

25 September 2014

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
Level 5, 201 Elizabeth Street  
Sydney NSW 2000

Dear Mr Pierce

**The NSW DNSPs response to the *NEM Financial Market Resilience Second Interim Report***

The NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) welcome the opportunity to provide this joint submission in response to the *NEM Financial Market Resilience Second Interim Report*.

We note that the AEMC commenced its NEM financial market resilience review after receiving a request from the COAG Energy Council (formerly the Standing Council on Energy and Resources) to provide advice on: the nature of the risks to financial stability in the NEM arising from financial interdependencies between market participants; whether the existing mechanisms to mitigate these risks are adequate; and if necessary, options to strengthen those existing mechanisms and minimise the identified risks and their consequences.

In responding to this review, we note that the consultation has been split into two separate stages. The first stage focused on post event measures that seek to minimise the risk of financial contagion following a large retailer failing; and the second stage focused on examining other sources of financial contagion and the application of potential G20 over the counter derivative reforms to the electricity sector.

The NSW DNSPs were particularly interested in the first stage because there is significant risk to DNSPs in the event of a large retailer failing. As such, NSW DNSP business Ausgrid developed a comprehensive submission on the options paper which informed the development of the first interim report and its recommendations. Our further submission in response to the first interim report strongly supported the AEMC's draft recommendations concerning changes to the Retailer of Last Resort (ROLR) scheme and the credit support arrangements required by the Australian Energy Market Operator (AEMO). These changes aim to mitigate the risk that an otherwise solvent retailer is unable to fulfil the significant financial obligations imposed on it due to its appointment as the ROLR.

We also supported the AEMC's decision not to recommend options aimed at amending DNSP credit support provisions or delaying the settlement period for the designated ROLR to pay network charges to DNSPs. As noted by the AEMC in its first interim report, these measures are likely to be of limited benefit in mitigating the risk of financial contagion. Rather, these options are likely to transfer significant risks to DNSPs and have a number of adverse flow-on effects because delaying the settlement period for paying DNSPs is likely to have adverse consequences in terms of DNSPs' cash flows, credit rating and financing costs.

In addition, the NSW DNSPs were broadly supportive of the establishment of a special administration regime which could be used as an alternative to the ROLR scheme. This option could be used if one of the largest retailers encountered financial distress and there was concern that the ROLR scheme would not effectively manage the transfer of customers without the risk of financial contagion.



Given the consultation history, the NSW DNSPs are disappointed that the AEMC has made a recommendation in the second interim report that any requirement for the ROLR to provide increased credit support to DNSPs following a ROLR event be deferred for five weeks. We note that this recommendation was rejected in the first interim report based on evidence presented in the Ausgrid 2012 submission.

We note that the Frontier Economics report which underpins the AEMC's analysis, quantifies the effect of a designated ROLR's DNSP credit support obligations under three scenarios. However, these scenarios do not reflect the reality that there are three large retailers that dominate the Australian energy market, and collectively account for 70+% of energy consumption. This concentrated market share is unlikely to change in the foreseeable future and as a result, DNSPs are heavily exposed to these three retailers. Moreover, the method<sup>1</sup> of determining the Network Charges Liability (NCL) may be inconsistent with the rule provisions under 6B.B2.3 of the NER and it appears to rely on an unsupported assumption regarding the billing cycle<sup>2</sup>. For these reasons, we suggest that the AEMC review the method against the NER to assess the risk to DNSPs arising from the proposed approach to credit support under a ROLR scenario.

In the case of Ausgrid and as outlined in the 2012 submission, the failure of the largest retailer with one month's outstanding network charges could equate to \$140 million, a problem that is exacerbated by monthly billing so that by the time a ROLR event is called the amount of network charges owed to Ausgrid would be substantially higher.

The three largest energy retailers each have a Standard & Poor's corporate credit rating which applies to the consolidated entity, its group financial results and risk structure. Each of these large energy retailers operate under multiple financially responsible market participants (FRMP) and various legal entities. However, Ausgrid's experience is that a retailer (or retailers) within the group seeks to rely on the corporate credit rating for the rated FRMP and a Dun & Bradstreet dynamic risk score for the other un-rated FRMP's, thereby availing the group of multiple credit allowances, resulting in the DNSP having no or inadequate credit support.

We submit that clauses 6B.B3.3 and 6B.B3.4 of the Rules contemplate a retailer relying either on its own credit rating or dynamic risk score for the individual entity or "sharing" the credit rating of a guarantor. Noting that a credit rating can only be "shared" if the DNSP has received an unconditional written guarantee of the retailer's financial obligations from the guarantor and if more than one retailer relies upon the same guarantor's credit rating then the guarantor must advise the DNSP how the guarantor's credit allowance is divided amongst the retailers.

---

<sup>1</sup> Frontier Economics. *Policy Responses to mitigate against the risk of financial contagion in the NEM*. Section 6.2, pp 19-20. Credit outstanding is defined by Frontier Economics in terms of the retailer's market share, total revenue for the relevant distributor and the number of days, on average, between the provision of the network service and payment by the retailer ie = [(Days/365) x Market share x Distributor annual revenue]. However, this method of determining Network Charges Liability (NCL) may be inconsistent with Chapter 6B part B of the NER, which states:

**6B.B2.3 Determining a retailer's NCL**

(a) A Distribution Network Service Provider must estimate the amount of a retailer's average billed and unbilled network charges liability in accordance with the following formula:

$NCL = \Sigma NCL_c$  where  $NCL_c$  means the forecast network charges (determined as an average daily amount for a retail billing period) relating to those shared customers of the retailer for which the maximum days outstanding (MDO) is the same, multiplied by that MDO.

<sup>2</sup> Ibid, p 22. The assumption that retailers pay bills on average about 3 months in arrears is not correct. DNSPs bill retailers for network charges on a weekly or monthly basis. DNSPs share customers with a retailer, these "shared customers" are the final consumers of energy and are billed by the retailer on a monthly (30 days) or quarterly (90 days) basis, but only for those customers whose meters were read in that month. This is referred to as Maximum Days Outstanding (MDO) and part of the NCL calculation.



Whilst clauses 6B.B3.3 and 6B.B3.4 do not explicitly state that only the retailers corporate credit rating is to be used for calculating the credit allowance for entities/ FRMP's within the group, the NSW DNSPs do not believe that the policy makers intended that large retailers would use a combination of corporate credit rating (for the rated FRMP) and dynamic risk scores for un-rated FRMP's within a group entity as this would result in the doubling of credit allowance and inadequate credit support for a DNSP. We strongly urge the AEMC to include a recommendation in its report that these provisions be amended to ensure that large retailer groups cannot use a combination of corporate credit rating for a rated FRMP and dynamic risk scores for un-rated entities.

We contend therefore, that the assumption in the second interim report that a DNSP holds credit support in accordance with the credit support provision of the Rules prior to a ROLR event (allowing the DNSP to manage its cash flow) is not accurate. As a result, DNSPs would need to borrow additional funds to meet the cash flow shortage, in Ausgrid's case, at or around week five.

Given the above, we are concerned that the five week deferral decision has not been sufficiently justified in the second interim report, particularly in light of the reversal of the decision from the first interim report. Further, we do not believe that this report has addressed the analysis of the 20 December 2012 Ausgrid submission which analysed the magnitude of the risks that could be transferred to DNSPs and the flow-on implications. If such analysis had been considered, it is unlikely that the AEMC would now make a five week deferral recommendation.

We submit that the AEMC should consider the original analysis and evidence provided in the Ausgrid 20 December 2012 submission (Attachment A) and revise its recommendation on credit support arrangements to that of the first interim report.

More generally, we submit that DNSPs should not assume the commercial risks of retailers, a more appropriate approach would be to embed a framework of risk mitigating strategies in regulation. The most effective way of mitigating the potential credit and cash flow impacts from a retailer failure is through having credit support arrangements that can be enforced. Currently we are concerned that the remedies available to DNSPs to enforce requirements for credit support through the conduct provisions are likely to be frustrated due to the time required for court proceedings to resolve such issues. We urge the AEMC to review the effectiveness of current enforcement options, in particular whether the conduct provisions and the ROLR provisions are properly integrated. More detail on enforcing credit support provisions is provided in Attachment A.

In addition to the above, we are concerned about the proposal of limiting the extent to which ROLR arrangements apply to very large customers. In particular, that very large customers have a one week 'period of grace' following a ROLR event to nominate a back-up retailer (if they have not already done so with AEMO), before disconnection. We note that the AEMC considers that the proposed arrangements would need to specify how directions for disconnection are given to the relevant distributor (and who would give them) as generally rights of disconnection are set out in the customer's retail contract. However, no information is provided on how this would work in practice. We strongly urge the AEMC to reconsider whether this proposal is well conceived and, if it proceeds, ensure that it does not involve any transfer of risk to DNSPs if they are required to disconnect a major load. We recommend that a more preferable approach would be for the Rules to provide for the automatic transfer to the designated jurisdictional ROLR after expiry of the one week period.

If you would like to discuss our submission further or arrange a meeting with NSW DNSP representatives, please contact Ms Jane Smith, Manager Network Regulation at Ausgrid on (02) 9269 2023 or Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249 3120.

Yours sincerely



**Justin De Lorenzo**  
**Group Chief Financial Officer**  
**Networks NSW**

Attachment A – Excerpts form the 20 December 2012 Ausgrid Submission – NEM Financial Resilience Options Paper



## Attachment A – Excerpts form the 20 December 2012 Ausgrid Submission – NEM Financial Resilience Options Paper

### Quantifying the impact to DNSPs

#### Scenario 1: large retailer failure

##### *Direct costs*

If one of the three largest retailers in Ausgrid's network area failed, the outstanding network charges to Ausgrid would range between \$10 million to \$35 million per billing week. By the time a RoLR event is declared, the failed retailer could have accrued several weeks of outstanding network charges. This would represent a significant short fall in revenue and will have a corresponding impact on cash flows. For instance, in the case of largest retailer one month of outstanding charges could equate to a shortfall of over \$140 million.

### Amendments to DNSP credit support provisions

The Options Paper proposes to waive or reduce the increased credit support requirements for a short transitional period. As noted earlier in our submission, if a large RoLR event were to occur, Ausgrid would not hold nor would it be in a position to request credit support which would mean cash flow issues and financial distress.<sup>19</sup>

Under the NECF regime, NSW DNSPs will be able to request credit support from large retailers.<sup>20</sup> If the timeframes for which the designated RoLR is to provide increased credit support to DNSPs were to be relaxed, we consider that this period should only be relaxed for as long as it would reasonably take the designated RoLR to obtain suitable bank guarantees. Ausgrid further considers that this period should be capped as a maximum period in the NER to mitigate DNSPs credit exposure.

### Delayed settlement period for designated RoLR to pay increased network charges

Ausgrid is concerned that extending the settlement period would adversely impact the DNSP's cash flow, revenue and provisioning, which would impact the DNSP's credit rating.

As noted previously in our submission, current NSW arrangements allow for weekly billing. Once NSW adopts the NECF, billing will change to monthly. An inherent short-coming of monthly billing is that it leaves DNSPs more exposed to late payments and non-payment by retailers. This is because DNSPs must continue to supply electricity regardless of whether the retailer has paid its network charges. Meaning a retailer can continue to operate in the NEM without paying its network charges until such time that:

- the retailer is unable to meet payments to generators and AEMO suspends it from operation; or
- the DNSP commences civil proceedings<sup>21</sup> or issues a statutory demand for payment.<sup>22</sup>

DNSP's do not typically have large cash flow contingencies. Once outstanding network charges start approaching \$170 million, Ausgrid would have insufficient cash flows to meet its commitments and would need to borrow extra funds. In the event of the largest retailer in Ausgrid's network failing, Ausgrid would need to borrow funds once the retailer reached approximately five weeks in arrears.

As the failed retailer can continue operating for some time before being suspended, it is likely that the failed retailer could have accrued close to two months in outstanding network charges before a RoLR event is declared. If the largest retailer in Ausgrid's network area failed, the outstanding network charges could be of the order of \$280 million. Given the delay existing delay that exists for DNSPs before a RoLR event is called, Ausgrid is concerned that introducing further delay will increase DNSPs credit exposure and further deteriorate its cash flows, requiring the DNSP to incur higher levels of debt.<sup>23</sup>



## Appendix 1: Enforcing credit support obligations

The limitations that a DNSP may face in enforcing compliance with credit support provisions will be influenced significantly by the basis for the retailer's failure to comply.

In circumstances where there has not been a RoLR event, the limitations faced by the DNSP include:

- a claim for loss or damage can only be made in circumstances where the DNSP has suffered actual loss or damage – the mere likelihood of loss or damage (e.g. future unpaid network charges) will not be sufficient to justify a claim for loss or damages;
- unless the DNSP has grounds to justify an urgent application, the Supreme Court processes from application to hearing and decision are likely to be lengthy such that seeking an order from the Supreme Court is not likely to result in immediate recovery for the DNSP.

In the event of a retailer failure, the key limitation on the DNSP's ability to take enforcement action for breaches of conduct provisions is the interrelationship between the conduct provisions and RoLR arrangements. These regulatory arrangements while interrelated are not integrated. At best, they enable the DNSP to exhaust all avenues for recovery of unpaid credit support. At worst, the exercise of one option may have the affect of precluding the DNSP from successfully adopting another course of action.

In addition, the dual recovery streams may not prove efficient as DNSP's will not be able to recover all its costs by one application in one forum. Instead, a DNSP may need to submit a cost pass through application to the AER for unpaid network charges and a separate application to the Court to recover any other costs incurred, while also awaiting the results of any insolvency proceedings.

Specifically:

- while the same factual information will be considered by a Court in determining a claim for recovery of actual loss or damages and the AER in determining a pass through application, the amount recoverable by a DNSP under each process may vary substantially given the different means used to calculate the amount recoverable;
- the DNSP can only make a claim for damages and losses for unpaid credit support in circumstances where the DNSP has actually suffered loss or damage;
- in relation to any court claim for damages or loss, the Court may be reluctant to award damages until a bankruptcy/insolvency proceedings in respect to the failed retailer have been finalised;
- any order for damage is likely to be limited by any amount that the DNSP will recover by way of a pass through application;
- the Court may defer consideration of a damages claim until the RoLR mechanisms under the National Energy Retail Law (NERL) have been exhausted.
- if the DNSP is able to recover some of its costs through the cost pass through mechanism it may no longer be worthwhile recovering the remaining amounts by way of a damages claim to the Court;
- where the retailer is in administration, any successful claim for damages will be affected by preference payments due to the retailer's other creditors;
- the RoLR arrangements provide for the DNSP to be given notice where the AER considers there is a risk of the RoLR event. The DNSP has confidentiality obligations in relation to this information and will not be able to rely on this information as a basis to take action for recovery by way of the conduct provisions. Conversely, the AER may withhold giving the DNSP such notice if the notice could lead to a RoLR event (e.g. by the DNSP taking court action); and
- any legal action that a DNSP takes could be superseded by a RoLR event (particularly since the DNSP is likely to be required to notify the AER of non-compliance with credit support obligations).