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Chris Spangaro
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Australian Energy Market Commission
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Project number: EMO0024
By email: electricity@pc.gov.au

Dear Senior Director

AEMC NEM Financial Market Resilience Options Paper

AGL thanks the Australian Energy Market Commission (AEMC) for the opportunity to comment on its National Electricity Market (NEM) Financial Market Resilience Options Paper (the Paper).

AGL operates across the energy supply chain and has investments in energy retailing, energy services, coal-fired electricity generation, gas-fired electricity generation, renewables and upstream gas extraction.

AGL acknowledges the considerable effort the AEMC has expended in preparing the Paper. Having been closely involved in the completion of the Paper, AGL considers that the options presented are comprehensive and that the AEMC clearly understands the implications and risks – not only of the possible failure of a large retailer and subsequent enaction of the Retailer of Last Resort provisions (ROLR) – but also the potential risks associated with implementing measures aimed at mitigating the possibility of financial market contagion that could arise from such an event.

In this submission AGL has separated the fourteen options put forward by the AEMC in the Paper into three distinct groups; supported options, not support options and the options that may benefit from further assessment and analysis.

Although AGL considers that the possibility of a large retailer failing is remote, there are currently impediments to the efficient operation of the market that may actually increase the liklihood of retailer failure. Specifically, AGL is firmly of the view that the ongoing use of retail price regulation may increase the probability of retailer failure – as retailers in regulated markets are unable to efficiently pass through their costs. To address this risk, AGL considers that retail prices should be deregulated, smart meters introduced on a contestable basis and that cost-reflective time-varying tariffs be adopted – provided there are appropriate safeguards for hardship customers.

From AGL's persepective any measure or measures that may ultimately be introduced to mitigate the possibility of financial market contagion following a ROLR event should:

- Recognise that no one measure will ever be a panacea, given the possible scope and scale of impacts from such an event;

- Aim to ensure that appropriate commercial signals remain in place so that participants incentives are not diminished or diluted;
- Be least instrusive, and minimise financial imposts, so as not to diminish the efficient operation of the market overall; and
- Clearly stipulate the role, if any, of Government in responding to such an event.

If the ROLR provisions came into effect the key matters that the designated ROLR would have to rapidly address are:

- Ensuring compliance with relevant prudential obligations – this would likely necessitate a significant increase in financial capital, or similar, to match the obligations arising from the increased customer load;
- Ensuring that the new customer load is hedged – so that the ROLR's new customer base is effectively 'insured' against the wholesale pool price fluctuations[1]; and
- Instituting billing arrangements – so as to ensure timely recovery of additional costs arising from the new load.

Each of these is a non trivial matter to address and, in the event of the failure of a large retailer, may take considerable time to put into effect. Accordingly, AGL readily supports measures that provide assistance to the designated ROLR in addressing these matters. The following options are identified as meeting this criteria:

Option 1: Revised cost recovery arrangements

This option is supported as it would effectively allow the ROLR to recover its costs from the new customer load.

Option 7: Amendments to Distribution Network Service Provider (DNSP) credit support provisions

This option is supported as it would reduce the ROLR obligations to DNSPs – which will assist them with transitioning the new customer load into their business.

Option 10: Delayed settlement period for designated ROLR to pay AEMO; and Option 11: Delayed settlement period for the designated RoLR to pay network charges

These two options are supported as they would effectively assist the ROLR in transitioning the new customer load into their business whilst delaying the financial imposts associated with doing so.

Noting that no one option will provide a panacea, some – or all – of the options supported by AGL above, may need to be implemented in combination.

In contast, AGL does not support the following options in the Paper:

Option 3: Transfer of hedge contracts to designated ROLR

This option is not supported for two reasons. Firstly, the failure of the initial retailer is likely to be directly linked to hedging arrangements – as such it would unlikely to be beneficial to pass these contracts to the ROLR. Secondly, in the event of a

[1] One potential impact of having to absorb costs related to the failure of another large retailer is the detrimental effect it might have on that retailer being able to meet the financial requirements test under their Australian Financial Services (AFS) licence. While these financial requirements are currently under review by ASIC, at the moment each licence holder needs to ensure that they hold a minimum amount of Adjusted Surplus Liquid Funds (ASLF). If a retailer was to incur large and sudden hedge or other market costs from another retailer being in default then not being able to meet the ASLF requirement would prohibit them from being able to transact additional hedges with over the counter counterparties while additional funds were sourced or relief from licence obligations was sought from Australian Securities Invesment Commission.

default on part of the failing retailer all of the hedging contracts in place would be suspended – removing the possibility of them being transferred to the designated ROLR.

Option 4: Amending the ROLR event triggers; and Option 6: Amendments to AEMO credit support provisions

This option is not supported as it merely transfers the risk away from the designated ROLR directly to generators – who may be unable to adequately manage this risk. This is clearly noted in the Paper "generators would bear the risk that the designated ROLR fails and does not pay AEMO".

Option 8: Spot market price cap

This option is not supported as it would significantly adversely effect the operation of the market by reducing the revenue of generators that may not have actually been linked to the initial failing retailer.

Option 9: Initial period where the designated RoLR passes through retail prices

This option is not supported as, given its complexity, it is unlikely to be readily implementable. This is clearly noted in the options paper which notes the difficulty of setting a transitional tariff, setting the trigger mechanism, defining the transition period and that generators would ultimately bear the cost of this approach.

Option 12: Industry co-insurance fund

This option is not supported as it would be extremely difficult to determine what volume of funds were necessary to adequately insure a ROLR event which may lead to the over recovery of funds from the sector. Further, if such a fund sat unused for a period of time the possibility exists that the funds may be directed to alternative objectives. Finally, the imposition of such a fund would increase retailers costs.

Finally, AGL considers that there is merit in the AEMC further exploring the following options:

Option 2: Enhanced preparation arrangements for a ROLR event

This option is supported, as warranting further assessement, as such an exercise will clearly inform the steps necessary to respond in responding to a ROLR event involving a large retailer. However, AGL considers that it is not reasonable for the AER to be able to interrogate all retailers in order to inform their planning and preparation for a ROLR event.

Option 5: Delayed designation of ROLRs

This option is supported on the basis of it being assessed further because it may provide a better spread of the risks between relevant market participants. Further, by designating numerous ROLRs it may also dilute the burden placed on a single designated ROLR.

Potentially such an option could be included within the mix of options supported by AGL above.

Option 13: A government entity posts credit support for the designated RoLR; and Option 14: Enhanced administration arrangements coupled with interim government funding

In the event of a large retailer failure, and enaction of the ROLR provisions, it is likely that government's will be keenly interested in taking steps to ensure that customers needs are met given that electricity is an essential service.

However, the involvement of governments in such a situation is difficult to frame given that government would effectively become a lender of last resort. Such involvement could potentially lead to the dilution of commercial incentives for market participants and the socialisation of the costs associated with failure of the retailer. In addition, if government were to post credit support or provide funding it is likely to lead to more intrusive intervention and the requests for greater information gathering powers.

Any role for government should be clearly defined and exercised by an independent agency, with costs recovered from consumers through network charges or levees.

Given these issues, these options are only tentatively supported.

An option that is not raised in the Paper, that may warrant further investigation, is the possibility of excluding large loads i.e. industrial and large commercial consumers from the ROLR. Given the size of these customers, this approach may reduce the scale and scope of the response required following a ROLR event. Such an approach would however require that these customers manage their own risks if their retailer failed.

Should you have any questions on issues raised in AGL's submission, please contact Simon Camroux at scamroux@agl.com.au or (03) 8633 6967.

Yours sincerely,

Alex Cruickshank
Head of Energy Regulation