20 December 2012

Mr John Pierce
Commissioner
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted online: www.aemc.gov.au

Dear Mr Pierce

EMO0024 – NEM Financial Markets Resilience

Origin Energy (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Options Paper on the National Electricity Market (NEM) financial markets resilience. Origin agrees with the AEMC that the financial relationships underpinning the NEM are generally robust. Notwithstanding the financial integrity of the NEM the collapse of the Retailer of Last Resort (ROLR) following the failure of a tier 1 or large tier 2 retailer remains the highest risk for financial contagion in the NEM.

As Australia's largest default ROLR Origin has an ongoing interest in the development of a national ROLR framework. Origin participated in previous ROLR events with the collapse of Energy One in June 2007 and Jack Green in December 2009. Integrating the customers of a failed retailer into an existing retail portfolio is complex and we welcome options to improve processes that mitigate the potential risks involved.

Origin commends the AEMC for identifying a broad range of options that could mitigate the risks for a ROLR. We consider a 'tool kit' response or combination of options could form an optimal framework to manage the continuation of supply to consumers after a ROLR event. The AEMC has accurately identified that minimising regulatory intervention and distortion to the efficient operation of the NEM should be an objective of the ROLR framework.

Making the ROLR event commercially viable for retailers to be incentivised to register with the Australian Energy Regulator (AER) to participate as a ROLR is important to helping the ROLR regime function effectively, and could diversify and reduce the overall risk for each individual retailer. A clear process and right for cost recovery is a key element to making the framework commercially viable and minimising regulatory intervention. Alongside this, appropriate mechanisms must be in place to manage the step change increase in credit support requirements over the short period when a retailer takes over the customers of a failed retailer subject to a ROLR event.

Origin strongly advocates that the ROLR scheme supports the financial viability of the ROLR and recognises the importance of its role as supplier of last resort. The ROLR performs a unique and important role as a guarantor in Australian energy markets. Enabling the ROLR to manage the costs and risk of continual supply while minimising the financial credit support requirements over the initial months of a ROLR event should be an objective for a ROLR framework.

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Yours sincerely,

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1. *Challenges with the Retailer of Last Resort Arrangements*

Origin has consistently maintained that the ROLR provides a guarantee for the continual supply and overall financial stability of energy markets. The ROLR provides an important service to consumers and incurs a range of costs for doing so. Origin considers the primary risk for a ROLR is where the timely recovery of costs is inadequate and, in an extreme scenario, causes cash-flow constraints[1]. Where limited cash-flow results in short payments to the Australian Energy Market Operator (AEMO) secondary risks in financial markets could arise through non-compliance with credit support requirements triggering a default and potential market suspension for the ROLR.

Consumers are an asset for retailers. There is a cost to retailers, however, to acquire, retain and manage customers whether gained through a ROLR event, business acquisition or market churn. The asset value of consumers is therefore intrinsically linked to their profitability; the retailer needs to be able to generate stable revenue from customers that allows the retailer to recover the reasonable costs of supplying them. An inability of a retailer to recover costs from a consumer, through churn or default, creates a direct cash-flow and profitability risk for the retailer.

In this extreme scenario, an inability to recover reasonable costs could result in the ROLR defaulting itself through making a short payment to the AEMO. Under the National Electricity Rules (NER), AEMO would be required to draw down on the credit support provided by the retailer to keep payments to generators whole. The retailer would be required to rectify any potential short fall in credit support requirements within 24 hours. Where credit support requirements remain non-compliant AEMO would be obliged to issue a default notice followed by market suspension.

Arranging a potential $100 million increase in credit support requirements from lenders within the timeframe of market suspension is a challenge for a ROLR. The subsequent implication is the downward pressure the increase in financing requirements could have on the credit rating of the ROLR. The significance of this is where, under NECF the credit rating of the ROLR is linked to the quantum of credit support requirements for DNSPs.

2. *Assessing the options*

Origin agrees with the AEMC that “mechanisms that operate within the market frameworks are generally preferable to an undefined government response.”[2] Managing the risk of financial distress at a retailer being transferred to other retailers needs to be balanced against regulatory intrusion that could reduce competition, investor confidence and threaten the longer term reliability of supply. The ROLR mechanism is a temporary safety net in the NEM, which provides consumers and investors stability in the ongoing operation of the NEM after the collapse of a retailer.

Origin considers there are two key principles for assessing the options raised by the AEMC:

- Does the option mitigate a risk or diversify it between the ROLR and third parties, depending on who is in a position to manage it efficiently; and
- Does the option minimise interruption and intervention in the NEM that could adversely affect its efficient operation.

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[1] Origin refers to cash-flow constraints where the receivables from the ROLR event are inadequate to service the costs incurred and payments are facilitated through drawing down lines of credit.

[2] AEMC 2012, NEM financial markets resilience, Options Paper, 8 November 2012, Sydney. p. 22.

Using this framework, Origin considers some of the options raised by the AEMC are effective at diversifying risks away from the ROLR to other voluntary participants with minimal interruption to the operation of the market. Other options, however, are likely to increase the risks for the ROLR; introduce a market intervention; or transfer costs from the ROLR to other market participants who are not in a position to manage them.

The remainder of the paper is structured as follows:

- Implementing the National Energy Consumer Framework (NECF);
- Options to improve cost recovery in the NEM;
- Reducing financial market risk through credit support requirements;
- Options not suitable for implementation; and
- Operational practicalities of being a ROLR.

In assessing the range of options, Origin also considered the operational practicalities of being one of the largest retailer's of last resort in the NEM. While not explicitly discussed in the AEMC's Options Paper, we provide some suggestions on operational improvements that could greatly assist ROLRs in performing their functions, particularly with respect to managing cash-flows and cost recovery.

3. Implementing the National Energy Consumer Framework

Origin considers a nationally consistent ROLR framework is critical in reducing complexity and duplication of process especially considering retailers operate in a national market. Origin notes that legislation was passed in March 2011 to create NECF. The NECF comprising the National Energy Retail Law was to allow for a national ROLR scheme with common arrangement across participating jurisdictions and is yet to be implemented across all NEM jurisdictions.

While the scheme was to commence in July 2012, to date NECF has only been implemented in Tasmania and the ACT with South Australia and New South Wales expected to pass legislation in February and mid-2013 respectively. Victoria has withdrawn the legislation to implement NECF although has committed to harmonised legislation with NECF with Queensland currently undecided about committing to the scheme.

Origin supports the objective under NECF that the ROLR have an opportunity to recover reasonable costs[3]. The ROLR provisions under NECF mitigate some concerns over cost recovery through enhancing the cost recovery mechanism. Allowing additional ROLRs to register as firm or non-firm ROLRs also allows for the costs and risk to be shared among participants willing and with the resources to manage the transfer of customers.

Importantly, jurisdictional differences in Victoria and NSW impose a cap on what can be recovered from consumers. Origin agrees with the AEMC that "the risks of a large retailer failure could be exacerbated by retail price regulation which remains in place in most NEM jurisdictions."[4] Origin considers price caps for cost recovery constitute a form of retail price regulation that increases the risks for a ROLR. A preferred option would be for the AER to determine the reasonable costs that can be recovered from consumers.

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[3] AER 2011, Retailer of Last Resort Statement of Approach, Melbourne. p. 3.
[4] Op Cit, AEMC 2012. p. 10.

4. Options to Improve ROLR cost recovery in the NEM

Cost recovery mechanisms should reflect the benefit that the ROLR provides a guarantee for the continuation of supply and ongoing financial stability in energy markets. Origin considers the ROLR scheme should support the ongoing financial viability of the ROLR and recognises the importance of its role as a supplier of last resort. The ability to recover reasonable costs could also influence the voluntary participation of additional ROLRs diversifying costs among ROLRs and minimising potential cash-flow risks overall.

4.1. Principles for efficient cost recovery

Origin notes the ROLR cost recovery scheme in the AER Retailer of Last Resort Statement of Approach, November 2011. The principles created a gap in the costs incurred by the ROLR and the limits on recoverable costs by stating:

> *…the ROLR should be provided with a reasonable opportunity to recover its reasonable costs incurred, and given the need to ensure the market integrity and security of the energy market following a ROLR event, limits on the classes or magnitude of costs will generally not be imposed…[However] cost recovery should not result in onerous price shocks for small consumers, as this may present hardship issues for some consumers.*[5]

We consider that the reasonable costs of acting as a guarantor and supplier of last resort should be recoverable. The practical application of cost recovery is more difficult. For example, imposing a price cap on the costs that can be recovered from a ROLR event could be seen as a form of price regulation, which imposes risks for the ROLR. We agree with the AER that upfront fees may not be appropriate[6] both for the consumer and on a commercial and marketing basis; if you charge a customer as soon as you become their new retailer, they are more likely to seek a new retailer.

Origin supports the amendments to cost recovery arrangements proposed by the AEMC including:

- A clear process for cost recovery through the AER;
- A right to recover reasonable costs incurred in the ROLR event for example;
    - Administrative costs
    - Spot market or hedge costs
    - Financing costs related to any additional credit support
    - Financing costs from when the costs have accrued and when the costs have been recovered.[7]
- The ROLR framework in energy markets should also allow for the full cost pass through of carbon and associated green schemes.

We agree with the AEMC that a clear timeframe covering what costs can be recovered should be stated and support a three to six month timeframe as adequate. A timely cost recovery mechanism is also critical for it to be successful in mitigating cash-flow risks for the ROLR.

[5] Ibid. p. 19.
[6] Ibid.
[7] Op Cit, AEMC 2012. p. 39.

4.2. National Electricity Rules ROLR Compensation provision

The AEMC raised an option for the establishment of an industry compensation fund to assist with financing the costs of the ROLR event. Origin does not support maintaining an industry fund to support the costs of a ROLR[8]. We do, however, consider there may be a case for the ROLR to be eligible for compensation where there is a gap between the costs recovered from consumers and the costs incurred by covering the ROLR event. The ROLR could make its case to the AER or AEMO identifying the gap payment. This would be consistent with the compensation provisions in the NER clause 3.15.7 for directed generators where AEMO directs them to generate when the market conditions would otherwise make it uneconomic to do so. While this would not necessarily assist with the immediate cash-flow issues, we do consider it could assist in improving certainty around cost recovery more generally.

4.3. Incentives to encourage voluntary ROLRs

Origin considers an enhanced cost recovery mechanism could assist with encouraging additional retailers to participant in a ROLR event. Customers are an asset to retailers and enabling retailers to benefit from the collapse of a failed retailer is an efficient market based method to encourage greater retailer involvement in a ROLR event. This diversifies risks away from the default ROLR minimising cash-flow risks. An enhanced cost recovery mechanism is crucial for this to succeed.

The AEMC has proposed an option for the augmentation of the NECF ROLR provisions for a greater role for the AER to appoint a ROLR. Origin supports the NECF provisions for retailers to be able to register an expression-of-interest with the AER to be either a firm or non-firm ROLR in a ROLR event. We do not support nor do we consider there to be justifiable reasons to enhance the role of the AER.

We note the AER may appoint a designated or an additional ROLR on the provision it considers the retailer has the financial and business resources to act as a ROLR.[9] While this may be considered a prudent measure, it in no way constitutes a premise for the AER to "be given stronger powers to compel retailers to provide information on a regular basis so it [can] decide who is best placed to act as the designated ROLR."[10]

Market based incentives are more preferable to regulatory intervention to enhancing and achieving the National Electricity Objective. To this extent, we consider there to be a limited justification for the AER to mandate retailers to participate in the ROLR framework when, if possessing the requisite resources, they most likely would register in a non-firm capacity with the AER when they are incentivised to do so.

5. Reducing financial market risk through credit support requirements

Origin agrees with the AEMC that the financial relationships underpinning the NEM are generally robust. As a default ROLR, consistent with the AER ROLR guidelines, Origin has the resources to adequately manage risks in electricity markets from the transfer of a large number of customers and could access financial resources at short notice. The ROLR therefore, Origin or otherwise, becomes responsible for payment to AEMO and for posting credit support to AEMO and Distribution Network Service Providers (DNSPs) for the customers of the failed retailer. This does however increase the financial risk for the

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[8] Origin considers an industry fund would be an inefficient use of capital with it unlikely to be of sufficient size and where the funds are utilised it would be unlikely for the funds to be recovered from the ROLR.
[9] Op Cit, AER 2011. p. 5.
[10] Op Cit AEMC 2012. p. 45.

ROLR that could be reduced were the Commonwealth government to underwrite the credit support guarantee for the ROLR.

An AEMC option was for the Commonwealth government to provide credit support for the ROLR. This is a preferable option to deferring credit support to DNSPs and AEMO for the ROLR as the link between the credit support requirements and the ROLR remains. The role for the Commonwealth government through Treasury and the Reserve Bank could decouple the financial market risks from the ROLR allowing the ROLR to perform the role of guarantor and continuing supply to the customers of the failed retailer in the electricity market.

The materiality of financial risk estimated by the AEMC is significant and could exceed $100 million[11]. Origin considers this to be an accurate estimation of the credit support requirements under the collapse of a large retailer under the current 20 business day settlement cycle. This liability could potentially be imposed on a single ROLR and where the ROLR failed, the cost would be allocated across generators in the NEM.

The step change in credit support requirements under the ROLR framework could potentially have broader unintended consequences that: flow through to a ROLR's credit rating; impact its ability to meet its ASIC Australian Financial Services Licence requirements; and impact credit standing with energy market counter-parties. This is a critical issue under the NECF scheme where credit support requirements are linked to the credit rating of the ROLR. In attempting to mitigate financial risks they are imposing escalated liabilities on financially resilient retailers possessing investment grade credit ratings.

Any role for the Commonwealth government could only be considered in the extreme, low probability high impact scenario of the collapse of a major tier 1 or large tier 2 retailer. Importantly this option should not be considered in a limited context of the credit rating or financial resilience of electricity retailers but to financial intermediaries more broadly as it is financial institutions that would be expected to underwrite the financial risk. In this context the intervention would remove the $100 million risk to both participants in the electricity and financial markets allowing the ROLR to act as a supplier of last resort unencumbered by the significant additional financial credit support requirements.

6. Options not suitable for implementation

Origin does not support the options that sought to change the settlement process through amending the suspension provisions, administering the spot market for the ROLR customers and amending the settlement period for the ROLR. We consider these options are not suitable as they transfer costs onto third parties who cannot manage them and disrupt the efficient operation of the market.

6.1. Amending NEM suspension provisions and delaying the appointment of ROLR

Origin does not support amendments to the NEM settlements provisions to delay market suspension or delaying the appointment of a ROLR. Origin considers changing the settlements process could lead to inefficiencies in the AEMO settlements process through:

- Delaying the suspension provisions would also be extending the settlement cycle and increasing the prudential requirements on retailers;

[11] Ibid. p. 63.

- Delaying the appointment of the ROLR could result in an accumulation in liabilities for the ROLR that they would have no visibility over and limited in the capacity to hedge; and
- Amending the settlement provisions could also lead to an increase in liabilities owed by the retailer to AEMO that could either result in:
    - A short payment to generators; or
    - Increase payment by banks to cover the credit support provided through bank guarantees.

6.2. Administering a $300MWh price cap or "transitional ROLR tariff"

The AEMC raised the option of a $300 spot price cap or a "transitional ROLR tariff" to limit the wholesale market costs and risks to the ROLR. Origin does not support administering the spot price through a ROLR event as it transfers costs from the ROLR to generators. The NEM was designed with a high Market Price Cap (MPC) to allow for generators to recover the capital cost of the investment and it is therefore important to preserve investor confidence and encourage investment in the NEM consistent with the National Electricity Objective

6.3. Extended period for ROLR to pay AEMO or DNSP

Extending the period for the ROLR to pay AEMO and DNSPs was an option noted by the AEMC and is not supported by Origin. We consider delaying payment to AEMO or DNSPs beyond the 20 working days is likely to be of limited benefit in improving cost recovery or minimising cash flow risks for the retailer. The primary reason for this is the customer of the failed retailer has either transferred from the ROLR to another retailer or there is a limited ability to collect outstanding money from the consumer.

Origin considers the option for delayed payment has other potential risks for the ROLR, AEMO and DNSPs. Delaying payment would involve extending the settlement cycle and would consequently involve the ROLR having to meet higher prudential requirements as a consequence. Delaying payment could respectively result in a reduction in cash flow and working capital for generators and DNSPs transferring the costs and risks from the ROLR to third parties.

6.4. Acquiring hedge contracts and government appointed receivers

Origin also does not support options to transfer hedge contracts or have government appointed administrators as both seek to impose obligations on counterparties and products that are outside current market frameworks where participants can voluntarily enter commercial agreements with other participants.

The hedge contracts of a failed retailer are unlikely to be 'in the money'. The default however, more importantly would likely trigger a credit event that would void the contract between the two counter-parties. Having the ROLR become the counter-party to a hedge contract would likely change the risk profile and therefore cost for both the generator and the ROLR and be in neither participant interest for the contract to be transferred.

Government appointed administrators would represent an intervention in the normal operation of the market. Where a retailer was in distress a trade sale or the equity valuation of the failing retailer could make it an attractive option for potential new investors. Retailing in the NEM requires detailed knowledge of the operational risks and challenges that would likely render government administrators ineffectual in mitigating the risks of failure.

7. Operational practicalities of being a ROLR

As discussed, a ROLR event transfers large risks to the ROLR. The challenge for the ROLR is arranging credit support, hedges and performing administrative functions in a limited timeframe and with incomplete information. In order to respond as efficiently as possible a ROLR requires information on customers to enable the ROLR to make informed decisions based on the customer load profile to enable optimal hedging.

From a wholesale market risk perspective the ROLR requires an understanding of the number of customers and customer classification including residential, commercial and industrial of the failed retailer. The jurisdictional location of the customers is also critical in establishing the load size and profile to determine available hedging options. Without this information the ROLR is making decisions based on estimation and 'rules of thumb' leading to inefficient hedging options potentially exposing the ROLR to elevated market risk.

From a retail perspective the ROLR requires a range of detailed customer information including;

- Names and billing address;
- Identification of hardship customers;
- life support flags; and
- Concessions.

The more standard this information is, the easier it can be to import into a ROLR's systems, streamlining the ROLR's ability to start billing its new customers.

Origin supports the AEMC investigating operational arrangements that ensure:

- The ROLR has clear customer information and classification and suggest AEMO could 'flag' customers based on load volumes
- The ROLR could have access to organised customer information in a standardised format. For example, gas retailers must provide AEMO each month an updated data file with customer information.
- The AEMC could also confirm whether there are any operational impediments with AEMO's transfer systems for example, is there a limit to how many customers AEMO can transfer in a day? Delays in transferring customers could increase the risk for the ROLR.

Origin notes the AEMC concern that the 36 hour suspension provisions represent a risk for the ROLR through the short suspension timeframe. We consider there are risks for the ROLR with the short suspension timeframe and despite the AEMO Market Settlements and Transfer System (MSATS) and ability to identify the National Metering Identifiers (NMIs) and bulk transfer the accounts to the ROLR, the establishment the accounts and identifying the various customer classes could potentially take weeks. This however does not imply that changing the settlement process will alleviate this risk or for the costs of doing so outweigh the benefits.

8. Conclusion

Origin considers the AEMC has identified some credible options to mitigating the risks to a ROLR. The options are legitimate and important measures to supporting the financial viability of the ROLR and recognise the importance of its role as a supplier of last resort. Cash-flow pressures arising from an inability recover cash payments for the costs incurred in preparing for the ROLR event in a timely manner is a risk for ROLR. The secondary risks are in financial markets where cash-flow constraints cause a short payment to AEMO triggering the non-compliance with credit support requirements and subsequent market default and suspension provisions. The risks in electricity and financial markets need to be addressed to mitigate the risk to and of a cascading ROLR failure.

Making the ROLR event commercially viable for retailers to be incentivised to register with the AER to participate as a ROLR is important to helping the ROLR regime function effectively, and could diversify and reduce the overall risk for each individual retailer. A clear process and right for cost recovery is a key element to making the framework commercially viable and minimising regulatory intervention. Alongside this, appropriate transitional mechanisms must be in place to manage the step change increase in credit support requirements over the short period following a ROLR event.