10 November 2022

Anna Collyer
Chair
Australian Energy Market Commission

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AEMC Ref: RPR0016

Dear Ms Collyer,

Failed Retailer Review

The Australian Financial Markets Association (AFMA) is responding to the AEMC's 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.

This review is timely as the recent unprecedented disruptions in energy markets and the resulting failure of a number of retailers has highlighted the need to ensure arrangements to manage the failure of energy retailers are robust. Previous reviews of the Retailer of Last Resort (ROLR) arrangements have focused on the operational mechanics of ensuring customers are transferred to the ROLR smoothly but have not adequately dealt with the risk to the ROLR of being required to take on additional load during a volatile period. This review presents an opportunity to consider how risk should be allocated between; the failed retailer, the ROLR and the market as a whole.

Our submission focuses on the appropriate allocation of risk as a result of a ROLR event and the challenges for the financial market of options 3A, 3B and 4. It focuses more on electricity, as the financial market for power is more developed than in gas— but we consider that the principles are equally relevant to gas.

In summary, AFMA's view is that, as ROLRs provide critical services to customers and the market. To mitigate the risk of a cascading retailer failure, they should be adequately compensated for the risk they take on by providing ROLR services in a way that minimises disruption to the financial market. We consider that in the first instance, the costs of compensating the ROLR should be paid from the assets of the failed retailer.

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1. Objectives

The ROLR framework serves a number of purposes, and its main objective has been described variously as consumer protection and protecting the AEMO settlement process. Managing risk in the energy market has not been a key feature of the framework. We consider this approach inadequate, as it does not mitigate the risk of a cascading retailer failure. Additionally, the framework has not included any mechanisms to deter a retailer from making a commercial decision to exit retailing, by triggering a ROLR event.

AFMA proposes that to minimise the risks that ROLRs face and the cost that customers incur, the review should aim to achieve the following objectives:

> i. ROLRs should be able to recover the full cost of taking on responsibility for transferred customers, in a simple and timely manner, to ensure they are able to provide the services
> ii. Retailers should be disincentivised from using the ROLR framework as a commercial mechanism to exit retailing

2. Protecting customers

The majority of your consultation paper deals with the management of financial risk as a result of a ROLR event, but section 6 deals briefly with a number of undesirable behaviours that were observed from retailers towards their customers, during the recent period of market stress. AFMA agrees that rapid increases in prices and communications encouraging customers to move to another retailer are issues worthy of consideration by policy makers; but considers that they may be better dealt with in a review focusing on consumer protection rather than financial risk. We also note that a number of regulatory changes have already been made to restrict retailers from raising prices without notice.

In the same section, you also ask if retailer hedging behaviour and wholesale market behaviour should be part of this review. Our view is that market participants are best placed to manage their risk and that existing market conduct requirements for financial products under the *Corporations Act 2001* are adequate for energy derivatives. We therefore do not think these matters should form part of this review.

> i. Consumer protection matters should be dealt with in a separate review
> ii. Financial market behaviour is regulated under the *Corporations Act 2001* and should not be part of this review

3. Challenges with financial contracts

AFMA is the leading association representing participants in Australian financial markets. Our role includes administering market conventions and template financial contracts for the OTC electricity market. As you have identified in your consultation paper, derivative contracts are the key instruments used by electricity market participants to manage their exposure to the NEM spot price; and one of the biggest risks for a ROLR, is that they may have inadequate derivative cover for the transferred customers. Your options 3A and 3B (collectively "option 3") propose to address this risk by allowing contracts to be novated from the failed retailer to the ROLR; and your option 4 proposes using the proceeds from their 'in the money' contracts to meet the ROLR's costs. These proposals have obvious appeal, but AFMA considers that the complexity required to implement them and the additional risk

they would introduce to the market, particularly at times of high stress — ultimately makes them problematic and undesirable.

3.1. Risk management in derivatives markets

Systemic risk within derivative markets has been a key focus of financial market regulators since the Global Financial Crisis. Efforts have focused on managing the complex relationships in the derivative market where many participants can be exposed to the failure of an individual participant. Reforms have included introducing requirements for; contract documentation, margining and central clearing. Additionally, OTC documentation and futures market rules contain arrangements to manage the default of a participant in a way that limits contagion within the market. In OTC markets, this will involve close-out netting where the defaulting participants' OTC transactions are closed out and payments are netted. The result of this is that instead of multiple contracts with the defaulting participant, each counterparty is entitled to the payment of a single sum. In futures markets, the retailers clearing participant will suspend the failed retailer and then liquidate its positions to manage the exchange's exposure; they may also access a default fund if there is a deficit.

3.2. Unscrambling the egg

AFMA is concerned that that the proposed options 3 and 4 will be difficult to implement and may increase risk in the derivatives. Implementing options 3 and 4 would require legislation to cut across the current regulatory and contractual arrangements that are designed to minimise risk in the derivatives market and facilitate access to collateral by financiers. We anticipate that this would be a very complicated process which is likely to increase risk in the derivatives market; as it would reduce the certainty that participants currently have regarding the resolution of a default and potentially expose a larger number of participants to risk as a result of the retailer's default.

Option 3 involves compulsorily novating the failed retailer's hedge contracts to the ROLR. While this potentially has a benefit for the ROLR; it is worth noting that it also has an impact on the failed retailer original counterparties ("continuing parties") who would find themselves in contracts with a counterparty that they have not chosen. This could result in number of issues for the continuing party, including:

a) 'know-your-customer' onboarding requirements have not been met for the ROLR
b) ISDA documentation is not in place with the ROLR
c) credit risk approvals are not in place with the ROLR

Additionally the new contracts could result in the continuing parties breaching their market risk and credit limits, or requiring collateral from the ROLR to support these positions, which will have been set by their risk areas to minimise the risk to the continuing party of the failure of any individual counterparty. It is also worth noting that options 3 does not deal with the failed retailers reallocation or settlement residue auction positions which may be used to compliment or substitute derivative hedges. These issues may mean that a measure that is intended to reduce risk for the ROLR has the unintended consequence of increasing it, for the market as a whole.

A further complexity the consultation paper identifies is that the ROLR events are not in and of themselves, default events in the financial market. As a result, the treatment of a failed retailer's derivative position will vary depending on if the ROLR event was triggered by an insolvency (or other contractual default event) or by another trigger such as withdrawal of a bank guarantee. In the first

instance, where a contractual default has occurred, the contracts will be closed out as described above in (3.1) while in the second, the contracts will remain on foot.

AFMA's view is that managing this additional complexity will further complicate options 3 and 4 and make it less desirable for the market as they would have less certainty about what would occur during a ROLR event.

3.3. Option 3B

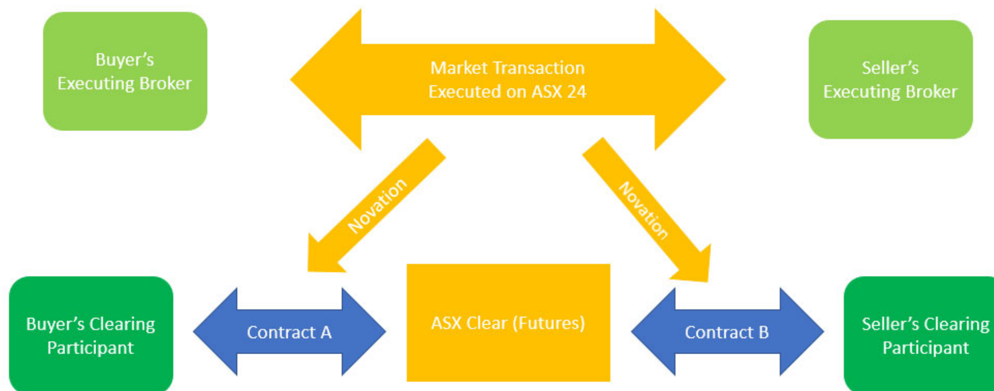
For the reasons set out above, AFMA considers that both option 3A and 3B are impractical, but we have an additional comment on option 3B which proposes to transfer contracts at the current market value. While this approach is fairer to the failed retailer, it is unlikely to be valuable to the ROLR as the occurrence of a ROLR event is likely to be the peak (or a stressed level) of market prices; and therefore, the market is likely to place a very high value on any 'in the money' contracts held by the failed retailer. It is therefore unlikely that accessing them at market value would be of much use to the ROLR who may decide that they are unaffordable, even compared to the spot market. AFMA understands this made the novation of Weston's gas contracts under the AER's direction, impractical. We therefore do not consider option 3B to be a valuable option, even if the practical challenges set out above could be resolved.

3.4. Observations on the futures market

AFMA would like to clarify some points about the operation of ASX 24's futures market that are relevant to options 3 and 4. ASX 24 operates differently to AEMO's physical markets with intermediaries performing many of the roles that market participants and AEMO perform in AEMO's markets. ASX 24 has a reasonably small number of direct participants separated into executing brokers who execute trades on the exchange for their clients (such as energy retailers); and clearing participants who clear trades executed on the exchange.

Under ASX 24's market rules, those wishing to transact futures will contract with an executing broker to execute market transactions on their behalf. Shortly after the transaction is executed, it will be registered with the exchange and then novated into two contracts between the clearing house (ASX Clear (Futures)) and the buyer and seller's clearing participants. As a result, ASX Clear (Futures) does not have any contracts with the ultimate beneficial owner of the futures contract (the retailer)— but has contracts with its clearing participants.

The market arrangements can be illustrated as follows:



ASX Clear (Futures) and the clearing participants have off-market mechanisms to transfer futures positions between clearing participants but these processes cannot currently be used to change the ultimate beneficial owner of the position, i.e. these mechanisms could not be used to transfer a position from the failed retailer to a ROLR. Clearing participants are not permitted to transfer ASX24 contracts between clients off-market, unless the arrangement meets the requirements for block or exchange-for-physical trades, which are unlikely to apply to the proposed transactions. Alternatively the failed retailer's contracts can be closed out on market and the RoLR can open new ones, though that would need to be done at the market price. As discussed in your consultation paper, the failed retailer would have to make a payment to the ROLR equivalent to the change in value of the contract between execution and the date of the transfer for the ROLR to get the full benefit of the contract. This may be problematic as the failed retailer may not have the funds available to make this payment.

As discussed in 3.2, options 3 and 4 could also complicate the market default arrangements. One of the advantages of ASX 24's use of intermediaries is that the exchange is only exposed to defaults by clearing participants. As a result, if an energy retailer defaults their clearing participant, rather than ASX 24, is responsible for managing their positions. They would do this by closing out the position and, if necessary, drawing on the failed retailer's initial margin payments to manage their exposure.

In ordinary circumstances the clearing participant of a distressed client is incentivised to increase initial margin requirements, impose trading limits and ultimately to close out contracts to minimise its credit exposure to the client. A termination payment would then be payable between the clearing participant and failed retailer, netting profit and loss on all contracts and incorporating any initial margin paid by the retailer. The proposed arrangements would impact the clearing participant's ability to make decisions to manage its risk at that time, and potentially increase their exposure if only a portion of the failed retailer's portfolio of open contracts are transferred, or increase credit losses if material assets are transferred out of the failed retailer at that time.

The clearing participant for the ROLR would similarly apply risk limits to the ROLR's portfolio, to manage its credit and market risk within its own appetite and regulator and stakeholder requirements. That clearing participant would be taking on further risk related to the contracts novated to the ROLR

which would need to be managed within that framework, which could include requiring the ROLR to make additional initial margin payments or to reduce the size of their position.

Altering the futures market risk management arrangements would be complicated and involve changes to financial services and insolvency regulation. AFMA encourages the AEMC to consult broadly if they are considering it.

3.5. Funding implications

Another factor the review should consider is the impact of the reforms on the ability of retailers to access funding from banks of other providers. Before offering funding a secured creditor will assess its risk in respect of the failed retailer basis its assets and secured rights, including those related to the retailer's derivative positions. In the event of an insolvency a secured creditor has the right to appoint an administrator to protect their rights. If this right is eroded, this could have unintended consequence of removing of a key collateral base from lenders which could have competitive and transaction cost implications for the retailer sector access funding arrangements.

iii. Options 3 and 4 are not AFMA's preferred approach as we think they could inadvertently increase risk in the financial market by:
    a. Altering the existing risk management arrangements in the financial market
    b. Introducing significant complexity

iv. Option 3B is unlikely to offer significant value to the ROLR

4. Gas contracts

The consultation paper notes that the AER currently has powers to make directions in relation to the failed retailer's gas contracts and that this power was used for the first time following the failure of Weston. The gas and electricity markets are different, in the NEM all electricity is supplied through the market while in gas, delivery is fundamentally provided under physical supply agreements. AFMA's understanding is that policy makers' primary intention when creating the NERL directions powers was to ensure that the ROLR would be able to physically supply gas to the regions it was required to. They appreciated that outside the regulated markets, this may require the AER to make directions to ensure that they are able to supply all distribution networks.

Access to the distribution network did not end up being a major concern following the failure of Weston. AFMA's understanding is that the AER's directions were intended to provide the ROLR access to more competitively priced gas during a period of unprecedented high gas prices and that the market does not generally consider that the results were optimal. It is therefore tempting to consider revising the direction powers to make them more effective, AFMA cautions against this. Our view is that, while physical gas contracting is in some ways simpler and less intertwined than derivative transactions, intervening in physical gas contracts will be complicated and face many of the same obstacles as intervening in derivative contracts. We think the AER's experience with Weston demonstrates this. 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, but that the AER should be able to make directions in relation to any type of contract that is required to provide these services (e.g. supply, storage, capacity and transport contracts). While managing a ROLR's financial risks should be done in substantially the same way for both gas and electricity, our preferred approach to managing the ROLR's financial risk is discussed in section 6 below.

v. The AER's gas directions powers should be limited to ensuring that the ROLR is able to physically access the services it needs to supply the transferred customers

5. AER information powers

The proposed option 2 is essentially to give the AER additional information powers to collect information about the failed retailer's hedge position and share it with the ROLR. AFMA thinks the ROLR should be able to access information about the failed retailer that will assist them to perform their functions as ROLR. But we believe additional information powers are unnecessary as energy ministers are currently consulting on a new wholesale market monitoring function for the AER. The wholesale market monitoring function is anticipated to give the AER substantial powers to collect information about hedge positions that they could use to manage a ROLR event; and we therefore think additional powers are unnecessary.

Any powers to share information with the ROLR should be limited to information that will assist them to provide ROLR services. Unless option 3 is implemented, we do not consider that the AER should be able to share confidential information about the failed retailer's contracts as this information would be commercially sensitive to the failed retailers counterparty and would not assist the ROLR to provide ROLR services.

vi. The AER does not require additional information powers as they will have adequate powers under their proposed wholesale market monitoring function

vii. Confidential information should only be shared with the ROLR where it is necessary for them to provide ROLR services

6. A preferred approach

AFMA's view is that the ROLR framework should:

a) assist the ROLR to manage the costs of providing ROLR services to the market, while minimising disruption to the financial market
b) disincentivise retailers from using ROLR as a commercial mechanism to exit retailing

For the reasons set out above we think option 3 is impractical and suggest that a better solution should be built on a combination of option 1 and a revised version of option 4 which avoids interfering in derivative contracts and allows costs to be recovered from all of the failed retailer's assets. We think this combination can provide certainty to the ROLR that they will be able to recover the costs of the ROLR event in a timely fashion; while minimising the costs to the market and disincentivising use of the ROLR arrangements as a commercial mechanism to exit retailing.

6.1. A timely cost recovery mechanism

Recent experience has shown that acting as a ROLR can be a costly activity that exposes even very large and financially robust retailers to substantial market risk as a result of a sudden unanticipated increase in their load. ROLRs perform important functions protecting customers and minimising disruption to the market and the prospect of a cascading failure of a ROLR who is unable to manage these costs is something the market wants to avoid. AFMA therefore considers that it is critically important that ROLRs are able to recover the actual costs of providing ROLR services.

The National Energy Retail Law (NERL) contains provisions allowing ROLRs to recover costs through an AER administered process. The scope of costs that can be recovered under these provisions is currently unclear as to date it has only been used to recover additional administrative costs incurred by the ROLR. We think it should be reviewed to ensure it allows the ROLR to recover all costs related to providing ROLR services. We also think that given the emergency nature of ROLR events and the critical importance of avoiding a cascading failure, the cost recovery provisions should be written generously to recognise that the costs incurred in managing a ROLR event, are unlikely to be efficient given the time and market pressures that apply when ROLR services are provided. Certainty about the ROLR's ability to recover costs will also assist them to access financing to support their business during the period between the ROLR event and payment under the cost recovery scheme— which will also minimise the chance of a cascading failure.

Minimising the period between the ROLR event and payment to the ROLR will also be important as this will reduce the period of time that they have to manage the costs themselves. We therefore recommend that cost recovery payments should be determined and paid as quickly as possible. This could potentially include multiple phases where an initial payment is made based on early cost estimates and further payments could be made as the actual costs become clearer. Because of the importance of timely payments to the ROLR, we think that these payments should be made by the AER (or another body chosen to administer the scheme) to the ROLR; and that the AER should be responsible for recovering costs from the failed retailer (as discussed below in 6.2).

6.2. Failed retailer responsibility

AFMA supports a competitive energy retail market. Low barriers to enter and exit are key factors supporting a competitive market and we consider that the free entry and exit of retailers is a positive feature of the market. Despite this, we consider that the ability of retailers to use the ROLR framework as a commercial mechanism to exit retailing is an undesirable feature of the market and AFMA's members are keen to see it made less attractive. We suggest this could be done through a combination of regulatory restrictions that make it more difficult for a retailer to trigger a ROLR event and financial incentives that make it commercially unappealing.

6.2.1. Regulatory provisions

AFMA considers that the circumstances in which a ROLR event can be triggered should be reviewed. The provisions covering the triggering of a ROLR event are fairly complicated as they sit across the NERL and the gas and electricity rules. In essence a ROLR event can be triggered if the retailer:

a) has its authorisation revoked
b) becomes insolvent
c) is suspended from the NEM or a regulated gas market

In AFMA's view option (a) is unlikely to occur as we anticipate the AER is unlikely to initiate a ROLR event for a solvent retailer as a result of regulatory non-compliance; and option (b) is unproblematic as it aligns with default arrangements in OTC and futures markets.

In our view option (c) is the most problematic. The market default rules appear to have been written to ensure AEMO is able to suspend the participant before AEMO (and the market) are exposed to non-payment. A probably unintended consequence of this is that retailers are able to trigger a default in circumstances where they are able to pay but choose not to. For instance, they may refuse to make

a payment by the required time, despite having access to the funds, or may terminate their agreement with a credit support provider.

AFMA's view is that the market default provisions should be tightened to make it difficult for a retailer to elect to initiate a default when they are able to pay. This will probably also require new powers for AEMO to allow them to ensure payment from an unwilling retailer.

6.2.2. Financial incentives

In addition to strengthening the regulatory arrangements to limit retailers' ability to choose to initiate a ROLR event, we think the problem could be mitigated by changing the incentives to make it financially unattractive. As stated above, our view is that failed retailers should, in the first instance, be responsible for meeting the costs of the ROLR. We think the AER should be empowered to recover ROLR costs from all of the assets of the failed retailer.

AFMA's view is that this will provide a strong disincentive for otherwise solvent companies to use the ROLR framework as a commercial mechanism to exit retailing, as the costs of compensating the ROLR are likely to be the same or greater than continuing to supply the customers. We think this would result in a slight reduction in ROLR events as retailers would choose to exit retailing via trade sales or orderly run-offs of their business. We anticipate this approach would have no impact on unsuccessful retailers who have expended all of their resources attempting to remain in operation; and would not expect that in these cases there would be substantial assets for the AER to recover.

As discussed above, AFMA considers it is undesirable to interfere in the existing risk management arrangements for derivatives. As a result, we do not support the current option 4 as it would interfere with the default arrangements for futures and OTC derivatives. We think a more appropriate approach is to allow derivative positions to be resolved in accordance with the existing arrangements and for the ROLR's costs to be recovered from the failed retailer's total assets, including any revenue from the close out of its derivative positions.

6.2.3. Recovery process

AFMA appreciates this option presents implementation challenges. As stated in 6.1, we think it is important that the ROLR is able to access funds quickly and consider that it should be the AER's role to pursue failed retailers for any costs. Enabling the AER to do this effectively will require careful consideration of the impact of corporations and insolvency legislation; and we encourage the AEMC to consult Treasury on any proposals.

Some of the issues we think would need to be considered are:

a) The ability to recover from related companies
b) The ability to claw back payments made to related third parties
c) The interaction of the framework with insolvency legislation, including priority in insolvency and the treatment of arm's length secured creditors

viii.	ROLRs should be able to recover all the costs of providing ROLR services through a timely process
ix.	The ROLR triggers should be tightened to make it more difficult for a retailer to choose to initiate a ROLR event
x.	Failed retailers should, in the first instance, be responsible for payment of the ROLR's costs
xi.	The AEMC should consult with Treasury about the development of the framework

7. Application challenges

The proposed reforms are ambitious and will present implementation challenges. AFMA makes the following observations about how implementation could be approached.

7.1. Phased implementation

Some of the proposed options will be complicated to implement as they are technically complex and involve legislation beyond the responsibility of the AEMC and energy ministers. Option 1, allowing the ROLR to recover all costs, is probably the most straight-forward to implement as if legislative amendments are required the could be done with only changes to energy laws. AFMA's view is that option 1 should be a critical part of any reform and could be implemented before other options. The AEMC's final report should consider how implementation could be phased.

7.2. Application to Victoria

Victoria's ROLR arrangements are, partly, managed under Victorian law rather than the national framework. This arrangement is sub-optimal, as ROLR events will typically involve multiple jurisdictions. We think this approach will become untenable if either option 3 or 4 is implemented as there could be conflict about how the failed retailer's assets are to be used. We therefore encourage the AEMC to discuss implementation options with Victoria, with a view to Victoria being incorporated into a national ROLR framework.

xii. The AEMC should explore phased implementation of the options
xiii. Victoria should be part of the national ROLR framework

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
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