be able to recover all costs in a timely manner. This is critical to support short term funding to cover the step change increase in settlement and prudential costs well in advance of receiving additional revenue from consumers. RoLR tariffs should allow for full cost pass through (including time of use components where interval metering is in place).

- b) Delayed notification of RoLR (box 6.3). A short increase in time may be acceptable if this materially assists the AER allocate customers based on expressions of interest. It is not obvious that a short extension of time for the AER to nominate RoLRs to AEMO as recommended would deliver a material benefit.

The interim report observes that this recommendation may marginally increase the financial challenges faced by the designated RoLR. It would be perverse to make a change that increased contagion risk and this option should only be pursued if this increased risk is more than offset by other arrangements.

The AER should actively maintain and encourage a market driven allocation through regular voluntary pre-registration of interest at all times. The RoLR rules need to provide better incentives for retailers to nominate as non default RoLRs.

- c) Amendments to AEMO credit support provisions (box 6.5). The interim report identifies that in the event a large retailer fails, the remaining RoLRs may face an increase in credit support requirements of up to \$500 million. The potential exposure is high because the RoLR inherits the failed retailer's load, but none of its generation or reallocations.

The need to provide credit support is a key driver of the risk of financial contagion. Providing the RoLR with one week's grace, and then ramping their credit support obligations up over a four week period may assist by providing the RoLR greater time to arrange finance, provided the ramp up is carefully designed not to significantly reduce settlement credit quality and transfer risk to generation.

If a large retailer fails it is likely to directly impact on generators (through ownership and/or contracts). Options that transfer risk to generators should be avoided as they may exacerbate the risk of contagion.

The interim report observes that this option may be most beneficial when combined with changes to allow the Commonwealth to post credit support. An alternative interpretation could be that if the Commonwealth is well prepared to offer credit support to a RoLR then delay in the provision of credit support should be unnecessary.

- d) Allowing the Commonwealth government to offer credit support (box 6.6). We support the recommendation that the NER be amended to enable, but not oblige, the Commonwealth government to provide credit support. State and Territory governments already have this capacity.

The interim report identifies that this recommendation would have most benefit if combined with the recommendation to allow a transition period for RoLRs to meet AEMO credit support requirements as Governments are likely to need time to assess the situation before agreeing to post credit support on behalf of a RoLR. Increased certainty and timely decision making may be facilitated by effective planning and the development of decision criteria and draft loan terms in advance.

➤ **Operational refinements to the RoLR arrangements (chapter 7)**

We support refinements to improve operation of RoLR.

- a) Improvements to RoLR processes. The AER and AEMO should continue to investigate improvements to the process of transferring customers to the designated RoLR, particularly the timely provision of accurate customer data. Care must be taken to ensure this activity does not result in significant system change costs for industry based on the low likelihood of such an event.
- b) RoLR arrangements for large customers. The interim report recommends that the AER and AEMO should ensure large customers are informed about their right to opt out of RoLR arrangements and the potential benefits of doing so.

We support this recommendation and encourage the AEMC to consider options to further reduce the magnitude of the RoLR intervention by requiring large customers to nominate their own back up retail arrangements by default.

Reducing the load covered by RoLR reduces the magnitude of the regulatory intervention and all its unintended consequences.

Large industrial and corporate consumers can be excluded as they have the resources and purchasing power to manage the risk of retail failure through procurement and contracting strategies, insurance, and back up generation for critical loads.

- c) Partial market suspension. AEMO has raised concerns about the implications of a retailer failing when it is part of a vertically integrated business and notes that there 'is no mechanism in the NEM for ongoing operation of generation when a business is insolvent or suspended'.

We agree that the rules give rise to some uncertainty as to whether a generator would be available to the market if it is part of a retail group that was suspended, or is itself in administration. In tight supply / demand conditions this could impact supply reliability.

This situation should be resolved through a review of the relevant rules, including the merits of the existing prohibition on trading while in administration¹. It is not obvious why this should be the case for generators or any participant where an administrator is able to provide suitable binding guarantees that they will meet their obligations under the NEM.

The interim report suggests that there may be a conflict between the interests of an administrator of a generator and the best interests of NEM customers or the NEO. It is not obvious why this would be the case as the energy only gross pool appears to align the interests of a generator and the interests of consumers.

We thank the AEMC for the opportunity to respond to the interim report. For any questions regarding this submission, please contact me by email ralph.griffiths@energyaustralia.com.au or by phone on (03) 86281034.

Regards

[signed for email]

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¹ Section 3.3.1 of the national electricity rules