AUSTRALIAN ENERGY REGULATOR

Our Ref: 15374292
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Level 15, 60 Castlereagh Street
SYDNEY NSW 2000

Dear Michael

Re: Review into the arrangements for failed retailers' electricity and gas contracts – directions paper

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the AEMC's directions paper as part of its Review into the arrangements for failed retailers' electricity and gas contracts.

By way of background, the purpose of the Retailer of Last Resort (RoLR) framework under the National Energy Retail Law (NERL) is to ensure that in the event of retailer failure, customers can be quickly transferred to a new retailer to ensure continuity of energy supply.

In addition to this core function, the RoLR framework has an important role in maintaining the stability and resilience of the national market for energy. In particular, it sets out a RoLR cost recovery framework to minimise the financial risks for the retailer that takes on the failed retailer's customers (the Retailer of Last Resort), to ensure a RoLR event does not precipitate a cascade of retailer failure.

The AER's powers under this framework include:

- making determinations for RoLRs to recover the costs associated with preparing for RoLR events and taking on new customers:
- for gas RoLR events, the ability to direct the failed retailer's contracted pipeline capacity or gas supply to the RoLR under certain conditions, to support continued supply to the failed retailer's customers.

Since May 2022, the AER has overseen the transfer of more than 30,000 customers (excluding Victorian customers) to new retailers under the RoLR framework, triggered by an unprecedented number of retailer failures.

Some of these events highlighted a number of previously unforeseen issues or challenges for the AER to manage.

- Weston Energy Pty Ltd was the largest ever failure of a gas retailer. The resulting challenges for designated RoLRs saw the AER issue gas directions for the first time. Our views in relation to the AEMC's proposed gas reforms, set out below, are informed by our experiences in overseeing the transfer of Weston Energy's customers.
- Mojo Power East Pty Ltd is the first time the AER has issued a RoLR Notice for a situation in which the retailer has ceased sale of energy to customers.

The AER's experiences through these events highlighted areas where the RoLR framework did not work optimally.

In this context, it is timely to review the framework to ensure that any future RoLR events can be managed in a way that secures the best outcomes for customers, RoLRs and the market. We support the objective of the review to improve the electricity and gas RoLR schemes. Our comments on the AEMC's proposals are provided in the attachment to this letter.

If you have any questions about this submission, please contact Simon Kidd via email at [redacted] or by calling [redacted]

Yours sincerely

[redacted]

George Huang
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Electricity Retailer Failures

Improvements to the RoLR cost recovery framework

Defining costs

We remain supportive of the AEMC's proposal to clarify that hedging and wholesale costs are recoverable through the cost recovery framework.

Overall, the current cost recovery framework provides the AER with discretion to take a holistic approach to costs and revenues, when making a determination for costs. In our view, this is appropriate given the importance of access to the cost recovery process for maintaining an effective RoLR mechanism.

The AEMC has sought stakeholder views on the proposition that costs above the level of the default market offer (DMO) should be recoverable, as part of a RoLR cost recovery process. If the recoverable costs for a RoLR event were strictly those that exceeded the DMO, the AER would lose a degree of flexibility in the cost recovery process. This may not provide enough certainty of cost recovery to incentivise retailers to become designated RoLRs.

There are of issues in using the DMO price as a reference for recovery of RoLR costs for small customers by designated RoLRs, that the AEMC would need to carefully consider, including:

- Proposed changes to the NERL allowing the designated RoLR to place transferred customers on a market offer, where preferable to the DMO. Linking cost recovery to the DMO may reduce or remove incentives for designated RoLRs to place customers on a market offer, once this option is introduced in the NERL, which may ultimately be a better outcome
- Arrangements in non-DMO jurisdictions, and arrangements for gas, given there is no gas DMO price
- The DMO is a benchmark, but costs may reasonably vary from one situation to another. If the AER retained its discretion, it may be better able to reflect the reasonable costs incurred by wholesale prices.

For large customers, we agree with the AEMC's view that large customers are not necessary to be covered, as the NERL only requires that terms and conditions for large customers are fair and reasonable.

For how long should costs be recoverable?

The AER's RoLR Guidelines set a period of 9 months for a designated RoLR to identify its reasonable costs,[1] which allows a scheme determination to be made less than a year after the RoLR event, in most cases. This provides RoLR scheme participants with certainty about their RoLR scheme obligations and liabilities.

However, the RoLR Guidelines also acknowledge that costs may be identified and quantified but not yet incurred as at the 9-month deadline. We encourage the AEMC to seek stakeholder feedback on the types of costs that may be incurred after the 9-month period, so as not to unnecessarily restrict cost recovery.

Progressive payments

[1] AER, *RoLR final statement of approach*, 2011, p. 18

The AEMC has also asked stakeholders about the benefits of introducing progressive or estimated payments for a designated RoLR.

These may mitigate the short-term financial risk for a RoLR, which we consider is an important goal of the RoLR framework. However, introducing this type of mechanism creates new risks that would also need to be considered.

We note that Ofgem (the retail energy regulator for Great Britain) introduced a temporary multiple claim process in response to the large number of retailer failures during 2021-22.[2] Under this process, retailers submitted an initial claim for costs in the period immediately after the RoLR event, followed by 'true-up claims' intended to reconcile costs with the initial claims.

Ofgem identified a risk that if the RoLR initially receives an overpayment, customers may receive higher bills in the interim period before the true-up. For this reason, it intends to end the temporary measure once more stable market conditions return.[3]

Our view is that while a multiple-claim framework may reduce short-term risk to RoLRs, its design will require careful balancing of the short-term financial risks to RoLRs with the risks of overpayments, which may place further pressure on already high retail electricity prices, and which may have a disproportionate impact on customers experiencing vulnerability.

We consider it is unlikely that the clarification of market costs alone would alleviate short-term financial risks for RoLRs, as they would not be able to recover these costs for a number of months after the RoLR event(s) have occurred.

Issuing the failed retailer a bill for the costs of its failure

Our previous submission supported the principle that a failed retailer's customers should receive the benefits of contracts purchased on their behalf, in the form of lower prices, rather than failed retailers benefiting from the sale of the contracts.

The AEMC has proposed that the AER would become a secured creditor of any retailer in the event of failure. Our initial view is that this proposed reform would entail complexity and a significant expansion of the AER's responsibilities, while not necessarily guaranteeing that transferred customers will see the benefits. As the AEMC notes, if the failed retailer is insolvent, it is possible that the AER may receive little to no return once the insolvency process is complete, so the mechanism may not result in all or any RoLR costs being covered.

In this context, we consider the AEMC needs to undertake further work to understand the risks and benefits, before determining whether this is an appropriate approach. This includes the legal, competition and other risks to the AER, RoLRs and the market, and whether the proposal is practical and in the long-term interests of consumers.

We discuss some of the key issues below.

Discretion to pursue a debt

[2] Ofgem, *Decision on last resort levy claims true-up process*, 2022, p. 4
[3] Ofgem, 2022, pp. 34-35.

Noting the prospect that the AER may receive little or no return once the insolvency is complete, it would be an inefficient outcome if the AER was compelled to pursue a debt in every instance of insolvency.

The process to pursue an insolvent retailer for a debt is likely to be time-consuming, costly and divert resources for other AER functions. In our view, a debt will only be worth pursuing if there is a reasonable prospect that the return will have a material impact on recovering the RoLR's costs.

We note that under the proposed framework, a debt would arise when the AER issues a bill to the failed retailer. To the extent that the AER could determine whether it issues a bill, and the amount of the bill, this would appear to provide some flexibility, which would assist the AER in choosing to pursue the debts which likely can be recovered.

However, there are a range of challenges to the AER forming a view about the prospects of recovering any debt, which may result in the AER issuing bills to failed retailers in the absence of clear information about the prospects of material recovery:

- If the RoLR event does not cause the retailer to go into administration, then the retailer's business or assets may be of significant value, which we could pursue. However, for other RoLR events, we would be unlikely to be able to form a view about the prospects of recovery.
- The AER's decision on the costs to be recovered and the amount of the bill is likely to take time. There is a question of how the AER process interacts with the insolvency process. Depending on the progress of the insolvency process, the AER would need to make a debt claim in the insolvency process in order to benefit from its secured creditor status.

The AEMC should further consider the extent to which issuing a bill to the failed retailer (and thus creating a debt) may obligate the AER, as a Commonwealth agency, to pursue that debt.

Other issues

It is unclear which parties would carry the burden of costs to pursue the debt. If the AER was to bear these costs, these would need to be taken into account in the overall cost/benefit assessment of each action.

Given this proposal for the AER to be a secured creditor would be a significant change, we would also encourage the AEMC to consider whether alternative regulatory measures may achieve similar outcomes. For instance, provisions to prevent asset hiding under the insolvency framework could be investigated for their application to failing energy retailers. We would welcome discussion with the AEMC on possible approaches.

Market impacts

It is possible that the AER becoming a secured creditor, and having a higher priority in the hierarchy of creditors, may have some impact on retailers' finance costs and their ability to seek investment or debt from financiers.

Higher costs of obtaining finance may affect the profile of retailers seeking to enter the market, and the market strategies of those retailers in the market.

At this stage, we do not have a view about the likelihood of this outcome, or whether it would impact competition. We would encourage the AEMC to undertake further analysis and engage with smaller retailers and financial institutions, to ensure that the likely impacts are fully understood.

Potential market impacts would be lessened if the AER were to become a regular creditor, rather than a secured creditor. However, as the AEMC has noted, the AER's ability to recover material debts would be reduced under this approach, which may lead to an outcome similar to the status quo.

Information for the AER and electricity RoLRs to fulfil their duties

In principle, we support customer information being made available to designated RoLRs more efficiently. It may be efficient for the failed retailer to share directly with the designated RoLR under the direction of the AER to protect market integrity and consumer welfare.

The AER could have the power to compel the failed retailer, by way of the RoLR Notice, to provide information to the designated RoLR, so that the AER would control what information is to be transferred. Our approach could be included in the RoLR Guidelines, which we consult on.

An example of the type of information which could be made available to the AER and designated RoLRs is the load characteristics of the failed retailer's customers, particularly large commercial and industrial customers, to allow the designated RoLR to manage their wholesale exposure.

A further example would be information regarding any embedded network customers being supplied by the failed retailer, including what back-up arrangements are in place to ensure continuity of supply to those customers.

Gas Retailer Failures

Changing the RoLR gas directions trigger

In our submission to the AEMC's consultation paper, we highlighted that:

- While the AER was able to exercise its direction power with respect to Weston Energy's failure, the wholesale market conditions experienced more broadly during winter highlighted the need for greater flexibility around the directions power
- Broadening the trigger to reference the National Gas Objective (NGO) and National Energy Retail Objective (NERO) would remove any ambiguity that the AER has flexibility and discretion to consider other factors that may impact the designated retailer's ability to manage the price and supply risk associated with taking on new customers, such as specific market conditions, and the broader impact on the market.

Our view remains that broadening the gas directions trigger, by explicitly referencing the NGO and NERO, would improve the framework. It would allow the AER the flexibility and discretion to consider specific market conditions and other factors that may impact a designated RoLR's ability to manage price and supply risk, which ultimately impact the failed retailer's customers.

In our view, a materiality or financial threshold for the trigger may impede the efficiency of the framework. Given the number of factors that may be in play, the AER is best placed to weigh up these factors on a case-by-case basis in order to determine what is in the long-term interests of consumers. It will allow us to act swiftly to ensure that gas or capacity is made available to the designated RoLRs for the benefit of customers as soon as possible.

The NGO and NERO provide adequate guidance for the AER to issue gas directions effectively, since they already require the AER to act in the long-term interests of consumers. If the AEMC considers it important that the financial impact on the designated RoLR and the current market prices must be considered, the framework could empower the AER to have regard to these factors in addition to AER discretion to consider any factors it considers relevant.

Our preliminary view is that expanding the RoLR gas directions trigger would not materially impact the cost of obtaining finance, or act as a disincentive to enter the market, because:

- The proposed change would only impact retailers that have failed. We consider few genuine prospective retailers would be deterred from entering the market on the basis that AER has greater discretion as to when it issues a direction
- Even with expanded scope to trigger a direction, the conditions that the AER must meet will remain rare, reducing the significance of this potential outcome in the consideration of prospective market entrants

Increasing the length of time RoLR gas directions apply

In our submission to the issues paper, we supported extending the RoLR gas directions negotiation period beyond 3 months, noting the current period may not allow enough time for parties to negotiate the novation or replacement of the failed retailers' gas contracts. We noted that more time would allow negotiations to take place while gas supply would be ensured for the designated RoLR in the interim.

Our position remains that more time should be available, if needed, to facilitate the potentially complex negotiations required. Should the negotiations fail, this would extend the maximum timeframe for a direction to be in effect to 9 months (assuming the timeframe for the failed retailer to arrange auction of the gas remain unchanged).

Similar to the points made above in relation to expanding the directions trigger, our preliminary view is that extending the gas directions period would not materially impact the cost of obtaining finance, or act as a disincentive to enter the market, because:

- few genuine retailers would be deterred from entering the market on the basis that less favourable regulatory arrangements for the disposal of their gas would apply at the point of their failure.
- the conditions that must be met for the AER to issue a gas directions are relatively rare.

Under the current framework, directions remain in place until a replacement contract is negotiated, or until the fixed negotiation period elapses and the gas is sold, whichever comes first. The AEMC has asked stakeholders whether a flexible directions period would be preferable to the fixed period. We note that a fixed period provides the designated RoLR(s) and the parties subject to the direction, such as gas producers, with more certainty around the length of time of a gas direction. Subject to stakeholders' views, it could be appropriate to allow the AER discretion to extend a direction period beyond the fixed period under certain market conditions. However, it would be difficult the specific market condition 'thresholds; that would trigger such an extension.

A shorter direction period effectively means reducing the duration of the fixed negotiation period where the designated RoLR has certainty of physical supply (and the terms and conditions for that supply). From our experience managing gas RoLR events, we cannot envisage a situation where this would result in a better outcome for the designated RoLR or the customers of the failed retailer.

Negotiation principles

Our submission to the AEMC's issues paper highlighted that we would support the introduction of a 'good faith' or 'best endeavours' requirement into the negotiation principles if introduced in conjunction with the requirement that the benefits of a contract must be passed onto the RoLR.

While we note there are challenges in defining a 'good faith' or 'best endeavours' requirement, principles and criteria exist within other regulatory frameworks that could be explored in this context. For example section 228 of the Fair Work Act includes a principles-based definition of 'good faith bargaining', which contains criteria such as:

- attending, and participating in, meetings at reasonable times
- disclosing relevant information (other than confidential or commercially sensitive information)
- responding to proposals made by other parties to the negotiations in a timely manner
- giving genuine consideration to the proposals of other parties to the negotiations, and giving reasons for the responses to those proposals
- refraining from capricious or unfair conduct
- recognising and negotiating with all parties to the negotiation.

The AER would support the AEMC to further consider this approach, noting that more work may be needed to consider the appropriate framework for this purpose. A good faith or best endeavours requirement would help to diminish the incentive for any party to stall negotiations. Parties would need to be seen to be acting in good faith, and it would be more difficult to introduce unnecessary delays while meeting this requirement.

In order to ensure compliance with such a requirement, we consider that a civil penalty provision would be an appropriate measure.

Negotiation principles provide a minimum standard for the novation/transfer of gas contracts and are likely to be complementary to any incentives the parties have (which may depend in large part on their financial circumstances).

Removing the mandatory negotiation process

The AER still sees value in retaining the mandatory negotiation framework as a mechanism that brings parties together to attempt to quickly negotiate a sale of contracts.

Our submission to the AEMC's issues paper highlighted that under the current 3 month direction period, there are incentives for failed gas retailers not to participate in good faith as there are likely to be commercial incentives for them to avoid negotiating a sale to the RoLR while there is a prospect of selling contracts at a high price at the end of that period.

However, strengthening the framework, for instance by introducing negotiating principles and, critically, introducing the ability for the directions period to be extended beyond 3 months, as discussed above, would better align the incentives of the negotiating parties.

We note that the negotiation framework contemplates that the designated RoLR may be able to negotiate ongoing gas supply or transport rights into the future arising from the direction. The choice to retain the mandatory negotiation framework depends on whether stakeholders see value in this approach.

Clarifying what happens to contracts that begin or end during directions

When a directed contract expires, it may be appropriate for the direction to cease, given the possibility that a gas producer may not have an equivalent amount of uncontracted gas available to meet the requirements of the directions.

However, after a direction ceases, gas would need to be purchased from spot markets, which could increase costs for consumers impacted by the RoLR event. One option could be to create a requirement for the gas producer to show it had no spare gas to contract at the end of the failed retailer's contract, on the day the retailer failed. This would help to avoid large cost increases for gas customers in the process.

Our initial view is that it would be appropriate for the direction to continue to apply, if a directed contract includes options to extend the contract past the period of the direction.

We support the AEMC's proposal that directions should include contracts that are due to commence.

Considering gas storage contracts in the RoLR gas directions framework

We support the AEMC extending the AER's directions powers to include gas storage contracts, as it could ensure adequate supply of gas by a designated RoLR during times of peak demand.

The RoLR's acquisition of storage could be to limit exposure of the new retailer (through injections) to high prevailing wholesale gas spot market price or National Electricity Market spot prices. There is potential for the value of the storage to be contested. In this circumstance, consideration could be given to the price for the gas being determined by spot market prices of gas on days the retailer has withdrawn gas into storage.

Sharing benefits or costs of gas RoLR events with customers

We agree with the principle of mandating that any benefits from a gas RoLR event should be shared with customers of the failed retailer. However, there may be challenges in designing such a requirement through the regulatory framework.

In place of a specific requirement, designated RoLRs could be required to report to the AER on how the benefits have been passed onto customers. This would create transparency and visibility for stakeholders, and provide assurance that the benefits are being passed on, without specifying a particular mechanism.

Information for the AER and gas RoLRs to fulfil their duties

We consider that failed retailers, gas producers and/or other contracting parties should provide information about gas supply and transport availability to the AER on request.

Our experience is that the ability to get this information quickly is important when the AER is considering applying the directions framework. Where gas is directed, and there is a requirement for designated RoLRs to share the benefits with customers, additional customer information (such as pricing information) may be necessary to allow the designated RoLR to allocate benefits equitably. However, we would also suggest the AEMC keep in mind the upcoming mandatory Gas Code of Conduct, and whether it may have implications for these (or other) aspects of RoLR management.