

8 June 2023

Anna Collyer
Chair
Australian Energy Market Commission



Submitted online: www.aemc.gov.au
AEMC Ref: RPR0016

Dear Ms Collyer,

Failed Retailer Review – Directions Paper

The Australian Financial Markets Association (AFMA) is responding to the Directions Paper the AEMC has prepared as part of its review into the arrangements for failed retailers' electricity and gas contracts.

AFMA is the leading industry association promoting efficiency, integrity, and professionalism in Australia's financial markets. AFMA has more than 125 members reflecting a broad range of participants in financial markets, including energy companies who are key participants in Australia's energy markets.

Key Points

- **AFMA supports the AEMC's decision not to intervene in derivative contracts**
- **ROLRs should be able to recover the full cost of acting as a ROLR**
- **Gas and electricity cost recovery frameworks should be as similar as possible**
- **To the extent possible, failed retailers should be liable for the cost of a ROLR event**

AFMA considers that this review is timely as the recent unprecedented disruptions in energy markets and resulting failure of a number of retailers, has highlighted the need to ensure arrangements to manage failures, are robust. AFMA appreciates the AEMC's engagement with us and our members on the Review's implications for the financial market and welcomes their decision to explore options based on our recommendations.

AFMA supports the AEMC's decision to explore a ROLR cost recovery framework based on allowing the ROLR to recoup the full cost of acting as a ROLR and making the failed retailer liable for the costs of the ROLR event. Our submission provides suggestions on how this framework could be developed and encourages the AEMC to not pursue separate approaches to gas and electricity ROLR events.

1. Treatment of Gas and Electricity ROLR events

The Directions Paper proposes to take different approaches to ROLR events for gas and electricity on the basis that the differences in risk management between the two fuels warrant this approach. AFMA thinks the AEMC should reconsider this approach, as while the instruments used to manage risk vary between the two fuels,

being mostly physical supply contracts in gas and a combination of financial contracts and asset ownership in electricity; we think that the risks faced by retailers in both markets are fundamentally similar.

1.1. Need for a gas cost recovery mechanism

The AEMC has proposed a number of enhancements to the electricity ROLR cost recovery framework to clarify that the ROLR is able to recover costs incurred in the wholesale market and to make the failed retailer liable for these costs, but is not proposing to make the same changes for gas. The approach taken in the Directions Paper appears to be that, in gas, the fundamental risk for the ROLR is a lack of physical supply, rather than adverse market outcomes, and assumes that the appropriate mechanism to deal with this is to allow the failed retailers gas contracts to be novated to the ROLR. AFMA does not agree with this approach. While we acknowledge that the markets are different and that physical supply is a more important concern in gas, the risk faced by the ROLR is fundamentally the same as in electricity.

For retailers of either fuel the result of a ROLR event is that the ROLR has a number of new customers transferred to them which increases their exposure to the wholesale market beyond the level of the (physical or financial) hedging that they had in place to support their existing customers. Regardless of the fuel, the ROLR has a new wholesale market cost which they have to manage. The main difference is that in gas, this will probably be through physical purchases of gas (either under contract or through spot markets), while in electricity, the retailer will generally have to buy additional financial hedge cover. While the instruments used to cover the ROLR's wholesale costs vary between fuels, AFMA thinks the AEMC should consider the underlying costs as being fundamentally of the same type, i.e. the cost of managing market price risk, and adopt similar policies to assist the ROLR to recover these costs.

Regardless of whether the AEMC chooses to enhance the gas direction power, AFMA thinks it will be necessary to implement a similar cost recovery mechanism for gas as for electricity to deal with circumstances where the failed retailers' gas contracts are either unavailable (see section 3) or are inadequate to meet the ROLR's needs. We understand that the key factor in the failure of Weston, was that its supply of contracted gas was inadequate to meet its customers' demand and therefore Weston was unable to manage its exposure to the spot market. While the ROLRs were no doubt keen to get access to Weston's gas supply contracts, in and of themselves, these were not adequate to cover the ROLR's full exposure to the market. AFMA understands from market participants that in future gas ROLR events, it is likely that the failed retailers' gas contracts will be inadequate to meet the ROLR's costs and that it would be prudent to ensure that there is an appropriate mechanism to allow the ROLR to recover these costs in the same way as in electricity.

1.2. Challenges of intervening in physical gas contracts

AFMA wants to reiterate the views we expressed in response to the AEMC's consultation paper that intervening in physical gas contracts will be complicated and face many of the same obstacles as intervening in derivative contracts. The challenges of intervening in physical gas contracts were highlighted by the AER's experience with Weston's contracts. The Direction Paper is clearly engaging with these issues in its discussion of enhancements to the directions power, including by considering:

- Changes to the triggers.
- Increasing the duration of directions.
- Provisions to govern negotiations about the contracts.
- Expanding the power to include different types of contracts.

While we appreciate the AEMC's efforts to make this framework workable, we question if it is the wisest approach. We anticipate the directions framework will probably result in the AER having to mediate in difficult

commercial discussions between a (probably unwilling) failed retailer and a number of ROLRs. We do not think this is a role that the AER is particularly well qualified to perform and suggest that these discussions are likely to distract the ROLR from the key tasks of managing its increased wholesale market exposure and looking after the transferred customers.

We therefore suggest that the AER's direction powers should be limited to ensuring that the ROLR has physical access to the services it needs to supply the transferred customers, including where necessary, supply, storage, capacity, and transport services. While managing a ROLR's financial risks should be done in substantially the same way for both gas and electricity.

1.3. Gas retail prices

The Directions Paper indicates that the AEMC considers that gas ROLR's are unlikely to need a mechanism to allow them to recover market costs, on the basis that as the Default Market Offer framework does not apply to gas, there is no restriction on them raising prices to recover costs. AFMA thinks this analysis is simplistic and that gas retailers are unlikely to be able to raise prices to recover wholesale costs. We also think it would be undesirable for ROLRs to significantly increase small customer bills and think policy should discourage it.

Under the National Energy Retail Law, gas ROLRs are required to supply transferred small customers at their Standing Offer Price. The Standing Offer Price is the published price that the ROLR supplies all its standing offer customers at. The ROLR can vary their Standing Offer Price without regulatory approval, but they can only be varied once every 6 months and customers must be given at least 10 business days' notice of the change. Assuming that a ROLR wished to increase its standing offer prices to recover the costs of a ROLR event, in the best case it could not do this for 10 business days, and the worst case may not be able to for 6 months, leaving them exposed to the wholesale market in the interim.

An additional constraint on the ROLR's ability to increase its Standing Offer Prices is that the increases will apply to *all* of the ROLR's standing offer customers, not just the ones transferred as a result of the ROLR event. Standing offer customers tend to be some of a retailer's most valuable customers as they pay higher tariffs and have lower churn rates than other customers. Retailers are therefore likely to be very reluctant to increase prices for these customers in a way that could result in a significant number of them choosing to change retailer. AFMA therefore thinks it is unlikely that ROLRs will choose to recover ROLR wholesale costs by rapidly increasing small customer tariffs.

AFMA recommends that a similar cost recovery mechanism should be included for gas as for electricity. Both as it is unlikely that ROLR's will be able to recover the full cost from the transferred customers, and because subjecting transferred customers to large price increases would be an undesirable policy outcome.

AFMA Recommendations

- i. Similar cost recovery mechanisms should apply to both gas and electricity
- ii. Gas ROLR's should not have to rely on lifting Standing Offer Prices to recover ROLR costs
- iii. The gas directions framework should be limited to ensuring physical access to distribution networks

2. ROLR costs

2.1. Allowable costs

AFMA supports the ROLR being able to recover the full costs of providing ROLR services and encourages the AEMC to ensure that any legislative provisions are written appropriately broadly to allow this to occur. That said, we thought it would be helpful to provide some observations on how the AER should consider the

wholesale market costs a ROLR is able to recover. At the highest level, AFMA considers that the ROLR should be allowed to recover the cost of putting in place prudent risk management arrangements for the transferred customers. Given the importance of ROLR services to the market, and the need for the ROLR to act quickly to manage its risk, and prevent further contagion, we think the AER should show significant deference to the ROLR's commercial decision making when deciding what costs are recoverable.

Without limiting the range of costs that a ROLR can recover, AFMA thinks the AER should allow the ROLR to recover the cost of putting in place at least the same level of hedging protection as it has for its existing customers, noting that hedges may be needed for multiple types of products including, energy, environmental products (such as LGCs), weather and potentially more traditional financial risks such as interest rates and FX. Determining the cost of this hedge cover during a period of potential market volatility following a ROLR event will be difficult and the ROLR is likely to face elevated costs. Circumstances like this are currently addressed commercially in the ISDA Master Agreement which allows a party who has been disadvantaged by the failure of their counterparty to recover their loss from the counterparty. The value of their loss is determined based on the cost of a person acting in good faith, using commercially reasonable procedures to produce a commercially reasonable result to purchase replacement financial products. In practice, this will generally result in the disadvantaged party being able to recover the cost of buying a replacement product at current market prices.

Additionally, to the extent that ROLRs incur financing costs as a result of delays in the payment of their ROLR costs, they should be able to recover these costs.

2.2. Timing of payments and evidence

One of the key risks following a ROLR event is the subsequent failure of the ROLR as a result of them being unable to meet their wholesale market obligations in the immediate aftermath of the initial ROLR event. AFMA therefore thinks that it is critically important for the ROLR to be able to access funds quickly after a ROLR event to ensure they are able to meet their obligations.

AFMA suggests ROLRs should be able to access payments quickly after a ROLR event based on high level estimates of their expected costs. Given the nature of ROLR events, initial estimates of costs will be made on limited evidence and are likely to be inaccurate. We therefore think the AEMC should consider developing a fairly flexible multi-stage process where the ROLR is able to recover an initial amount based on their early estimates, with limited supporting evidence, and further amounts as their costs become clearer. To mitigate the risk of over recovery, there should be a reconciliation process after all costs, and any additional revenue from the transferred customers, are fully known. The ROLR should be required to substantiate its costs at this point and return any over recovered amounts.

2.3. Funding payments

Under the current framework, the AER must determine the process for recovering ROLR costs following each event. AFMA understands that in practice, the AER will generally decide to recover ROLR costs from regulated distribution networks, who in turn will be allowed to recover the costs through higher regulated tariffs.

To date this arrangement has worked well as the recovered ROLR costs have been modest and we understand that networks have paid the costs promptly. But we are concerned that this framework probably is not responsive enough for cases when ROLRs need to recover substantial costs (probably in the order of tens of

millions of dollars) at very short notice (probably a handful of days). As suggested in our earlier submission, to allow the ROLR to recover costs promptly AFMA recommends they should be able to recover them from the AER (or another market body) who would then be able to recover the costs from the market more broadly as is currently the case. We want to emphasise that we are not suggesting that the AER should ultimately bear the cost of a ROLR event, just that to avoid a cascading ROLR event, the ROLR may need to be able access funds more quickly than the current mechanism would allow and we consider that only government will be well placed to provide the requisite funding.

AFMA Recommendations

- iv. Cost recovery provisions should be written broadly to allow recovery of all relevant costs
- v. The recovery provisions should show deference to the ROLR's commercial decision making
- vi. The cost recovery mechanism should allow initial payments to be made to ROLR's quickly, with further rounds to allow for adjustments

3. Cost recovery from failed retailers

AFMA considers allowing the costs of a ROLR event to be recovered from a failed retailer will serve an important function to deter disorderly exits from the energy market. For the deterrent to be effective the AEMC will have to balance designing a mechanism that can credibly recover costs from the failed retailer against the increase cost such a mechanism will impose on all retailers.

The issues involved in recovering costs from a failed retailer are complicated and there may be merit in implementing the AEMC's other proposals first and allowing more time to develop a mechanism to recover costs from failed retailers. Our views on how to strike this balance are set out below.

3.1. Deterrence

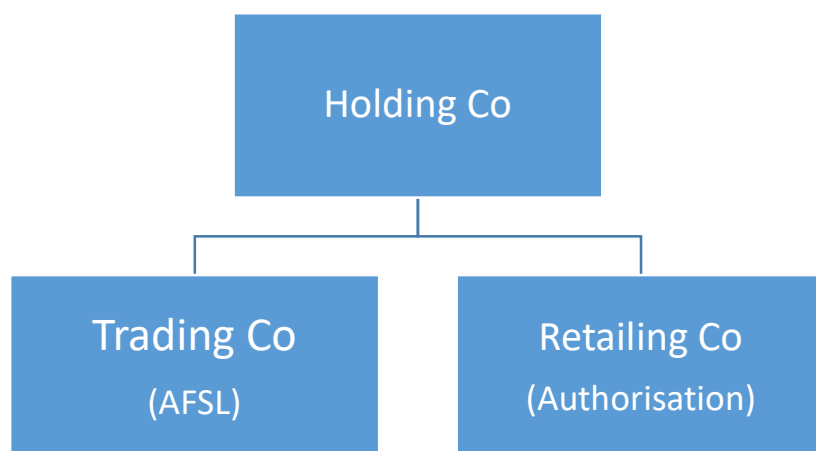
AFMA welcomes the AEMC's decision to explore cost recovery from the failed retailer. While it is unlikely that the full costs of a ROLR event will ever be recovered from a failed retailer, AFMA thinks that being able to pursue costs will act as an appropriate deterrent to retailers looking to use the ROLR framework as a low cost way to exit energy retailing. As stated above, AFMA considers the proposed cost recovery framework should also apply to gas, part of the reason for this is so it can serve as a deterrent for gas retailers who are considering exiting the market in a disorderly manner.

3.2. Corporate groups

While AFMA supports recovery of costs from the failed retailer we consider that there are a number of practical challenges that will limit the effectiveness of both; cost recovery from the failed retailer and the gas directions powers. We have provided some recommendations about how these risks could be minimised but want to be clear that in both gas and electricity, there will need to be a mechanism to recover ROLR costs from the market more broadly when these arrangements fail.

Our previous submission encouraged the AEMC to engage with the formal structure of corporate groups to ensure that the cost recovery mechanisms are effective. The below example depicts a simple corporate structure that AFMA understands is similar to ones used by many energy retailers:

Example:



The market participant has adopted a simple holding company structure with two wholly owned operating companies:

- **Holding Co** – is the parent company that all profits and losses are reported through
- **Trading Co** – holds an Australian Financial Services Licence (AFSL) and is party to all hedging and physical gas contracts
- **Retailing Co** – holds a Retail Authorisation and is part to all gas and electricity customer contracts

Under the current arrangements, the AER can only make orders in relation to Retailing Co. Under the current rules the AER cannot make an effective gas direction in relation to the group as the physical gas contracts are held by Trading Co. The AEMC’s proposed framework would encounter the same problems for both gas directions and cost recovery as the AER would be unable to make orders against the gas and derivative contracts held by Trading Co or any profits held by Holding Co. In this example, neither the gas directions power or the cost recovery mechanism would be effective as the relevant assets would be in different companies within the group. As a result it also would serve limited deterrent value to this entity.

In our previous submission, we argued that costs should be able to be recovered from related companies of the authorised retailer. We still consider that this should be the case.

3.3. Funding implications

AFMA’s members think that authorised retailers should have an adequate level of financial resources to allow them to conduct their business and that inadequately resourced entities should not be able to become retailers. But they are also keen to preserve competition in the retail market by not setting barriers to entry too high. AFMA is concerned the AEMC’s proposal for the AER to register PPSR securities may make it more difficult for retailers to access funding for their business, with the unintended consequence of decreasing competition.

In our previous submission we pointed out that to allow retailers to access credit lenders need to be confident that they can take security over the retailer's assets and that in the event of an insolvency they will be able to access them. We advised that the AEMC should consider how the ROLR cost recovery framework could be designed to protect the rights of arm's length secured creditors. We are concerned that the proposed approach of allowing the AER to register security interests does not strike the right balance. Particularly we are concerned that retailers will find it difficult to access credit after the AER registers a security interest as that security will have higher ranking priority than the lenders.

We encourage the AEMC to consider how the cost recovery framework could be designed to minimise the impact on retailers' ability to access credit. An approach that could be adopted within the energy regulatory framework would be to have the AER perform a more rigorous assessment of assessment of potential retailers' financial requirements, in a way similar to ASIC's assessment when granting an Australian Financial Services Licence, and potentially requiring poorly resourced retailers to hold capital to ensure they can meet their obligations.

AFMA Recommendations

- vii. Allowing costs to be recovered from the failed retailer will have an important deterrent effect
- viii. Cost recovery should be permitted from related companies of the failed retailer
- ix. The cost recovery mechanism should be designed to limit the impact on retailers' ability to access credit
- x. An effective mechanism to allow gas and electricity retailers to recover costs from the broader market when the failed retailer's assets are inadequate will remain necessary
- xi. The AEMC should consult with Treasury on the development of the cost recovery mechanism and should if additional time is required for implementing the cost recovery proposals.

AFMA would welcome the opportunity to discuss the AEMC's review of the arrangements for failed retailers. Please contact me on 02 9776 7994 or by email at lgamble@afma.com.au.

Yours sincerely



Lindsay Gamble
Policy Director