

Survey of
Second Tier Retailers

REPORT

by the

Financial Markets Working Group

established under the
Ministerial Council of Energy
Standing Committee of Officials

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2. Executive Summary

At its May 2008 teleconference, the Financial Markets Working Group (FMWG) established by the Senior Committee of Officials under the Ministerial Council of Energy, approved a survey of second tier retailers in the National Electricity Market (NEM) in accordance with the Terms of Reference (refer **Error! Reference source not found.**).

Broadly the Terms of Reference covered four key areas:

- Prudential Requirements imposed on Retailers
- Liquidity for Financial Contracts
- General Barriers to Entry for small retailers
- Other Issues affecting Competition

Interviews were conducted with executive management of twelve retail companies over a four month period between June and September 2008. Each retailer was identified by a random number and comments in this report by retailers are identified only by that number.

Summaries of each interview were provided to the respective retailer for confirmation as to the accuracy of the interview summary. Adjustments or corrections provided by each retailer were included in the summary of each retailer's interview.

2.1. Background to the Prudential Framework

NEMMCO imposes a default \$100,000 Bank Guarantee as its minimum prudential requirement on small retailers for registration as a retail market participant in the NEM – without such registration, a retailer cannot obtain wholesale electricity for on-sale to customers. NEMMCO also operates the systems for customer transfer and metering data provision.

For start-up retailers, this cash guarantee can be many times the annual customer revenue volume and usually requires a capital raising, parent company guarantee or personal guarantee by directors to obtain such from a financial institution.

Distribution Network owners (DNSP's) also impose a prudential requirement which usually consists of 90 days of anticipated purchases. However, in Victoria, a reform by the Essential Services Commission (ESCV) has significantly mitigated this impost for small retailers whose payments are not materially significant to the DNSP.

Generators can also impose a prudential requirement on small retailers, either because of their lack of a credit rating or because of acceptance of a re-allocation agreement (this latter also having the effect of reducing the retailer's NEMMCO prudential liability – provided it is above the fixed minimum prudential level).

2.2. Key Findings

2.2.1. Fixed Basis of Prudential Calculation Inequitable

Bank Guarantees were seen as inequitable to small retailers as, without ownership of generation assets and without a very large customer base, they

did not have a "significant" relationship with either a bank or a government funding authority and so were charged significantly higher fees for a bank guarantee than their larger competitors.

Small retailers also adversely suffered from the tendency, in all prudential guarantees, to impose a fixed minimum prudential amount (rather than, in every case, an amount based on the expected purchase obligation of the retailer from NEMMCO).

2.2.2. Issues with the Basis of Prudential Calculations

The guarantee amount is calculated using a formula which utilises past spot prices and a measure of volatility to determine a future price upon which the guarantee is based (for the higher of the default minimum \$100,000 or about 42 days worth of electricity).¹ There was very considerable support for a review of the formula on the basis that a past spot price in one season was not a good predictor of the future spot price in a different season, yet this is exactly what the current calculation is based on.

By way of example it was pointed out that the forecast price for November 2008 (using the formula) was over three times higher than the traded futures contract price for the same month.

2.2.3. NEMMCO "Margin" Calls & Suspension

Retailers generally expressed a fear of the "7.30am" phone call from NEMMCO requesting an increased or additional prudential guarantee that had to be lodged by 10.30am that day (given that banks open at 9.30am, this was seen as challenging).² The fear was that, for non-achievement of this tight schedule, NEMMCO could or would suspend the retailer³ – thereby initiating the Retailer of Last Resort provisions in the market and so leading to NEMMCO irrevocably transferring the retailer's customers to the dominant host retailer in each area and, in the process, destroying the retailer's customer base and hence its business.

2.2.4. Prudentials other than a Bank Guarantee

A few retailers had attempted to provide an alternative prudential instrument to the bank guarantee. No non-Victorian DNSP has accepted an alternative to the bank guarantee – and this has been irrespective of each retailer's payment record.

2.2.5. Preferred Financial Support Contract

Retailers preferred an OTC (over the counter) contract with a generator counterparty where they could obtain one.

Retailers reported that generators were disinclined to contract with small retailers because of their credit risk, the small volume involved and the

¹ The Rules refer to this as a reasonable worst case exposure that is not likely to be breached more than one in four years – see Schedule 3.3, clause S3.3.1(a) and definition of "*reasonable worst case*".

² NEMMCO has the position that it is the obligation of each market participant to monitor its exposure to "outstandings" in the market and, if done so, then there should be no surprise element in any call it may make to assist the retailer in this area.

³ NEMMCO notes that " This overly simplifies the NEM Rules in this area. The 0730 call is to avoid a call notice being issued , followed if necessary 24 hrs later by a default notice, and finally, if not addressed, then suspension would be considered. While the Rules in this area might be seen by some as heavy handed, changes will transfer risk to other parties, making consensus on change difficult to achieve."

relatively fixed cost involved in the administration of an OTC contract – so a larger contract has "more bang for the buck" than a small one.

Where retailers were unable to obtain an OTC contract (because of volume or counter-party credit issues), futures contracts were employed.

Retailers commented that futures contracts had the disadvantages of:

- (i) not paying out till the end of the contract (whereas OTC contracts pay throughout the contract period); and
- (ii) not being "shaped" to match the retailer's load and small retailers, operating on tight margins, cannot afford the "gap" risk.

However, these were also seen to have the significant advantage of being "available", particularly to those small retailers who could not support the \$0.5million cost of running a "hedge trading operation".

2.2.6. Physical Asset as the Ultimate Hedge

A number of retailers pointed out that the best hedge investment was in ownership of physical generation as ownership of such an asset carried with it:

- (i) a "virtual" and, if required, actual credit rating by virtue of owning the generation asset with its income potential;
- (ii) a guarantee of a shaped OTC hedge for the retail load; and
- (iii) a re-allocation agreement which then reduced the NEMMCO requirements for a bank guarantee for the retail load purchases from the market.

Retailers noted that no purchase of either an OTC hedge or futures contract could provide a similar suite of benefits for the same capital outlay.

2.2.7. Retailer as Collection Agent for DNSP's

All retailers objected to the current situation where retailers are fully responsible for customer network payments to DNSP's irrespective of whether the customer actually pays the DNSP and that such payments must be made to the DNSP before payments are received from customers.

Retailers noted that this situation pertained despite the fact that DNSP's argue with regulators that they have significant revenue risk and such is factored into the revenue and return calculations in the determination made by jurisdictional regulators.

Retailers also noted that, of all parties in the NEM, retailers have the least ability to fund customer payment defaults as they operate on the slimmest of margins in the NEM.

2.2.8. State Levies Based on Fixed Charges

Retailers noted that, in a national market, each jurisdiction had its own rules for retailer licensing, compliance auditing and levies for their specific renewable or environmental energy scheme.

For small retailers, this complexity is aggravated by the fact that such levies often have fixed minimum levels, so that a start-up retailer can be hit with the same fee (which can be many times the annual revenue from its small, initial customer base) as is paid by large established retailers.

2.2.9. Re-allocation

Small Retailers noted that many generators appeared disinterested in negotiating a re-allocation agreement with a small retailer. This means that the small retailer cannot mitigate the prudential guarantee amount which must be lodged with NEMMCO – whereas the larger retailers are not similarly disadvantaged.

Where a generator accepts re-allocation because of an OTC contract, the generator is likely to impose a prudential guarantee obligation onto a retailer. However, retailers claimed that, overall, there was a net benefit in having a re-allocation agreement, not least because it reduced the "circular" flow of cash (retailer to NEMMCO as market settlement, NEMMCO to generator as market settlement, generator to retailer as OTC settlement) which results in the retailer requiring access to a large amount of cash for settlement purposes despite the net owing to the generator being much less.

With the claim that small retailers pay significantly more for bank guarantees, this "dead-weight" cash requirement doubly impacts small retailers compared to larger retailers.

2.2.10. Futures Offset Arrangements ("FOA")

For small retailers, who often do not have access to OTC contracts and thus not to re-allocation, the main risk management contract available is a futures contract.

Small retailers maintain that, due to the daily "true-up" calls made by the futures contract market, contract settlement is guaranteed, independent of any participant's credit rating, in the futures market. In fact, payment on the futures contract should seem more assured than on an OTC contract (where default risk resides with either party).

Because of this, small retailers expressed serious concerns about the fact that the NEM does not recognise the futures contract settlement payments as an offset to the retailer's liability in the physical market.

Small retailers expressed strong objections to the, in their opinion, arbitrary manner in which the FOA proposals were (apparently) withdrawn in March 2008 and those retailers believe that it is not equitable that large retailers get access to re-allocation (with its default risks) whereas small retailers do not get the benefit of the futures contract commitment (with its guaranteed settlement at futures contract end).

2.2.11. Physical Generator Ownership

Retailers indicated that, provided the company had access to the capital, the best "hedge" investment a retailer could make was the purchase of a physical generation asset as such a purchase provided access to:

- (i) a long-term OTC hedge (often tailored);
- (ii) a re-allocation agreement;
- (iii) a concomitant reduction in prudential requirements for both NEMMCO and generation; and
- (iv) a credit rating (as there was now a physical asset, with revenue potential, to base the rating assessment on).

2.2.12. Credit-rating Acquisition

Small retailers generally cannot acquire a credit rating and, consequential on that, often cannot therefore negotiate an OTC hedge. This lack of a credit rating increases their cost of funds (including for prudential guarantees) compared to larger retailers.

2.2.13. NEMMCO Suspension Power

Small retailers strongly expressed their fear that they could be suspended from the market for a minor infringement⁴ and that such suspension could then escalate into a "RoLR" event where their customers were irrevocably transferred to their largest local competitor thereby putting their business at risk.

Small retailers argued that the NEMMCO power of suspension ought to be conditional on a material, rather than a technical, breach of the NEM rules, should reflect the retailer's past performance (so that a consistent record of compliance is recognised rather than ignored as at present) and that there should be a reasonable time for a small retailer to remedy any breach (technical or material) before irreversible action, such as suspension leading to RoLR and licence revocation, is initiated.

2.2.14. Compliance Audits

Retailers noted that the process under which they are licensed and admitted as market participants in the NEM required them to demonstrate both technical and systems adequacy and also "good corporate citizen" status through proof of their in-house governance arrangements.

Having demonstrated this to the satisfaction of both NEMMCO and jurisdictional regulators, retailers argued that, as for any other company in business, once they were licensed, they should not have to submit to jurisdictional special audit requirements and that the normal audit and reporting arrangements, to which all companies are subject, should suffice for retail energy companies.

The fact that these compliance audit requirements were different in each jurisdiction only added to the impost. The retailers felt that such compliance audits added nothing to their retailer compliance with NEM and licence conditions yet cost a lot to have done (particularly as such compliance audits often had a relatively fixed cost and so impacted significantly more on smaller retailers as a result).

2.2.15. Renewable and Green Energy Schemes

Retailers noted that each jurisdiction had its own, unique renewable or green energy scheme.

Retailers indicated support for the concept of a minimum amount of renewable energy to be supplied to retail customers.

⁴ NEMMCO would argue that the small retailers, as market participants, have the obligation to monitor their credit exposure to the NEM and hence there should, with this knowledge, be no element of fear in the process.

However, small retailers indicated that the lack of nationally-consistent arrangements provided a significant benefit to large retailers who could afford to employ the necessary regulatory staff to manage the complexity of multiple, individual-jurisdiction schemes. As such the arrangements discriminated against small retailers and act as significant barriers to entry to small retailers seeking to expand from a one-jurisdiction to a "multiple-jurisdiction" or national retail energy role. This is to the disadvantage of small customers who, because of this, are denied greater (often any) real choice of retailer in some jurisdictions.

3. Terms of Reference

The Terms of Reference for the survey are at ATTACHMENT A.

4. Survey Format

The Survey Format is at ATTACHMENT B.

5. Retailers Surveyed

Invitations to participate were made via telephone contact and also via email to the heads of the relevant retail organisation. Of the retailers invited to participate, all but one responded and agreed to participate, so the participation rate was excellent.

The following retailers provided their valuable time for a personalised interview:

1. Australian Power and Gas;
2. Click Energy;
3. ERM Power Retail;
4. Independent Electricity Retail Solutions;
5. Jackgreen;
6. Momentum Energy;
7. Our Neighbourhood Energy;
8. Red Energy;
9. Simply Energy;
10. Victoria Electricity (and South Australia Electricity and Queensland Electricity).

For the purposes of documentation of the interviews, each retailer was assigned a randomly-generated number.

Some individual comments have been included, where these were particularly effective in expressing the views of those interviewed, and where inclusion is not believed to reveal an individual retailer's commercial position or identity.

Despite this, to ensure confidentiality of commercially-sensitive information within the small retail community, most individual responses have been incorporated into general comments or trends rather than specifically included in this report.

6. Prudential Requirements Imposed on Retailers

This issue was surveyed from the following perspectives:

- Prudential imposts during retail business establishment
- Prudential imposts currently subjected to
- Retailer recommendations for improvements in prudential imposts imposed on small retailers

6.1. *Prudential Imposts During Establishment*

6.1.1. **NEMMCO Prudentials**

To be a retailer in a jurisdiction covered by the NEM, a retailer must be able to buy electricity from the NEM to supply to a retail customer. To be able to do this, a retailer requires NEMMCO registration as a Market Participant.

At part of the process of authorising a new-entrant retailer as a Market Participant, NEMMCO examines, and at times has suggested changes to, the capital structure of the applicant retailer to facilitate new entrant authorisation as a market participant.

About half the retailers surveyed commented that this generally resulted in a higher capitalisation of their retail company than they initially wanted. These were therefore required to raise that capital by one of the following:

- (i) parent company guarantee or parent company injection of capital;
- (ii) injection of extra equity by directors (often via the medium of a mortgage on their private home); and
- (iii) further capital raising from shareholders.

Most retailers indicated that NEMMCO imposed a minimum prudential requirement of \$100,000 on each retailer participant. Most commented that this was a major impost on a fledgling retail company which may, initially, only have a few customers in a particular region. With a retail customer worth around \$1,000 per annum and, of this, about 10% of that tied up in the prudential guarantee, the NEMMCO minimum prudential requirement equates to a minimum start-up customer number of 1,000 customers. It also equates to being 100 times the total revenue of the first customer – a substantial barrier to new entrants.

Comments by retailers:

[372] *"Had to put up initial prudentials of \$100,000 minimum – challenging for a small business to raise that amount of equity."*

[677] *"\$5million locked up in initial guarantees (it would have been \$13 million without an initial hedge which involved reallocation). This \$5million had to be fully funded cash to obtain the required guarantees – the banks would not negotiate. We hired a financial expert to attempt to negotiate a better outcome, but even this had zero impact on the final outcome (which was the bank's initial position). We found that NEMMCO required \$6 in prudential guarantees for every \$1 of market liability we had (and it's getting worse as NEMMCO responds to more market price volatility by increasing the volatility factors in the "prudential guarantee required" calculation)."*

Issue: Should the AEMC investigate the current situation where NEMMCO imposes a minimum prudential charge on all new entrants and small retail participants irrespective of wholesale market purchases?

Issue: Should the AEMC consider replacement of the current minimum arrangement with a variable prudential requirement based purely on the expected purchases of that new entrant over the defined period covered by the guarantee?

6.1.2. DNSP Prudentials

With the exception of Victoria, most DNSPs in NEM jurisdictions impose a minimum prudential requirement on new entrants.

Retailers quoted this as often being a minimum of \$250,000 which had to be lodged before the first customer was acquired in that region.

Retailers quoted Queensland and South Australia as the regions where DNSP's were least flexible in the enforcement of this requirement.

The same retailers indicated that this imposition had caused them either not to enter those retail markets or to significantly delay entry – which they indicated would have reduced the product choice offered to small customers in those regions (and hence the level of retailer competition).

Comments by retailers:

- [57] *"We made no attempt to negotiate with network owners – they put their contract on the table and we just accepted it! No point trying to negotiate – they have all the power."*
- [435] *"DNSP's usually request full cover."*
- [372] *"DNSP's were just as onerous in their prudential requirements as was NEMMCO. However the first DNSP... did not, after discussions, demand a prudential guarantee from my company (though they normally require a guarantee covering 90 days value of expected customer load – which represents double the value of the financial risk we actually impose on their network revenue)."*

In Victoria, a reform in 2006 by the ESCV has resulted in small retailers being exempt from lodging prudential guarantees with DNSP's whilst their actual customer load is below a materially significant level (and so a default by the small retailer would not materially impact the DNSP). The ESCV has had developed a rating system by Dunn and Bradstreet to effect this reform.

There were no reports of small retailers, operating under this arrangement, defaulting on their obligation to make network charge payments to the relevant Victorian DNSP.

Comments by retailers:

- [360] *"DNSP's were very proscriptive: we had to initially set up \$50,000 in guarantees, that is, cash in the bank, which was securitised against the Directors. This worked out at \$100 per customer just for the DNSP use of system agreement – the situation is much better now that the ESCV has the "risk-rating" system operating as we are still small enough to be under the limit where we would now have to provide security to the DNSP's."*
- [677] *"DNSP's are the most difficult of parties to deal with. In particular, [one DNSP] will not negotiate on the minimum quantity of guarantee, nor on the form of the guarantee."*
- [635] *"About \$11million was demanded by [a DNSP]. The ESCV reform of the Victorian arrangements plus 95% re-allocation in Victoria both impact favourably on our prudentials obligations for our Victorian businesses. Prior to the ESCV change, we would have been up for about \$65million in prudentials for our Vic and SA distribution businesses! [Some DNSP] demands are completely out of proportion to the customer load we have on their system and could well be the factor which decides we close our doors in SA!"*
- [270] *"By way of final comment, we find that it costs ten times more in prudentials to operate with a DNSP in Queensland than with one in Victoria."*

Small retailers were extremely complimentary of the effort put in by the ESCV in this area and strongly felt that the reform should be rolled out nationally.

It should be noted that, subsequent to the completion of this survey, the National Energy Customer Framework (NECF) proposed a national regime for credit support between retailers and distributors. The First Exposure Draft

of the NECF was released by the Ministerial Council on Energy, Standing Committee of Officials on 30 April 2009.

Many Retailers noted that they were obliged to make payments to the network businesses regardless of when, or whether, the customers paid them, so the DNSP's carried no income risk but retailers received no fee income for providing this service to the network businesses.

Issue: Should the AEMC investigate a rule change to require networks to negotiate prudential arrangements consistent with the next period expectation of customer load for each small retailer and be prevented from imposing a high fixed-minimum-level prudential guarantee requirement?

6.1.3. Generator Prudentials

The present NEM design does not permit any purchases direct from supplying generators. This exposes small retailers to the full volatility of the spot market for all their electricity purchases with no options, in the physical market, to mitigate that price exposure risk. The NEM design envisaged that retailers would then enter into financial hedging arrangements to manage that risk.

Small retailers indicated that there were two sources of NEM price risk management available to them, namely:

- (i) an OTC contract with a generator (which can be tailored, as required, by negotiation); or
- (ii) a fixed shape, fixed period futures contract.

Those retailers, which are able to satisfy generator credit rating or credit support requirements, indicated a preference for OTC hedges (either acquired directly from a generator or via a trader). OTC hedge contracts were quoted as having the advantages of:

- (i) not requiring other than a minimum initial prudential (of range a "few" percent to 10% of the hedge contract value);
- (ii) of providing cash flow, on a weekly basis, once the contract was active; and
- (iii) of being able to be negotiated to match detailed requirements such as duration, load shape, load quantity, option to be called and could be provided in various forms (caps, collars, meter-following etc).

Retailers, who were unable to satisfy generator credit rating requirements or whose hedge requirements were too small to be of interest to a generator, preferred the purchase of futures contracts.

Futures Contracts had the advantage of not requiring a credit rating as full payment is made up-front and movements in the price of the futures contract are matched by daily margin calls.

Futures contracts were at a disadvantage to OTC hedges as they are:

- (i) paid out at the end of the contract only;
- (ii) fully paid at the start of the contract (which could be several years prior to the start of the contract);

- (iii) subject to daily margin calls; and
- (iv) either "flat" (or fixed period peak) and so unable to be effectively shaped to match customer load and so therefore left the small retailer exposed to spot price.

Those retailers who utilised futures indicated that, unlike OTC hedges, they were unable to get the futures contract recognised (as an offset to the physical purchase payment) and so were charged on the basis of being 100% exposed to spot price.

Retailers who, by virtue of size, ownership or alignment with a generator, were able to obtain an OTC hedge, were often also then able to "re-allocate" that volume with NEMMCO and so reduce the level of prudential guarantee required by NEMMCO.

Those retailers in possession of a "good" OTC hedge and who had access to reallocation through that hedge, indicated that reallocation reduced their prudential guarantee with NEMMCO considerably. One retailer quoted a reduction around 60%, another 95%.

In short, it is claimed that the current market arrangements reward larger retailers and those who own, or are owned by, a generator and penalise small, and "pure" retailers, for whom either their size or their "non-ownership of assets" prevent them obtaining a credit-rating and so prevent them accessing an OTC hedge and the associated benefit of re-allocation.

Retailers dependent on futures contract support indicated that, for the market to be fair, there must be some arrangement whereby their investment in futures contract support for their spot purchases was appropriately recognised and used to reduce the level of prudential requirement imposed by NEMMCO as NEMMCO similarly recognises the existence of an OTC hedge⁵ (which has a higher settlement default risk than a futures contract) for re-allocation (and consequential prudential reduction) purposes.

In this context, these retailers strongly voiced their (adverse) opinion of the reform process which resulted in the proposed Futures Offset Arrangement [FOA] being abandoned in 2008⁶.

It was the opinion of these smaller retailers that the introduction of FOA would have provided the sought after benefits to the smaller retailers and they saw its abandonment as a move to strengthen the market position of the large retailers at the expense of small new entrants. Small retailers noted that they could not afford the time nor HR resources required to lobby in favour of the FOA proposal, but the big retailers (secure in their OTC and reallocation environment), could afford to lobby against the FOA proposal.

⁵ NEMMCO commented that it "does not recognise the existence of an OTC hedge – only the existence of a reallocation agreement between two parties."

⁶ Note that, subsequent to the completion of the survey, the Australian Energy Market Commission has commenced a review into the role of hedging contracts in the existing NEM prudential framework, which is considering this issue.

Issue: Does there need to be regulation of the level of prudential guarantee imposed by a generator on a retailer associated with an OTC hedge to mitigate discrimination against small retailers? OR

Is this an area solely for negotiation between the parties as the OTC hedge is a negotiated instrument developed under the conditions imposed through the ISDA Master Agreement and so outside the field of jurisdictional or national competition regulation?

6.1.4. Generator Prudentials – Impact of Re-allocation

Generators, when agreeing to an OTC hedge, with or without re-allocation, usually impose a prudential obligation on smaller retailers.

Where the OTC hedge also involves re-allocation, the prudential requirement imposed on the small retailer is increased to, it is stated, cover the additional credit risk assumed by the generator.

Small retailers allege that such obligations are not similarly imposed on the very large retailers.

Comments by retailers:

[677] *" Where Large retailers have access to reallocation through vertical integration with generation, their generator prudential guarantee requirements are further reduced."*

6.2. Prudential Imposts During Establishment

6.2.1. NEMMCO Prudentials

NEMMCO assesses the prudential requirements of market participants, which particularly impacts retailers, large and small, on the basis of a formula which determines a market price for the following three months based on an assessment of regional volatility and actual price for twelve months just past.

Retailers commented that comparisons between OTC hedge and Futures Contract pricing (which are set by market participants) and the NEMMCO prudential price for the same period indicate a very significant divergence between the two (in one instance quoted, the NEMMCO price was three times the level of the market-participant-set contract prices).

Small retailers pay significantly more for bank guarantees (information provided indicated that large market participants pay around 0.5%-1% for a bank guarantee whereas banks are imposing fees of 3-10% on some very small participants).

Comments by retailers:

[372] *"Very large retailers and generator-retailers generally do not face the same prudential imposts as we small retailers do and, where they do, they can get much better deals from banks in the fees charged."*

6.2.2. DNSP Prudentials

The comments about DNSP prudentials referred to by small retailers as impacting their start-up arrangements were also voiced in regard to ongoing DNSP-imposed prudential arrangements. Refer to 6.1.2 DNSP Prudentials above for comments made about ongoing DNSP prudential imposts.

6.3. Type of Prudential Guarantee Provided

6.3.1. Bank Guarantee

The Bank Guarantee is an instrument provided by a bank, on behalf of a retailer, to another party which provides a facility for that other party to demand that the bank make payment, in cash, to the level of the bank guarantee, without recourse to the retailer concerned.

Banks, in providing this to small retailers, charge a high margin (the smaller the retailer, the higher the margin) and require the retailer to have cash deposited (and locked up) with the bank to the value of the bank guarantee provided.

The locked up cash has an opportunity cost. The retailer would otherwise have used this cash for:

- (i) acquisition of new customers,
- (ii) lower pricing to small customers, or
- (iii) expansion into other regions

More than half the retailers interviewed indicated that the cash locked away in prudentials had caused them to reduce their business plan objectives and had made them decide NOT to expand into another jurisdiction. With regard to expansion into additional jurisdictions, South Australia and Queensland were quoted as being "difficult" because of the requirement for full "three-month" prudentials by network owners.

6.3.2. Prudentials Other than Bank Guarantee

There was a general view amongst retailers that it was a pointless exercise to attempt to negotiate a non-standard Use of System Agreement with a network owner. They considered the standard contract to be a "take it or leave it" situation and that, on the margins on which they had to operate, there was limited utility in most attempts to negotiate alternatives.

6.3.2.1. ESCV DNSP Prudential Reform

The ESCV reform (using a Dunn & Bradstreet rating system for small retailers) was quoted as an excellent alternative to the previous requirement by Victorian DNSP's of full three month bank guarantees.

This arrangement was supported by all interviewed retailers who are operating in Victoria. All retailers, who were aware of it (and some very small retailers who did not operate in Victoria were not aware of it), supported the ESCV reformed prudential arrangements with DNSP's being adopted nationally.

6.3.2.2. Credit Insurance

When asked, most retailers indicated that negotiations with DNSP's were a fruitless exercise with all the power being held by the DNSP's. A common argument was that DNSP's considered their standard contract had regulatory approval and was therefore a reasonable outcome.

A few retailers indicated that they have had preliminary discussions with some Victorian DNSP's prior to the ESCV reform and that two of the privatised network owners in Victoria had been receptive to such discussions. No retailer had achieved an outcome before the ESCV reform rendered the discussions redundant. Those same retailers indicated that they had had some preliminary discussions on the subject in SA but with no success.

6.4. Other Prudential Liquidity Issues

6.4.1. NEMMCO Call Notices

Retailers report that one of the greatest concerns they have is that the phone will ring around 7.30am (on any business day) and it will be NEMMCO requesting a new, additional bank guarantee to be lodged by 10.30am that day in response to the retailer's total outstandings against NEMMCO exceeding the retailer's trading limits as at the previous midnight.

With banks opening for business around 9.30am each business day, this leaves the retailer 60 minutes to negotiate an additional bank guarantee with their bank, arrange cash to support that guarantee, get it physically issued and delivered to NEMMCO.

NEMMCO, in response to the above, comments that this is only the case if the retailer has not made arrangements to cover the prices that occurred the day before – the regime is designed with the expectation that retailers will "self manage" their outstandings, and a call from NEMMCO would only be a surprise if they are not on top of this.

The risk of not achieving the above is that NEMMCO has the power, to issue a Call Notice to the retailer (see 6.4.2 below). If the Call Notice, which can be substantially more onerous than just addressing the Trading Limit breach, is not satisfied within 24 hours, a Default Notice may be issued. If the Default Notice is not satisfied in 24 hours, the retailer may be suspended. Suspension leads to activation of the Retailer of Last Resort arrangement which, in turn, result in all the retailer's customers being irrevocably transferred to one of its bigger competitors.

Issue: Should prudential margin calls on retailers, given the timing involved, result in market suspension of the retailer for non-compliance by the retailer?

Issue Should NEMMCO be obliged to consider the payment performance of a retailer when it considers suspension? Particularly given the "loss of customer-base" consequences of suspension?

Note: The issue of a Call Notice triggers onerous obligations, but only after the retailer has failed to meet less onerous ones imposed by the NEM Rules: it does not result in suspension in the first instance. When considering suspension, NEMMCO would take into account any information provided by the market participant concerned. (see below)

6.4.2. NEMMCO Power of Suspension

NEMMCO has the power, and, it is alleged, the obligation, to suspend a retailer for both non-payment and also for non-compliance with a margin call associated with the prudential guarantee determined and held by NEMMCO. Steps toward suspension can be initiated for even a minor breach of the NEMMCO requirements.

Suspension of a retailer market participant by NEMMCO can initiate "Retailer of Last Resort" ["RoLR"] action against the suspended retailer.

RoLR involves the automatic, and irreversible, transfer of all the retailer's customers to a pre-designated, local large retailer (traditionally the original host or first tier retailer in the area). Under most jurisdictional legislation, such transfers also involve the automatic cancellation of all retail contracts that the suspended retailer had with its customers in that jurisdiction and consequential automatic creation of retail contracts between those customers and the RoLR.

This is all done with no entitlement to compensation for the suspended small retailer.

Consequential on suspension by NEMMCO is usually loss of the retailer's retail licence in that jurisdiction – initiated by the jurisdictional licence authorisation body (usually the jurisdictional electricity regulator).

Thus, whilst the retailer is reminded by NEMMCO that it must be under its Trading Limit by 10:30am or a Call Notice will be issued, the consequences of failure to complete the requirement for additional credit are severe, irreversible and probably ultimately destructive to the business of the retailer.⁷

⁷ NEMMCO comments that a "more graded response" (as set out further down in the report) would transfer risk to generators while the retailer continues to accrue unsecured debt.

Issue: Are the suspension powers of NEMMCO associated with cash flow and prudential issues appropriate given the consequences to the small retailer's business that flow from market suspension?

Issue: Should jurisdictional cancellation of a retail licence occur as a consequence of suspension by NEMMCO from the market? Should consideration be given to having a more-graded response by both NEMMCO and jurisdictional regulators to a failure by a retailer to respond in a timely manner to a call to lodge an increased prudential guarantee?

7. Liquidity for Financial Contracts

This issue was surveyed from the following perspectives:

- Liquidity issues with generator OTC contracts
- Liquidity issues with futures contracts
- Accessibility of market information (particularly contract pricing information)

7.1. OTC Hedges with Generators – Liquidity Issues

Retailers raised the following issues in regard to liquidity of secondary market financial contracts:

- (i) generator trades with small retailers who cannot obtain a credit rating;
- (ii) essential role of intermediaries in obtaining hedge cover for smaller retailers;
- (iii) government-ownership of both generation and retail businesses;
- (iv) ownership of generation as a means to a retail obtaining an effective credit-rating with other generation businesses; and
- (v) generation businesses may charge a premium, or require a prudential guarantee, for an OTC hedge contract.

7.1.1. Credit Rating – Impact on Generator OTC Contract Availability

Some generators are unwilling to deal with small retailers because they do not have a credit rating.

An additional factor in generator's lack of interest in contracting with smaller retailer is the size of any contract entered into as generators incur the same contract administration costs for large and for small contracts, so tend to naturally prefer to deal in large contracts as there is more "bang" for the same contractual effort.

The nature of small retail businesses is that they do not have the financial balance sheet to qualify for any credit rating.

7.1.2. Relationship Management – Impact on Generator OTC Contract Availability

One alternative to obtaining a credit rating is to establish credibility with a generator trader through establishing and maintaining a good relationship with that generation business.

However, the time commitment (and cost) required to develop relationships with individual generators is quite large. It is the nature of small and medium retail businesses to operate with small executive staffing levels (irrespective of their total employment levels) for cost control reasons – the margin available to retailers is small and often inadequate to support the executive resources required for wholesale supplier relationship management.

7.1.3. Role for Intermediary Hedge Traders and Futures Contracts

In the absence of either a credit rating or a sound relationship with a generator, small retailers must rely on intermediaries (OTC traders) to obtain OTC hedge contracts.

Where company size or balance sheet strength render this difficult, the default is to deal in electricity futures where the trading arrangements rely on cash up-front rather than credit. It should be remembered that there is no settlement default risk with a futures contract as daily margin call payment manage all changes in contract value and so payment is guaranteed by the futures market clearing house.

In this regard (the role of intermediaries to facilitate small retailer access to generator hedges), small retailers noted that the trend to generator-retailer combinations (either by ownership or strategic agreement) has reduced the quantum of smaller hedges available through intermediaries and could eventually lead to fewer intermediaries being in the market and so liquidity will worsen as generator-retailer arrangements proliferate.

For small retailers, the cost of maintaining a hedge-trading operation (quoted as being around \$0.3million per annum for two traders and associated support systems) is unsupportable with current retail margins available and so, in the absence of an in-house trading facility, access to skilled intermediaries is essential for some small retailers to access secondary financial market risk management.

7.1.4. Government Ownership as a Barrier to OTC Trading

Small retailers claimed that, in their experience, government-ownership of both generation and retailing in a jurisdiction was associated with the government-owned generators being willing to negotiate hedges with government-guaranteed retailers, but not with small, privately-owned, retail businesses.

Where government ownership of both generators and retailers is the case, it is possible that the links between the generator and retailer provide sufficient hedge for the production of those generators. This may have the effect of limiting opportunities for privately-owned small retailers (irrespective of whether the retailer has a credit rating or not). The reduction in liquidity of this market could have significant implications for the costs of these risk management products.

7.1.5. Generator prudential requirements

The design of the NEM has a market cap(called VoLL) of \$10,000/MWh and a market floor of -\$1,000/MWh.

For the purposes of an OTC hedge, the NEM spot price realistically varies between \$0/MWh and \$10,000/MWh with the expectation by both parties that the following flow of cash will occur on settlement day each week:

- (i) the retailer settles in cash with NEMMCO for its weekly purchase of all electricity for its customers from the NEM;

- (ii) NEMMCO settles in cash with the generator for all electricity sold by the generator into the NEM; and
- (iii) for spot prices above the effective hedge strike price, the generator will pay cash to the retailer for the difference between spot and hedge price. For spot prices below the effective hedge strike price, the retailer will pay cash to the generator for the difference between spot and hedge price.

The risk to a generation business, and its incentive to enter a hedge contract, is that low spot prices will result in revenue insufficient to service payment obligations (especially for generation businesses with a high debt/equity ratio on their balance sheet). The hedge guarantees an adequate cash flow at the required level to guarantee debt-servicing capability to the satisfaction of financiers.

The risk to a retail business, and its incentive to enter a hedge contract, is that high spot prices will result in it becoming insolvent within a few hours and, if unable to respond to a NEMMCO Call Notice and subsequent Default Notice, complete loss of its business consequential on losing all its customer base through a RoLR event and prosecution of its directors for either negligence in not managing that risk or for insolvent trading.

As the party exposed to the greater quantum of payment risk (the retailer will pay NEMMCO who will pay the generator before the generator has to pay out to the retailer under the hedge), the retailer is often required, by the generator, to lodge a prudential instrument to cover the risk of its non-payment under the contract.

Retailers in the survey indicated a range of prudential guarantee levels for their OTC contracts with generators, but values of around 10% of the total hedge value were quoted by smaller retailers. Bigger retailers in the survey were generally unwilling to respond to the question.

Where a generator has accepted a re-allocation agreement with a retailer, the retailer's liability with NEMMCO is consequentially reduced and so its prudential guarantee is also reduced.

The generator's payments from NEMMCO are similarly reduced by the reallocation agreement and so generators claim to be more-exposed to default by the retailer as a consequence of the re-allocation agreement.

For this reason, generators assess credit-worthiness of retailer counterparties to OTC hedge contracts and also their total exposure to particular retailers. Generators manage this exposure by requiring a retailer, with whom they have a re-allocation agreement, to lodge a prudential guarantee with them to manage the "re-allocation agreement risk" in addition to that lodged by the retailer to manage its OTC hedge payment default risk.

7.2. Physical Generation Ownership

(the preferred alternative to an OTC hedge)

Small retailers commented that the capital outlaid by a retailer to acquire a generation asset will result in the acquisition of an asset which will simultaneously:

- (i) provide an asset base on which to base a credit rating;
- (ii) reduce the need for a credit rating by facilitating a re-allocation agreement between the two self-owned parties;
- (iii) reduce the prudentials required by NEMMCO; and
- (iv) reduce the prudentials required by any generator for energy traded because of the re-allocation agreement.

Several retailers commented that investment in physical generation was a better use of available equity than tying it up in provision of bank guarantees and achieved the required "guarantee result" at lower net cost to the retail business.

That this is indeed the situation is self-evident from the actions of larger retailers in the market in recent years which have seen larger retailers increasingly acquiring physical generation and, consequentially, withdrawing both their retail and generation businesses from participation in the secondary OTC hedge market. Liquidity in the OTC market has suffered in consequence.

7.3. *Futures Contracts and Mitigation of small retailer credit risk*

7.3.1. Futures Contracts – nil settlement risk

The nature of futures contracts is that a party initially purchases (or sells) a future contract and payment occurs at that point. Parties are not identified because the futures market acts as the buyer and seller.

With full payment occurring when the trade occurs (and with each futures contract being adjusted to current market value at the close of each trading day), there is no settlement risk to either buyer or seller in the deal.

Buyers and sellers also have anonymity in the market place which appears to facilitate trading.

As the price of the futures contract changes due to further trading, the futures exchange makes margin calls on all such futures contracts so that, at the end of any trading day, full payment is effected for every contract. For a futures contract, there is no settlement risk at contract maturity and so no credit risk to either party to the contract.

7.3.2. Futures Contracts – management of small retailer credit risk

For small retailers, the futures market provides an opportunity to manage their lack of credit rating.

Purchases (or sales) of futures contracts by small retailers are accompanied by initial settlement and by ongoing payment adjustments as the price of the futures contract changes.

By comparison, for OTC (bilateral) contracts, generators can be uncomfortable with the credit risk associated with a retailer which may prevent them entering directly into a bi-lateral contract even when they would otherwise desire to. In such situations, the futures market provides a means of contracting bilaterally with the associated credit risk. Each party contracts,

at the agreed level, through the futures exchange (with full payment made). In this way, the need for the retailer to have an acceptable credit rating with the generator is bypassed as the generator is assured of payment through the futures exchange settlement process and its credit position is not compromised.

This technique is also utilised when generators and large retailers seek to contract to a quantity or level above the maximum assigned by each party's credit risk management procedures as the additional trades do not impact the total assessed risk of the counter-party.

For many smaller retailers, this provides the only mechanism for obtaining hedge cover to manage NEM spot market price risk.

7.3.3. Futures Contracts – Offset arrangements⁸

At present, there is no recognition in the NEMMCO settlement arrangements, of the improved payment surety provided by the retailer entering into a futures contract. This makes futures contract a less attractive vehicle than an OTC contract for a retailer.

Small retailers stated that they are actively seeking the resumption of the proposed "Futures Offset Arrangement", proposed in 2007, and which they saw as abandoned in March 2008, as a means by which NEMMCO would recognise the existence of the futures contract (as the current re-allocation arrangements recognise the existence of an OTC hedge) and so lead to NEMMCO requiring a reduced prudential guarantee from the retailer (similar to that which applies where an OTC hedge is used to support a re-allocation in the NEMMCO system).

Smaller retailers have argued that the availability of re-allocation to those large retailers able to satisfy generation business credit worthiness criteria and the absence of a similar provision for smaller retailers who, because of size are unable to obtain an OTC hedge and revert to futures contracts for price risk management, effectively provides a very significant advantage to large retailers in the retail market.

⁸ As stated previously, the Australian Energy Market Commission has now commenced a review into the role of hedging contracts in the existing NEM prudential framework, which is considering this issue.

8. General Barriers to Entry

8.1. Ability to acquire a credit rating

This issue is also canvassed in sections 7.1.5, 7.2 and 7.3.2.

Small retailers, when starting up, are capitalised to the minimum required by licensing authorities and NEMMCO. They necessarily, unless associated with physical generation, have few assets. Their key asset, a growing customer base, is at risk from market suspension, RoLR and from customer churn from competition with other retailers.

The lack of physical assets makes it nearly impossible for a small retailer to obtain a credit rating.

The lack of a credit rating impacts their ability to compete in many ways:

- (i) the cost of prudential guarantees provided by their bank is much higher than for a retailer with substantial assets or large revenue;
- (ii) generators assess a small retailer as higher risk and lower volume than large retailers but incur the same transactional fixed costs for a small hedge as for a large one. Generators therefore have a preference with dealing with large, established retailers in consequence;
- (iii) the inability of some small retailers to obtain a OTC hedge means that they do not have access to reallocation and so their prudential guarantee levied by NEMMCO is consequentially much larger;
- (iv) DNSP's are more likely to require a prudential guarantee from a small retailer because of their size and lack of physical assets (and, by implication, may not require a prudential guarantee from a large established retailer because of their size and customer base);
- (v) the minimum prudential guarantee required by both DNSP's and NEMMCO is a much higher percentage of the total revenue of a small retailer than it is for large retailers. The minimum guarantee amount often equates to a very significant percentage of the small retailer's total annual revenue – whilst being insignificant in the revenue base of a large retailer;
- (vi) Government-owned retailers are perceived to have an implicit credit-worthiness (by virtue of their government ownership) that a small, private, new-entrant cannot attain. The market does not believe that any jurisdiction would permit one of its owned retailers to fail (because of the political consequences the impact of such a failure would have on customers who are also voters);
- (vii) generators are more likely to enter into a re-allocation agreement with a large established retailer than with a small new-entrant; and
- (viii) small retailers believe that existing large established retailers are most likely to be classed as a "RoLR" and, because of their size, are less likely to be suspended quickly because of the difficulty in transferring a very large customer base to another retailer.

There appears to be a prima-facie case that the current market arrangements encourage and advantage large, established, first tier and generator-owing retailers and provide significant inequalities to small and new entrant retailers.

9. Other Issues Adversely Affecting Competition

At the end of the survey, respondents were asked whether there were prudential and competition issues which were significant for the retailer which had not been covered as part of the standard survey questions.

Retailers responded with a variety of issues (some of which were covered by comments raised in earlier Sections). The issues raised are covered in the sub-sections below.

9.1. Balance Sheet Equity at Start-up

A retailer pointed out that a NEMMCO requirement to provide a \$1 million prudential upon start-up required a \$25 million equity base to establish that level of prudential guarantee.

The retailer indicated that this had necessitated an additional capital raising to achieve this level of balance sheet support. Such capitalisation may represent a significant new-entrant barrier for prospective retailers.

9.2. Impact of "Gen-tailers" on Competition

With the exception of retailers in the survey who have a corporate or parent-company relationship with a generator, retailers considered that ownership of a generator (or by a generator) provided a competitive advantage.

The gen-tailers tended to be the larger retailers. Access to a hedge with a medium/large generator facilitated the retailer's ability to increase market-share and hence the number of customers available to spread fixed-cost fees across.

And so, to the above benefits was added the benefit of scale (of systems HR and other resources).

Comments by retailers:

[677] *"Retailers who are hedged and can reallocate have an advantage through lower prudential commitments."*

[74] *Gen-tailers have a competitive advantage, as they invariably have a reallocation agreement with their internal generator."*

[635] *"The gen-tailer generator treats an owned retailer similarly to other retailers. "*

9.3. Retailer as Collection Agent for DNSP's

All retailers expressed very strong objections to the current requirement that retailers must collect network fees from customers as part of their billing arrangement, but for which, they receive no payment from DNSP's.

The retailers also noted that they are required to remit such fees to DNSP's on a monthly basis and before they receive them from the customer. In

addition, should the customer not pay the fee, the retailer is still required to remit the fee and wear the loss. This is despite the fact that the DNSP have large asset bases, good credit ratings, access to funds cheaply on the basis of those credit ratings and are in receipt of guaranteed revenue whilst retailers are subject to the vagaries, have no assets, are generally unable to obtain a credit rating and are at risk of competition and customer default.

The retailers also noted that DNSP's invariably, in determination submissions, described their businesses as being at relatively high risk when it came to the determination of the return the DNSP could extract from customers for ownership of the network.

Retailers highlighted that rewarding risk in these determinations, while passing the risk onto retailers, created a significant inconsistency in the risk-reward framework.

Comments by retailers:

[635] *"Biggest bugbear is being a collection agent for the DNSP's as the retailer wears all the risk, but the DNSP then argues to the regulator that their business is risky and get a risk premium above the risk free rate for this but actually wears NO RISK whilst the retailer actually wears ALL THE RISK and gets NO compensation for that risk. The DNSP should either wear the payment risk or pay the retailer to wear that payment and collection cost for them (as their agent)."*

9.4. Green Energy Levies by Jurisdictions

Retailers noted that, despite the national character of the market, each jurisdiction introduced its own "green energy" (or "renewable energy") obligation with an associated "levy" on retailers to fund such renewable energy purchases.

In particular, small retailers noted that whilst each jurisdiction had its own, unique scheme, a common trend was to have a fixed minimum payment obligation which adversely impacted on small retailers.

Comments by retailers:

- [57] *"We cannot understand why each jurisdiction has to reinvent policies – this is supposedly a national market, but things like green energy, energy efficiency schemes are different in each State – why can't the same model be employed across all jurisdictions. This is needless complication of the retail energy market. There is too much "jurisdictional diversity" for no customer nor governance benefit."*
- [212] *"We are swamped by imposts such as MRET, VRET, EWOV (Victorian Ombudsman Scheme). As an example, we have to contribute \$5,000 for green power administration. This fixed amount has a much greater impact on a small or start-up retailer than on a larger one (\$5,000 across, say, 1000 customers is a lot more per customer that we have to contribute than \$5,000 across a million or so customers that a large retailer has); Regulators and government bodies have a preference for fixed fees, or fees in "bands", both of which provide a significant commercial and competitive advantage to large retailers."*
- [360] *"For schemes like VRET, which require independent auditors, the cost of an independent audit in terms of \$ per customer is huge when you only have a small number of customers to spread it over. Large retailers are not similarly affected as the fixed cost is spread over hundreds of thousands, or even millions, of customers. "*

9.5. Ongoing Compliance Audits

There was a general view that retailers, as good corporate citizens who are subject to effective oversight from Ombudsman Schemes and who have to routinely report in accordance with their licence requirements, should not then have to obtain independent compliance audits. There was a related concern about the generally limited list of "acceptable" compliance auditors who have obtained such status with the respective jurisdiction.

Retailers argued that, with their normal annual reporting requirements and the Corporations Law obligations on their directors, they should be treated no differently with regards to audits than any other company providing retail services to the community.

Comments by retailers:

- [57] *"We cannot see why, having been through a high hurdle to get a licence and national electricity market registration, that we then, on an ongoing basis, have to continually provide audit and other compliance reports. Surely having established our bona-fides at the start, this should be sufficient. The current arrangements leach capital out of our business (which increases the prices we have to charge the customers) but appear to do little other than support a group of independent consultants and State bureaucracy."*
- [74] *"Jurisdictions audit small retailers (which adds to our costs) apparently more often than the very large retailers (which reduces their costs) – how is this fair?"*

9.6. Ombudsman Should be Discriminating

Some retailers raised the issue of the nuisance complainant who would lodge a vexatious complaint with an ombudsman as a means of avoiding payment of an account and the inherent cost this imposes on responsible retailers. The words of one retailer state the case coherently:

Comments by retailers:

[57] *"Schemes like the Ombudsman, whilst providing customer protection, do not discriminate between genuine cases and those seeking to work the system. Every complaint costs us money – even if the customer concerned is a "serial offender" who has been proven to be in the wrong in every past instance – we are still hit for the costs of the complaint."*

[74] *"Ombudsman schemes – all the ombudsman schemes pass every complaint, even from those who complain frequently and are, each time, shown not to have a valid complaint, onto us without any attempt to manage the process or discern case validity. So perennial tariff evaders get the same response as genuine, once-only cases from the Ombudsman – this adds significantly to our operating costs as it costs a lot in time and money to respond to each complaint, high ombudsman charges and usually requires us writing off outstandings just to stop escalation. Ombudsman have effectively become consumer advocates."*

9.7. NEMMCO Methodology to Calculate Future Price

All retailers raised the issue of NEMMCO using a past regional spot price as the basis of calculating the future price (and future jurisdictional volatility factor) from which the required prudential guarantee amount is calculated.

Retailers argued that there was virtually no correlation between a market price spike in June and the expected price in October – calculated by formula based on the June price spike – yet this is exactly what the NEMMCO formula implies.

By way of example, one retailer also noted that, for November 2008, the NEMMCO formula expected a price above \$170/MWh yet the futures market was indicating a price under \$50 for the same period. The two prices result in dramatically different prudential guarantee requirements and the retailer's business would be significantly more viable with a forward looking formula rather than the backward looking one.

Comments by retailers:

[435] *"(i) NEMMCO credit assessments should be based on some form of forward curve, not past events (is a price spike mid-winter a good indicator of the future market price and market volatility in, say, mid-November? At present, this is the situation!).*

(ii) NEMMCO should be obliged to use some measure or formula which does not require a maximum worst case outcome (as is the case at present)."

9.8. State Retail Price Control and "Levies"

This was an issue raised by retailers for NEM jurisdictions (other than for Victoria) and is included here for completeness and because it was raised by the majority of retailers interviewed.

The issue is not new and has been argued, back and forth, between retailers, jurisdictions, jurisdictional regulators and consumer advocates for a number of years now.

In summary, retailers argue that state regulation of prices, by whatever mechanism, distorts the retail market and usually makes it uneconomic to compete at the small customer end of the market. Consumer advocates and jurisdictions (other than Victoria) have argued that small customers do not have market power and are unable to understand the complexities involved in contracting for their small amounts of energy.

Comments by retailers:

- [57] *We prefer to operate in Victoria where price regulation is minimal and so we are allowed to compete. NSW is the exact opposite – price setting by IPART is a real issue there... We found Queensland to be keen to facilitate our entry."*
- [372] *"I'd like to comment on the basis through which State regulators set retail prices. QLD looks at what a prudent retailer would do – and so assumes you have put trades (hedges) in place. However, NSW will only consider a move in retail prices if the wholesale prices have moved by more than 10% - irrespective of what OTC hedges are being priced at."*
- [270] *"The other major issue is retail price control by governments. With the wholesale prices offered by government owned generators and the retail prices determined for those states, there is no retail margin available and, with the high prudential guarantees required by gov-owned DNSP's, you cannot afford to operate there."*
- [74] *"Jurisdictional regulators seem to set prices based on what the jurisdiction government wants, rather than what wholesale market pricing would indicate should happen. Their decisions don't reflect true supply costs, nor wholesale costs, and they don't adjust their decisions when the decisions turn out to be wrong! This significantly impacts our decision as to whether we will move into a particular jurisdiction."*

ATTACHMENT A

TERMS OF REFERENCE

Survey/interview of second tier retailers in the NEM

Background

At its 13 April 2007 meeting, the Council of Australian Governments (COAG) asked the Ministerial Council on Energy (MCE) to develop options for the integration of spot and forward contract markets.

The Ministerial Council on Energy Standing Committee of Officials consequently established an industry-led Financial Market Working Group (FMWG), with relevant senior industry representatives.

The FMWG received anecdotal advice on barriers to competition faced by second tier retailers. The second tier retailers were concerned to avoid their individual views being identified. To address this, a consultant is to be engaged to survey second tier retailers in the market including those that have recently exited the market.

A survey would avoid sensitivities with views being attributed to particular retailers. The survey would make a useful contribution to policy consideration regarding possible barriers to entry by retailers and is timely given that in last 12 months a small retailer has exited the market. In addition, there are indications that several more second tier retailers are experiencing financial stress.

Scope/Objective

To interview and survey all the second tier retailers (strictly second tier only) in the market to assess whether there are unnecessary and burdensome requirements for these participants which act as barriers to effective competition or new entry. The information obtained from the interviews will be used to identify possible areas for policy action to create more of a level playing field for second tier retailers.

Second tier retailers include:

- Australian Power and Gas;
- Click Energy;
- ERM Power Retail;
- Independent Electricity Retail Solutions;
- Jackgreen;
- Momentum energy;
- Our Neighbourhood Energy;
- Red Energy;
- Victoria Electricity (including South Australia Electricity and QLD Electricity);
- Simply Energy.

This list generally excludes retailers that have any of the following characteristics:

- have an interest in electricity distribution;
- are first tier retailers in another state;
- are a subsidiary of a first tier retailer; or
- have significant generation

Detailed Requirements

Provide a concise report providing the results of a survey of second tier retailers in the NEM (see above). Whilst information will need to be collected under the Chatham

House Rule, data, if available, should be incorporated into the report to substantiate claims from retailers. The consultancy will also need to assess each jurisdiction individually and highlight any differences.

The interviews will need to investigate:

- prudential requirements imposed on retailers (Use of System charges, NEMMCO, hedging contracts);
- lack of liquidity for financial contracts;
- general barriers to entry;
- competition concerns;
- other issues that are adversely effecting competition in the market; and
- risk management strategies;

The report will need to include recommendations that identify areas for further analysis.

The consultant will need to present the findings to the FMWG at a working group meeting and possibly to EMRWG/SCO.

ATTACHMENT B

Second Tier Retailer Survey June September 2008

Retail Business Registration (Authorisation) Process

- Impact of size:
- Was the size or structure of your business an issue during start-up?
- Did you have to change or revise your initial business financial arrangements to obtain the retail business licence/authorisation?
- Was it different across States? (explored in more depth below).
- Set up of prudential requirements
- Did establishing prudential requirements for your retailer licences and NEMMCO registration delay..., cause problems,.... or otherwise impact on the start-up of your retail business?
- How would you describe the financial impact on your fledgling retail business of setting up the initial prudential arrangements?
- Were any particularly vexing (eg DNSP's)?

Barriers to Entry

- Either from your start-up experience or for any other reason, do you think there are any significant barriers to entry into the retail market for small retailers (any that first-tier or very large retailers do not, or would not, face)?
- State Differences
 - Do you operate in more than one State?
 - If so, did you find that retailer requirements are different across jurisdictions?
 - Are there any jurisdictions where you think the barriers to starting up a new retail business are greater or more challenging?
 - Any comments on the differences and the impact of those on your business (both initially and ongoing)

Prudential Requirements (Ongoing) & Cash Flow

- Prudential Guarantees
- Is the on-going provision of prudential guarantees an issue for you?
- If so, what are the issues you face?
- Do you find such Prudential provision issues differ:
 - Across Regions/States?
 - Are impacted by market size?
 - Are impacted by factors like being linked with a significant asset like a generator or a physical network?
- Cash Flow Timing: Do you have any comments about the timing of cash coming into your business and associated cash payments to other businesses (wholesale in particular via NEMMCO or via hedge, futures settlement)
- Provision of Prudential Guarantees: What do you have to provide? and to whom?
 - Retail Business Authorisation body?
 - NEMMCO?
 - DNSP's (how many?)
 - Generators?
 - Financiers?
 - OTC counterparties?
 - Futures contracts support?
 - Funding of Prudential Guarantee Arrangements

- Does funding such commitments impact your cash flow or otherwise be an issue for your retail business?

Other Types of Instruments used for Prudential Guarantees (Alternate Arrangements)

- Have you attempted to negotiate with any of your counterparties to minimise or mitigate these impacts or to put in place alternate arrangements? If so, did you have any success with those negotiations?
- Are there any alternative financial guarantee options (which would be cheaper for you) that you think should be acceptable to the other party?
- Would you want to use these with all other parties or just some? Explain how these might work.
- From the other party's perspective, are there any payment limitations on these compared to the traditional Bank Guarantee?
- Impact of Prudential Guarantees
- Does the provision of prudential guarantees (of whatever form) impact your competitiveness in the market compared with other retailers (particularly with respect to larger retailers)?
- Are there any other factors or imposts in the retail and wholesale markets which impact your competitiveness compared to other (larger) retailers?

Risk Management Arrangements & Impact on cash flow

Preference for OTC-hedge or Futures Contract (or Settlement Residues)

- Do you have a preference for any particular type of financial risk management product (eg OTC hedges, futures, settlement residues)?
- If there is any preference, why do you have this preference?
- Is there any other risk management product you utilise? eg demand side response?
- Do you find these easier to obtain such cover in some jurisdictions or Regions compared to others? If so, which and why?
- Do you find it easy to get information on:
 - Types of hedge products available?
 - Pricing of hedge products?
 - Actual availability of hedge products?
- Is Availability of hedge products to you influenced by
 - Relationships you've set up (or tried to set up)?
 - Your energy or retail Turnover?
 - Prudential Issues?
 - Other Structural Issues (eg vertical integration, type of customer, size of customer base, size of customer load, personalities)?
 - Trades by other (larger?) retailers?
 - Retailers who own generation (vertical integration)?
 - Generators who self-retail?
 - Your', or the other party's, credit risk diversification policies
 - Limits on risk management availability
- Have you encountered times when hedge cover is unavailable? eg Peak Summer periods? Peak winter? Up to VoLL"? When gas for generation (or heating) is short? When water is short?

Reallocation

- Do you use reallocation? If not, why not?
- Do you perceive that retailers that are owned by a generator, have their own generation, or corporately part of a generation business have an advantage through better access to reallocation than small 2nd tier retailers?
- If you do use reallocation: do you view reallocation as:
 - A cash management tool?
 - A prudential or credit limit management tool?

- Not a lot of use in practice?

Anything Missed?

Is there anything that impacts your cash flow and competitiveness that you think is both important for your business and not covered by the questions and discussion so far? If so, let's talk about these impacts.