AUSTRALIAN ENERGY REGULATOR

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18 November 2022

Michael Bradley
Executive General Manager, Consumer, Markets and Analytics
Level 15, 60 Castlereagh Street
SYDNEY NSW 2000

Dear Michael

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

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 stability and resilience of the national energy market. In particular, it minimises 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.

Recent unprecedented market conditions, including significant surges in wholesale gas and electricity prices, have increased the financial risks to gas and electricity retailers. These conditions have contributed to 8 retailer failures since May 2022. Seven of these required the AER to use its powers under the RoLR scheme to ensure customers of the failed retailers did not have their supply disrupted.

The AER's experience through these events highlighted a number of areas where the RoLR framework did not work optimally to achieve good outcomes for consumers and the market.

The AEMC's review provides an opportunity to comment on important issues, in particular how the framework could enable the energy contracts of the failed retailer to be made available to the RoLR to reduce their financial risk.

The AEMC is also seeking feedback on the behaviour of some retailers in response to the unprecedented market conditions, including taking steps to shed customers in order to reduce their load, for the purpose of selling hedge contracts at high prices.

The AER has been monitoring this conduct and is also concerned about the impacts for consumers and the market. We welcome the opportunity to comment on these issues.

If you have any questions about this submission, please contact Simon Kidd, [redacted].

Yours sincerely

[redacted]

Mark Feather
General Manager
Strategic Policy and Energy Systems Innovation

Sent by email on: 18.11.2022

Context for our views

This year the AER has overseen the transfer of around 20,000 customers (excluding Victorian customers) to new retailers through the recent RoLR events.

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

- Weston Energy Pty Ltd was the only gas retailer of the 8 failed retailers and the largest ever failure of a gas retailer. The resulting challenges for designated RoLRs given supply conditions in the relevant wholesale gas market impacts saw the AER issue gas directions for the first time. Our views in relation to the AEMC's gas recommendations, set out below, are informed by our experiences in overseeing the Weston RoLR.
- 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.

It is expected that these upward price pressures will continue to pose challenges for retailers as well as consumers.

In this context, it is timely to review the RoLR 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.

Electricity Options

The RoLR framework for electricity should ideally achieve a range of objectives. It should enable a failed retailer's hedge cover to be transferred to the RoLR in a way that reduces its financial risk in the short term, and where the failed retailer's customers receive the benefits of the contracts, in the form of lower prices. It should also provide certainty and clarity to default RoLRs[1] and prospective additional RoLRs[2] while not creating incentives for financially stressed retailers to 'cash in' valuable contracts when they might otherwise trade through.

Our preliminary view is that option 3b appears closest to achieving the outcomes above.

We acknowledge, however, that there are likely to range of challenges and complexities that would need to be carefully worked through in order to implement this option. We discuss these below.

Options 1, 2 and 4 each address one or more problematic aspect of the current electricity RoLR framework.

At this early stage we consider these options should not be ruled out before the AEMC has undertaken a thorough investigation of the implementation risks and benefits of each.

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[1] A retailer appointed and registered as a default RoLR. (NERL section 122)

[2] A retailer may seek registration to be an additional RoLR for an electricity connection point or gas distribution system for which they are not the default RoLR. In the event of retailer failure, the AER may appoint as the designated RoLR an additional RoLR instead of, or in addition to, the default RoLRs. (NERL section 126)

Option 1 - Cost recovery clarity

The key benefit of this option is that it would address a barrier to retailers wanting to become additional RoLRs. Currently, no other retailer outside of Origin, EnergyAustralia and AGL are registered as an additional RoLRs in any jurisdiction, which in our view concentrates the financial risk of RoLR events with a small number of retailers. Encouraging more retailers to become additional RoLRs would spread this risk and increase the resilience of the energy market.

Removing ambiguity about whether a RoLR can recover wholesale and hedging costs associated with a RoLR event would address a key barrier preventing retailers becoming additional RoLRs.

However, this option does not materially change the status quo in relation to the key issue of assisting RoLRs with short-term financial risk.

In particular, a cost recovery determination under the existing framework means that any cost recovery will occur several months after the RoLR incurs the relevant cost associated with taking the failed retailer's customers. Depending on the prevailing market conditions, the size of the transferred customer base and other factors, it is possible that a lag of several months may increase the financial pressure on a RoLR in a future RoLR event.

While having certainty that they can recover wholesale and hedging costs may enable RoLRs to better forward manage the risk associated with taking on a large number of customers on short notice, it does not materially address the risk that a customer transfer may put a RoLR under extreme short-term financial pressure.

While the overall cost to customers may potentially be higher than if the designated RoLR had access to the failed retailer's hedge protection (for example, if the designated RoLR has to buy contract cover at the top of the market to cover the new customer load), we note a number of factors should prevent customers facing excessive costs:

- Cost recovery via DNSPs' customer base (the current mechanism) mitigates these impacts, as costs are spread across a large number of customers, meaning no individual customer experiences a material increase.
- RoLRs would also have incentives to keep costs low in order to manage the risks associated with carrying an unnecessarily large liability.
- In making cost recovery determinations, the AER only needs to have regard to reasonable costs incurred by the RoLR.

Option 2 - Matchmaking service

Our preliminary view is that Option 2 addresses some disadvantages of the current framework, but also carries some potentially significant risks that the AEMC would need to consider.

In our view, the main benefit of this option is that it creates the potential for a RoLR to curtail the amount of time to negotiate access to contracts, which at the time of retailer failure may be in a market which faces increasing prices and potential liquidity issues. To the extent that this can occur quickly, there may be benefits for the RoLR to reduce or mitigate its wholesale price exposure.

However, for this option to benefit the RoLR, it requires the failed retailer to have contracts that would assist the RoLR to manage the increase in their load, which is not guaranteed. In this context, this option does not provide much certainty to a designated RoLR, or a prospective additional RoLR, that it would actually assist them in managing risk. In particular, we note that having access to detailed contract position information may not translate into immediate tangible benefits to the RoLR in terms of wholesale price risk management. While designated RoLRs would have insights into the hedge book of the failed retailer, which may enable them to fast track any negotiations with the failed retailer to acquire the hedge book or with a generator for a replacement contract, this does not provide or guarantee designated RoLRs with timely access to relevant contracts.

A further consideration with this option is the potential commercial advantage it may provide to RoLRs over competitors.

The insights into how counterparties in the wholesale market approach negotiations, and the detailed terms and conditions of those contracts, potentially provide a significant commercial advantage in future negotiations, which may present risks to competition.

There may be cases where these risks are outweighed by demonstrable consumer or market benefit from sharing the information. If this were to occur, consideration would need to be given to measures to restrict the use of the commercially sensitive information within the RoLR, such as time limits, controls on which staff have access, or strict obligations to delete the information, to prevent it obtaining an enduring commercial advantage.

Option 3 – Introduce a directions framework

As noted above, the AER considers that the wholesale market price protection of a failed retailer should ‘follow the customer’ in a RoLR event. In our view, this approach fairly allocates risk, and ensures that a failed retailer’s customers continue to receive the benefits of the insurance purchased on their behalf.

As the AEMC notes, this principle currently applies under the RoLR framework for gas retailers, where the AER is able to direct gas supply/production contract counterparties (that is, producers and suppliers), to make available the supply/capacity under contract.

Of the options put forward by the AEMC, option 3b comes closest to achieving this outcome.

In particular, the creation of a ‘high risk’ period, in which the failed retailer must provide hedge contracts at their purchase cost (or payment equivalent to the contracted protection), addresses the risk that a RoLR may have to purchase contract cover at the top of the market, to cover the load associated with taking on the failed retailer’s customers. Given that RoLR events are more likely to happen in periods where high wholesale prices have increased financial risk for retailers, we consider this option would better assist RoLRs with cash flow, and reduce the risks associated with the long lag in recovering costs under the cost recovery framework (namely, Option 1).

In relation to a trigger, the AEMC has noted this may involve a materiality threshold such as a retailer failure above a certain size, liquidity constraints or extreme market conditions. As with the AEMC’s proposed change to the gas RoLR arrangements, the electricity threshold should provide the AER with flexibility to determine when a direction is in the interest of consumers and the market. In particular, we should be able to have regard to available access to hedging products, pricing conditions and the National Electricity Objective.

Of the two sub-options, option 3b, where the RoLR is able to purchase the hedge protection at the original prices paid by the failed retailer, appears to achieve the best outcomes for the market and customers. Hedge contracts are insurance against high prices that were purchased on behalf of that retailer’s consumers, and those customers should get the benefit of them, rather than benefiting failed retailers in the form of windfall profits. For the same reasons, we do not prefer option 3a – transfer at market prices.

As the AEMC highlights, there are likely to be a range of challenges implementing a directions framework for electricity. In particular, the potential risks and harms to counterparties of compelling them to negotiate, as well as potential intersection with insolvency laws, will need to be carefully considered.

A material risk with this option is that the prospect of losing the benefit of valuable hedge contracts may prompt retailers who might otherwise trade through a period of financial stress, to pre-emptively sell the contracts to avoid being subject to a forced sale. This outcome would not be in the interests of consumers or the market.

In this context, we note that the AEMC has referenced Ofgem's consultation on its supplier of last resort framework[3], and its potential interventions to disincentivise retailers from selling valuable hedge contracts to avoid the outcomes of the direction, including:

- requiring that proceeds from liquidated 'in-the-money' hedges be paid directly by the counterparty (for instance, generator or clearing house) into a separate trust. If a retailer fails, the money held in this trust can then be paid to the supplier of last resort (SoLR, equivalent to the RoLR) and therefore remain with the customers that it was originally intended to service (similar to option 4, discussed below).
- requiring provisions in retail market contracts that create a debt owed by the failed retailer to the customer in the event of that retailer's failure. This would make customers (with the SoLR as proxy) unsecured creditors of the insolvent retailer, meaning this debt would be paid before any payments to shareholders, alongside debts owed to other creditors of the supplier.

We support the AEMC exploring the feasibility of such options in the Australian market.

Option 4 - Use the failed retailer's 'in the money' electricity contracts to minimise RoLR cost recovery

We consider this option potentially addresses some disadvantages with the current framework, and we encourage the AEMC to undertake a full exploration of the risks, benefits and practicalities involved with its implementation.

The mechanism whereby the RoLR's costs are firstly paid for through the sale of the failed retailer's hedge contracts, with only the net costs recouped through the AER's cost recovery determination, in effect achieves the objective that the failed retailer's contract cover 'follows the customer.'

However, the sale of the failed retailer's contracts, and the subsequent transfer of funds to the RoLR, is likely to take some time. Accordingly, this option only offers an improvement on the current arrangements, in terms of the benefit to the RoLR's short-term financial risk, to the extent that the sale of the contract can be quickly executed, and the proceeds promptly transferred to the RoLR.

Independent administration of the contract sale and funds transfer would be critical to provide accountability and assurance to all parties that the funds were managed appropriately. It would be challenging for the AER to administer the contract and sale, and transfer of the sale proceeds, due to the skillsets and resourcing required. However, a potential option to address the issue could be to give the AER the power to appoint an administrator to manage the sale.

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[3] See https://www.ofgem.gov.uk/sites/default/files/2022-06/FRC_PC__1906_FINAL_PUBLISHED.pdf

As with Option 3, a material risk with this option is that it would create incentives for retailers to pre-emptively sell the contracts to avoid being subject to a forced sale.

We also note that significant market interventions that potentially materially change the consequences for retailers of failure, such as under options 3 and 4, may have additional market impacts. For instance, the profile of retailers wanting to enter the market may change, and perceived higher operating risks may flow through into higher retail margins. These impacts would be difficult to quantify, but would need to be weighed against the broader benefits of an effective RoLR framework.

Gas options

Expanding AER direction for gas to include storage contracts

We support the AEMC extending the AER's directions powers under s137 to making directions regarding gas storage contracts, in addition to supply and pipeline capacity.

Currently, RoLR gas directions only apply to gas supply and pipeline capacity contracts despite other contracts such as storage being commonly used. Storage contracts facilitate retailers managing how much gas they use at certain times. Without access to such contracts, retailers may be unable to manage fluctuations in gas demand and need to pay for additional gas on the spot market.

The key benefit of this proposed reform would be providing the designated RoLR the necessary contractual ability to cover the peak demand of the customers that they would be responsible for after a retailer fails.

Our understanding is that storage contracts typically come with rights to refill and withdraw and maximum storage levels. For this reason, simplicity and workability would suggest these contracts be designated in their entirety rather than split into components.

While storage is small presently in volume in comparison to gas production, it is likely to increase on the east coast, and become more relied on as a source of supply, particularly over peak demand periods, and become more common in gas retailer portfolios.

We further consider that any legislated direction timeframes for production contracts, should also apply to storage contracts.

We note the same issues of potential competitive advantage from direction appear similar for both storage and production contracts for the AER to consider when designating a direction. Storage may give the benefit of being able to move gas in and out of storage. Production likely gives access to greater amounts of volume of gas in a tight market.

To mitigate risks associated with this potential advantage:

- the AER could be allowed to designate contracts at the existing price in the failed retailer's contract to RoLR(s) for the balance of the contract period
- the framework could also require the AER to later review, for example after a minimum 6 months, whether some or all of that gas has been sold on by the designated RoLR (s), and that the benefits have been passed onto customers

Improving the current AER directions for gas supply

The AER has the ability to issue a direction to a distributor or transmission pipeline operator to make available the capacity of the failed retailer to the designated RoLR/s, or to a producer or any other person contracted to sell gas to the failed retailer to make that gas available to the designated RoLR/s.

The threshold that triggers the AER's power to issue a direction are:

- where there is no declared wholesale gas market or short-term trading market (STTM), or
- in the AER's opinion, sufficient capacity or gas is not available in a STTM. The AER may proceed on the assumption that there is not sufficient gas in a STTM unless, before the issue of a RoLR notice containing a direction, AEMO notifies the AER in writing that there is sufficient gas.

The AER's recent experience of issuing directions highlighted the importance of these powers and some limitations with the existing framework. These experiences have informed our discussion of the AEMC's options below.

Broaden the RoLR gas directions trigger

We support broadening the gas RoLR trigger to explicitly include that the AER can consider broader market conditions and pricing, in the context of the NERO and NGO.

While the AER was able to exercise our 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 NGO and NERO, as recommended, 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.

Increasing the duration of gas directions

We agree the current 3-month duration for a direction may not be enough time for parties to negotiate novating or replacing the failed retailers' gas contracts. This period should be increased to provide the designated RoLR with longer access to the relevant capacity or gas supply in the end consumers' interests.

Our experience is that 6 months would be a more appropriate timeframe to facilitate the potentially complex negotiations required. This may mean it takes longer for negotiations to be finalised but would ensure continuity of gas supply for benefit of the designated RoLR in the interim.

The AER's direction power arises when wholesale gas markets or capacity markets are under extreme pressure. In our view, in those situations it is likely that the markets will need longer than 3 months to return to more normal operating conditions. This creates a rational incentive for a failed retailer or administrator to view an auction as a more favourable outcome and/or seek to optimise the value of novating the contracts to the designated RoLR during negotiations. We consider extending the timeframe to 6 months allows market conditions more time to moderate such that negotiations are more likely to be successful and/or the designated RoLR has more time obtain alternate supply or replacement contracts.

Clarifying whether a direction should continue regardless of whether the contract expires or would have expired during the direction period

If an existing contract(s) terminates during the direction period, we support a requirement to supply to RoLR on same terms and conditions as at the transfer date remains in place for the duration of the direction.

Including an express requirement for all entities to negotiate in good faith or with best endeavours to negotiate new contracts

As noted above, the current framework creates a rational incentive for a failed retailer or administrator to view an auction as a more favourable outcome and/or seek to optimise the value of novating the contracts to the designated RoLR during negotiations, and therefore potential incentives to delay or stall negotiations to increase the likelihood contracts would be auctioned.

A good faith or best endeavours requirement in the framework would assist to address these incentives, if introduced in conjunction with the requirement (discussed below) that the benefits of a contract must be passed onto the RoLR. Without this, a good faith requirement would not ordinarily require a failed retailer to disregard its own commercial interests.

For contracts that remain in-force, consider including a requirement that the benefit of the direction must be passed to the designated RoLR and affected customers

The framework does not dictate, nor does it provide for any role for the AER to determine, how negotiations are to occur, how the benefit of the directed gas is utilised or how the proceedings from the auction are to be allocated. Greater clarity in the framework would assist all of the parties involved to approach negotiations in a consistent manner. In our view, the legislation should clarify the failed retailer's rights and obligations, and deter and prevent failed retailers from profiting from gas supply contracts.

Requiring the benefits of a contract sale to go the RoLR, and passed to affected customers, would address this issue.

We consider inclusion of this requirement will enhance stakeholder engagement with the proposition that the wholesale arrangements should follow the customer, as otherwise there could be a perception that the RoLR could obtain a windfall which may not benefit customers.

Retailer behaviour during volatile market conditions

The AER has been closely monitoring the behaviour of retailers in the recent volatile market conditions. We consider some of the observed behaviour is problematic.

In particular, the practice of retailers decreasing consumption load (by encouraging customers to leave) and then selling their contracts into the market during a period of high energy prices, damages consumer trust in the energy market, at a time when a high level of trust is critical to engage consumers on the energy transition.

It may also have a negative impact on retail competition and prices. For instance, if wholesale energy costs are high, potential retailers in the market who would normally be expected to compete for the customers who have left the failed retailer, may view the costs and/or risks associated with covering new customers' load from the contract or spot market to be too great. This may lead to them substantially increasing prices to cover their additional risk, or not taking on new customers.

If a number of retailers made this determination, it may have a cascading impact, ultimately pushing those customers towards higher prices than they would otherwise have been on.

Additionally, in our view it is inappropriate in an essential services market that retailers seek windfall gains by using their contracts for purposes other than hedging. If there are no consequences for doing the ‘wrong thing’ this may encourage similar conduct in future.

The conditions that gave rise to the conduct have largely passed. The significant spike in the value of contracts should not happen in the next immediate period, as the unit costs in current contracts are now at a higher price than before the market volatility.

The value of these contracts has decreased as the contracts have matured, however for contract positions which extend to June 2023 and beyond there might be an incentive to sell their contracts if the contract price remains high.

We consider that interventions that would disincentivise the conduct should be explored. These may include defining the problematic conduct and introducing sanctions for engaging in it, such as targeting an individual’s ability to re-enter the energy market at a future time, potentially by broadening the AER’s powers to revoke an authorisation.

For any intervention, we acknowledge there will be challenges in defining the conduct in a way that addresses the issues without impacting on legitimate contract trading.