16 July 2013

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

Dear Mr Pierce

RE: NEM Financial Resilience Review Options Paper

Thank you for the opportunity to respond to the National Electricity Market (NEM) Financial Market Resilience First Interim Report (the Interim Report).

The National Generators Forum (NGF) appreciates the level of consideration the Australian Energy Market Commission (AEMC) is giving to understanding the potential risks of financial contagion in the energy sector and raising mitigation options for consideration by stakeholders.

We note the AEMC is proposing a set of recommendations including: Changes to the Retailer of Last Resort (ROLR) Scheme, Australian Energy Market Operator (AEMO) credit support requirements for the ROLR (the upfront package) and the further assessment of a comprehensive Special Administration Regime, which would be triggered instead of the ROLR scheme in the event a large retailer encounters financial distress.

With respect to these recommendations, the NGF is supportive of changes that result in:

- Increased clarity and scope of cost recovery for ROLR;
- Delayed designation of ROLRs to allow customers to be spread across multiple retailers;
- The proposed amendments to the AEMO credit support provision timelines for ROLRs; and
- Allowing the government to offer credit support to AEMO in support of ROLRs.

We agree with the findings in the Interim Report that these particular changes implemented as part of the upfront package would mitigate financial contagion and the risk of cascading retail failure, in the event of a small or medium retailer failure.

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The upfront package and potential enhancements

As noted in our response to the AEMC's earlier Options Paper, we are supportive of exploring options to amend the ROLR credit support arrangements. Of the significant changes proposed, this recommendation represents the least distorting option to the market. While there is some level of increased risk for the generation sector in the event of a large retailer failure, the market would continue to operate without any substantial interference or disruption and generators would continue to be paid by the ROLR.

Further, we consider the enhancements to the cost recovery provisions and the application of Commonwealth Government credit support would mitigate the risk of a cascading retailer failure in the event of an initial large retailer experiencing financial distress.

The ability of this suite of changes to mitigate risk, in the event of a large retailer failure, would however be enhanced if the availability of government credit support was extended to parties other than AEMO. Credit support for financiers to cover immediate unhedged market exposures until cost recovery arrangements are in place, is an example. This credit support could also be provided in the form of a guarantee rather than a direct injection of funds. This would provide a more market based approach, as the designated ROLRs would seek private funding to cover any initial cash shortfalls supported by a government guarantee. With this support, any necessary funding could then be obtained more promptly and at potentially lower cost (to the ROLRs and ultimately customers). Additional enhancements to the cost recovery provisions to include ROLR re-hedging expense (discussed below) could also assist in mitigating contagion risk in the event of a large retailer failure.

Special Administration Regime

The NGF unequivocally disputes any assertion that a Special Administration Regime is required to mitigate financial contagion in the event of a large retailer defaulting. We hold considerable concerns regarding the immediate and longer-term impacts this proposal could present for the efficient operation of the market, access for the sector to sufficient credit liquidity, the efficient use of capital and end-use customer pricing. For example, the broad application of insolvency provisions across sectors promotes the efficient allocation of capital and does not create any investment distortions. The Special Administration Regime, by placing the interests of customers ahead of creditors could devalue investment in utilities and shift capital into other sectors. This could potentially alter investment decisions in the energy sector, which appears contrary to the overall objectives of the review – i.e. to assess and recommend measures to address systemic risk in the sector with a view of protecting the interests of energy consumers.

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The introduction of such a regime also represents a fundamental policy change and key elements are inconsistent with the insolvency provisions (or principals) in the Corporations Law. More importantly, it undermines the integrity of the market and does not support good market governance processes. A formal recommendation would need to be justified on the basis of material evidence that the risk-adjusted benefits of such a change would outweigh the overall costs. This has not been presented to date.

In considering whether the Special Administration Regime presents a necessary and proportionate response, at this stage, the NGF does not consider there is any evidence to suggest the proposed amendments to the ROLR credit support arrangements (coupled with the enhancements to the cost recovery arrangements and government support) will be insufficient to manage the risk of contagion. Further, the Special Administration Regime is likely to create immediate costs (e.g. corporate restructuring, higher hedge prices to off set generators' inability to terminate contracts etc.). Given the low level of risk, we do not see there is sufficient justification for imposing upfront costs on business and consumers. In the unlikely event the market is faced with financial contagion due to the failure of a large retailer, it would be preferable to utilise other mechanisms that would recover the costs at that point in time (e.g. the revised cost recovery arrangements and potential government support).

The NGF also notes that the AEMC is proposing that retail activities be ring-fenced from other business activities. While this may create costly corporate restructures, it could also preclude claims by creditors on other assets of the parent, as the retailer will be a shell company with liabilities and few assets. Depending on the corporate structure and use of reallocations in energy settlement from subsidiary generating companies it may have few hedge contracts that could be transferred upon default. The ring fencing may allow the defaulting party to withhold assets from creditors in the event of default and may encourage greater risk taking by participants in the NEM. This was apparent in the TXU Europe exampled discussed in the attachment.

The NGF also holds more specific concerns with the operation of the scheme and these are discussed below.

Decision making and market uncertainty

The introduction of a Special Administration Regime that may apply instead of the standard ROLR arrangements creates uncertainty for the market in the event a large retailer experiences financial distress. When a ROLR type event occurs, any ambiguity as to the process that will subsequently be followed will provide market uncertainty for a period. Market uncertainty would result in contract market illiquidity until such time as the decision as to whether standard ROLR or the Special Administration Regime is announced. An illiquid contract market would further limit efficient risk remediation opportunities for distressed market participants and thus potentially increase the risk of financial contagion.

Prohibition on termination of contracts

The Interim Report notes a series of potential benefits compared with existing insolvency regimes including a prohibition on the termination of hedge contracts, which does not apply under standard insolvency arrangements. The AEMC state this is a benefit and would allow the administrator to keep the hedge contracts in place during the administration period. This would reduce the amount of credit support required and the level of spot price exposure. While this could be viewed as a benefit from one perspective we consider it presents a range of other issues for the market which could result in higher costs upfront and potentially even bring forward the commencement of a ROLR event.

First, the ability to terminate hedges with a counterparty that is exhibiting a materially weakened financial position is of value to market participants. To remove such flexibility/optionality would reduce the value of derivatives as a market risk management measure and the cost of that uncertainty or lack of control of the credit quality to which they are exposed would filter through to consumers in the form or higher prices. Secondly, Over-the-Counter (OTC) contract holders might give notice to terminate contracts earlier than they otherwise would have to avoid uncertainty regarding to whom their contract position may be allocated under this Special Administration Regime. This could destabilise a weak counterpart earlier than necessary. While at first glance, it may appear to be in the interests of a generator to ensure the contracts remain active, there are numerous reasons why they may wish to terminate contracts with a weakening retailer rather than have them remain active, reallocated or sold. It will be driven on case-by-case basis and would depend on factors such as the size of the counterparty's existing position with the ROLR to which their contracts are being transferred (e.g. credit concentration levels).

Allocation of contracts

We must also raise a concern in an assumption regarding the asserted benefits to both the market and energy consumers of a special administrator transferring existing hedge contracts to alternative parties (the ROLRs). We are very supportive of allocating customers across multiple retailers however, the reallocation of hedge contracts across the designated ROLRs would not necessarily deliver an optimal outcome. Retailers hedge their exposures on a whole of portfolio basis. The hedges originally executed by the failed retailer once split amongst multiple counterparts are unlikely to be an optimal fit for the portfolios of the ROLRs. Further, it is quite likely that in the case of a large retailer failure, the terms of that party's hedge portfolio may have contributed to the failure of the business. Why pass on the decisions made by a failed counterpart to a ROLR? This issue is further explored in the attachment in the context of events associated with the TXU Europe failure.

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It would be preferable to allow the current insolvency provisions to apply and for the ROLRs to enter the market and most efficiently hedge their new loads in line with their individual portfolio requirements. The NGF proposes that a cost recovery allowance related to restructuring hedges and acquisition of new hedges appropriate for their expanded portfolio should be incorporated into the package The associated cost with undertaking this hedging (i.e. depending on market conditions, a retailer may not be minimising its costs by hedging at this time) should be spread across the broadest customer base possible, for example via Distribution Network Service Providers charges.

Partial market suspension

The NGF recognises the benefits of allowing the generation elements of a business with a failed retailer to continue to operate. For example, a single large retailer may own a material component of the generation supply in a NEM region. Allowing the generation component to continue to operate would provide a necessary revenue stream to the business which would assist the failed retailer in meeting its obligations to creditors (existing insolvency driver) and limits the impacts to the wholesale electricity market (i.e. avoids major supply disruption), which is also in the interests of end-use customers.

Summary

The NGF supports the upfront change package and considers that this is sufficient intervention to manage the risk of financial contagion should a small to medium retailer fail. The NGF proposes with enhancements to these recommendations including:

- cost recovery for re-hedging expenses incurred by a ROLR; and
- Government credit support being extended further than AEMO, to include private institutions providing upfront funding support for ROLRs' costs arising from taking on new customers.

The risk of financial contagion should a large retailer fail would also be mitigated and end-user interests protected without the development of a Special Administration Regime.

Yours sincerely

Tim Reardon
Executive Director

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ATTACHMENT

TXU Europe 2002 Events

It appears aspects of the Special Administration Regime are designed around managing the risk of contagion following the failure of a financially distressed retailer that was exposed to high pool prices without adequate hedge contracts in place. Specifically, requiring generators to retain the existing sold position of hedges to the defaulting retailer as they are transferred to another may impose losses onto generators and not the new retailer. While this is concerning, in the event of the failure of a major retailer due to low wholesale prices, it is unclear whether such a requirement would provide any assistance to any party. The following example of TXU Europe highlights this point. TXU Europe suffered financial distress due to holding contracts at higher prices than it was unable to pass on to customers as wholesale prices were low. We note the AEMC cited the TXU Europe case in its Issues Paper last year, as an example of financial contagion. In proposing this set of recommendations, the AEMC however does not identify how they would operate in a similar set of circumstances.

In 2002, TXU Europe went into administration. At this time, TXU Europe was contracted to buy 60pc of Drax's 4GW output for 15 years at a price substantially higher than the prevailing market value. It was reported that Drax abandoned talks over a renegotiated deal and asked for payment of a £267m termination fee within three working days. Drax also demanded £72m for outstanding payments from TXU Europe . Drax's approach appeared to be based on the potential for payment from the parent company TXU Inc, however the subsidiary, TXU Europe successfully went into administration to protect the parent. Drax eventually failed, although it was purported that it was supported by payments from the Market Operator, National Grid, socialised to participants under the New Electricity Trading Arrangements introduced in 2001. Please note that at this time British Energy, the nuclear generator with 10GW of capacity was in discussions with the Government over support to prevent it entering administration.

Based on this example, there does not appear to be any benefit in retaining the derivative contract and passing it onto another retailer – why would another retailer want the out-of-the-money contract that put it into bankruptcy? This is unfairly imposing the costs onto a third party and then rewarding the producer who is not punished for selling a hedge to the defaulting party.

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