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Level 33, Rialto South Tower
525 Collins Street
Melbourne, Victoria 3000
Fax +61 3 8807 1199
simplyenergy.com.au

11 December 2014

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

Submitted to the AEMC website

Dear Mr Pierce

Reference ERC0172: Retailer insolvency events – cost pass through provisions, consultation paper

Simply Energy welcomes the opportunity to provide feedback in response to the Australian Energy Market Commission's (AEMC) consultation paper on National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015. Simply Energy is a member of the Energy Retailers' Association of Australia and supports the Association's submission.

Simply Energy considers that if changes are made to reallocate credit risk from DNSPs to customers then this should only be done if the changes ensure that customers do not pay twice for the risk. Specifically, the equity beta used to determine the DNSP return on capital should be reduced to reflect the transfer of some of the business risk (the credit risk) to customers. If this is not done the customers will pay twice for this credit risk – firstly through the DNSP return on capital and secondly through the pass through.

We also consider that it is the best interests of customers to ensure that DNSPs have incentives to seek the return of lost revenues from an insolvent retailer's administrator. An arrangement that gives DNSPs no incentive to seek the return of lost revenues will lead to this money going to other creditors instead of being returned to customers, who have paid for the pass through.

Additionally, we are not aware of any evidence that the credit risk faced by DNSPs has increased, and that the current credit support arrangements are insufficient. If anything, the removal of any inherent risk to the distributor's revenue of a retail failure is removed by the creation of a pass through for insolvency, making the need for credit support redundant. In our view, creating a pass through for retail insolvency should lead to a commensurate reduction (if not removal) of the requirement to post credit support with the distributor.

The following sections of the submission address each of the questions posed in the consultation paper.

Responses to the AEMC's questions

1 Is it appropriate for retailer credit risk to be reallocated from DNSPs to customers under the current regulatory framework? Is there a more appropriate way to allocate this risk?

Under the current price cap and revenue cap approaches, the amounts paid by customers to DNSPs include amounts based on the risk the DNSP faces in carrying out its business. This is calculated using an equity beta for the DNSP.

However, some risks are explicitly not included and pass through mechanisms are used instead. Pass throughs are typically used for risks that are hard to quantify and manage, such as HILP (high impact low probability)

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events. It may be difficult for DNSPs to effectively self-insure or obtain insurance against these risks, and in these cases the optimal outcome is for customers to retain the risk, paying the costs of the event if it occurs.

Currently retailer credit risk is held by the DNSP and managed by retailers providing credit support. Customers pay for retailer credit risk through network prices that take account of the DNSP's equity beta (which reflects the risk of running that type of business, including credit risk) and through their retailer's credit support costs, which are ultimately recovered from customers.

The equity beta used for DNSP return on capital reflects these arrangements. If this risk is transferred to customers through a pass through or by including revenue lost due to retailer insolvency in the revenue true-up, then the business risk faced by the DNSP has reduced, and therefore the equity beta used should also reduce.

It may be appropriate for retailer credit risk to be reallocated to customers, as long as it can be demonstrated that this is in the long term interests of customers. For this to be demonstrated we would expect to see a reduction in the equity beta of the DNSPs, reflecting the reduction in risk from the reallocation.

2(a) Is it appropriate to recover revenue foregone resulting from retailer insolvency through the cost pass through mechanism?

Cost pass through were originally designed for weighted average price caps and aimed to cater for changes in a distributors' costs due to events that were outside the control of the distributor and were not anticipated at the time when the 5 year price path was established. As the weighted average price cap was supposed to reflect the efficient costs of investing in and operating the network, if there was a change to the efficient cost level due to external influences, then it was necessary to re-align the price path to have it again reflect efficient costs.

Over recent years, the AER has been moving many of the electricity distributors to revenue cap arrangements. Under a revenue cap, variances from the annual revenue allowance are trued up in subsequent years.

A retailer insolvency event is not a change in costs but is only a potential loss of revenue for the distributor. The potential exists for a distributor's revenue to no longer reflect the efficient costs of investing in and operating the network.

However, under a revenue cap, this lost revenue is recovered in subsequent years and thus no pass through is required.

It is also unclear to us how the pass through mechanism is supposed to work where there is a revenue cap. If an insolvency event occurs in year one, the revenue cap mechanism will adjust to recover any lost revenue in the subsequent year. Given the revenue cap recovers the lost revenue, what is this pass through event supposed to achieve? Is it intended that the revenue cap be adjusted mid-year so that affected network is allowed two prices changes in one year?

2(b) What distinguishes retailer insolvency events from other pass through events that would justify the recovery of revenue, rather than just costs?

For a cost pass through, the DNSP must demonstrate that it incurred additional costs, and the quantum of these costs is passed through. A DNSP may incur additional costs due to a retailer insolvency event, for example additional legal costs, but it is unlikely that the costs of providing network services are increased significantly by such an event. Instead, the impact on a DNSP of a retailer insolvency event is the loss of revenue that it was expecting to be able to use to cover the costs of providing network services. As the

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objective is to protect the DNSP from this kind of impact (justified by the reduced equity beta) then recovery of revenue rather than costs is justified.

2(c) has the level of risk faced by DNSPs increased, or changed, such that allowing recovery of revenue in the manner proposed is warranted?

No. We are unaware of any evidence that demonstrates that the risk faced by DNSPs has changed.

3 Is it appropriate to remove the materiality threshold for considering pass throughs resulting from retailer insolvency events?

No. Materiality thresholds reflect the administrative costs of preparing, assessing, and potentially approving and implementing pass throughs. These considerations apply to all sources of potential pass through including retailer insolvency.

Without a materiality threshold customers may (ultimately) bear the costs of administering a pass through process where the costs of the process outweigh the benefits of conducting it.

4 Do the current credit support arrangements provide a sufficient means of managing the retailer credit risk faced by DNSPs? If not, would strengthening these arrangements lead to a more efficient or more appropriate outcome than amending the cost pass through provisions as proposed?

There is no evidence that the current credit support arrangements are insufficient, and which would justify considering strengthening these arrangements. The current credit support arrangements have been widely consulted on and also reflect the experience of operating successfully under similar arrangements in Victoria for a number of years before the introduction of the national arrangements.

5 Does the relative certainty, and smoothness, of recovery through the regulatory determination process outweigh the potential inefficiencies? Should DNSPs have the discretion to use this approach?

It is not appropriate to use the regulatory determination process to recover the costs of the risk to DNSPs of retailer insolvency, and DNSPs should not have the discretion to use this approach. This approach is not appropriate due to the difficulties of quantifying the cost of each DNSP's risk, which would lead to the potential for customers paying more than is required to offset the risk. Also, it is unclear how this approach would protect customers from the risk that retailer insolvency causes significant financial disruption to a DNSP that has 'self-insured' against retailer insolvency such that network services are impacted due to the DNSP's loss of revenue.

6 Is use of the cost pass through mechanism an appropriate approach to managing the risk of retailer insolvency events?

The pass through mechanism is an appropriate mechanism for managing the risk for DNSPs under price cap regulation. DNSPs under revenue cap regulation should not need to use the pass through, as the revenue 'true-up' mechanisms enable them to collect additional revenue to address previous shortfalls.

Any pass through or shortfall recovery should, of course, be limited to the net revenue lost after taking account of credit support amounts and revenue collected by the DNSP from the administrator as part of the insolvency process.

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7 Do the current processes under the NER and corporate insolvency procedures provide adequate clarity and certainty for DNSPs seeking to recover costs and foregone revenue from a retailer insolvency event?

Any mechanism that enables DNSPs to recover lost revenues from customers reduces the incentive for DNSPs to pursue other ways of recovering the lost revenues. This is not a good outcome for customers, as they may pay more to replace lost revenues than if as much lost revenue as possible was recovered from other sources.

Therefore it is important that the AER has the following discretion when dealing with this type of pass through or revenue 'true up':

- Able to require sufficient information from the DNSP to ensure that only lost revenues that have not already been recovered from credit support or insolvency processes are passed through
- Can apply a 'negative pass through' to return to customers the value of lost revenue that has been passed through but is later recovered by the DNSP
- Can take into account in the next revenue determination the conduct of the DNSP in relation to seeking to recover lost revenues as part of insolvency processes. For example, if a DNSP failed to seek recovery of lost revenues from an insolvent retailer's administrator then this could be used to justify reduced revenues in the next regulatory period. This is required to ensure that all reasonable efforts are made to ensure that only the reasonable costs of retailer insolvency are passed on to customers.

A simplistic approach, such as preventing DNSPs from pursuing lost revenues from the insolvent retailer's administrator when they have recovered them from customers through a pass through process, will increase costs for customers. This is because money that could have been recovered from the administrator and returned to customers is instead paid to other creditors of the insolvent retailer.

We appreciate that there is the possibility that some customers will miss out on the benefit of a 'negative pass through' despite having contributed to the pass through payment. Simply Energy considers that the cost of implementing administrative procedures to ensure that this does not happen outweigh the potential benefits to customers as a whole, and should therefore not be pursued.

If you have any questions concerning this submission, please contact James Barton, Regulatory Policy Manager on (03) 8807 1171.

Dianne Shields
Senior Regulatory Manager