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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Electronic Lodgement – ERC0183

Dear Mr Pierce

RE: Consultation Paper – Retailer – Distributor Credit Support Requirements

United Energy (UE) and Multinet Gas (MG) (the businesses) appreciates the opportunity to respond on the Consultation Paper – National Electricity Amendment (Retailer- Distributor Credit Support Requirements) and the National Gas Amendment (Retailer- Distributor Credit Support Requirements), Rule 2015.

Victoria is a non NECF jurisdiction, the relevant credit support arrangements are in the UE Use of System Agreement and the Multinet Terms and Conditions of the Access Arrangement. The businesses have responded in view of the changes proposed to the NER and NGR and the relevance of the NECF starting point being the Victorian electricity credit support arrangements.

In March 2014 the COAG Energy Council requested a rule change to correct drafting errors in the NECF rules intended by the MCE/SCER relating to a definition and no materiality threshold for retailer insolvency pass through events. AEMC have advised an extension of time to make a draft determination on this rule change to 18 February 2016, making a final determination timing around mid 2016. The businesses are supportive of the proposed amendments in the 5DB submission to the initial consultation and suggest that the inadvertent drafting errors should be corrected as soon as practicable in the NER, preferably earlier than the two year timeframe being proposed.

The businesses have responded to the paper in more detail in the Attachment, the proposal to remove the need for retailers to provide credit support where they are BBB- or above no matter what the financial impact on the distributor or customer is, is not supported:

- The late changes in the NECF provide incentives for retailers to diversify and more evenly spread retail competition and hence the possible exposure they pose to an individual distributor. Ultimately this should also reduce the impact to a distributor and to end use customers of a pass through. While the model operating in Victoria and adopted by policy makers for NECF is founded on a customer's willingness to pay, these measures serve to reduce the impact on customers, which could add around $100 extra to a customer's bill if a large retailer failed.

- The proposed changes could expose customers to significant additional expense at a time when energy prices and affordability are already concerns. The higher the exposure on the distributor/customer, the higher the cashflow impact on the distributor and the greater the need for the distributor to hold increased levels of working capital to provide the necessary funds or to go to the market to get the funds at a time of market instability and possibly lack of confidence.

- Dun and Bradstreet have changed a number of aspects of their methodology for calculation of credit risk and there is benefit in refreshing the numbers in the Table 1 in Chapter 6B to bring them into line with current practice without changing the intent of the risk allocations between distributors and retailers. The businesses propose that this is a mechanistic update of the table as opposed to reopening the risk allocations.

- Retailers have a significant amount of available funds from the distributors delayed recovery of network services. Frequency of billing, timing of billing and payment terms are all established by the regulator or rules with in effect little room for commercial negotiation that might reduce the distributor and ultimately customer exposure.

- A better protection for distributors and customers would be to reduce the late payment periods before credit support can be requested in order to reduce the impact of the financial failure. Allowing 37 days for late payment before being able to ask for credit support is excessive.

UE and MG welcome the opportunity to participate in this rule change development and looks forward to the finalisation of the cost pass through rule change.

Should you have any comments in relation to this response please do not hesitate to contact me on (03) 8846 9856.

Yours sincerely

Verity Watson
Manager Regulatory Strategy

Attachment

Credit support arrangements

As a way of background to the issues in this response, we have summarised the key points from the Victorian credit support arrangements and the NECF supported by regulators and policy makers. This clarifies the policy rationale of the Victorian and NECF approach and the three key features of the model:

1. Breaking the link between the risk of retailer default and the risk borne by distributors by permitting a **pass through** for the cost of unpaid distribution charges. That is, if a default risk exists that it was inappropriate for distributors to bear the costs of unpaid network charges;

2. **Customers would bear the risk of retailer default**. Customers benefit from the enhanced competition therefore it is appropriate for them to bear the cost. A key issue is determining what is the maximum default risk that customers are prepared to bear noting the **potential trade-off** between the credit hurdle for entry and competition. The maximum default risk is the "maximum credit allowance".

3. Calculate credit support so that **all retailers impose the same expected cost of default** which depends on the probability of default and the size of the exposure. The approach was described as having a number of desirable economic features namely:
   - Taking account of the size of the retailer as well as its probability of default;
   - Is competitively neutral between retailers
   - Provides desirable incentives for retailers to diversify across distributors and retailers to improve credit worthiness as they get larger.

As noted in this submission the businesses consider that a robust pass through framework is a key feature of the credit support arrangements. The COAG drafting corrections should be progressed as soon as practicable.

The businesses do not agree that the proposed changes to credit support reflect the actual risks faced by distributors from retailer default. AGL propose that where retailers credit ratings are BBB- or above (Standards and Poor ratings), the retailer would not be required to provide any credit support to the distributor no matter how large the market share or exposure is to the distributor.

The Consultation Paper notes that distributors are reliant on retailers to collect network charges and transmission charges for services provided to customers over the last 1-4 months. The distributors are unable to withdraw services where a retailer does not pay for the invoiced services. The distributor provides connection and supply services to the retail customer directly.

Current credit support requirements

The businesses review the credit support arrangements each month based on the most recent retailer liabilities and updated credit ratings based on any changed ratings from Standards and Poor and Dun and Bradstreet. Where a retailer exceeds their credit threshold, UE may seek credit support for the differential amount only. These credit support review processes are an important part of credit management. Should there be a retailer failure, the cost pass through arrangements will require UE to have called on credit support where it is available first and only seek a pass through amount for the remaining liability.

The management of the participant IDs to the Victorian retail licenced entities has become more complex over the years with the number of mergers and acquisitions. Retailers naturally prefer not to provide credit support.

The AER or the ESC may call a ROLR event where a retailer was not paying network invoices, however this would not be done lightly. The maximum days outstanding for monthly billed smart metering in Victoria is 58 days (FCCP/2+RBP/2+IIPL, 15+15+28 = 58 days). Where a retailer was experiencing system or payment difficulties a further 37 days can elapse before credit support can be requested, a further 14 days before credit support needs to be provided and upwards of a further 14 days before a regulator might take action. These timeframes extend the maximum days outstanding to over 123 days of services provided and unpaid. In other words this roughly doubles the impacts of the liability on the distributors cash flow and ultimately on customers.

A key aspect of the credit risk based approach is that customers benefit from retail competition and also bear the risk of a retailer default. The businesses support that the 33% of the TARC being reduced to 25% as this means that for a large retailer there is a higher probability that the network may be able to ask for credit support given the lower threshold. The late amendments to the credit allowance percentages in the NECF also seeks to reduce the possible exposure to the distributors cash flow and ultimately to customers. These factors combined provide incentives for retailers to diversify and more evenly spread retail competition and hence the possible exposure they pose to an individual distributor. Ultimately this should also reduce the impact to a distributor and to end use customers of a pass through. While the model operating in Victoria and adopted by policy makers for NECF is founded on a customer's willingness to pay, these measures serve to reduce the impact on customers, which could add around $100 extra to a customer's bill.

The businesses do not concur with the AGL reliance on the concept that the risk of default for an investment grade retailer is the level of risk that a distributor and by consequence a customer is comfortable bearing. The proposed changes could expose customers to significant additional expense at a time when energy prices and affordability are already concerns. The higher the exposure on the distributor/customer, the higher the cashflow impact on the distributor and the greater the need for the distributor to hold increased levels of working capital to provide the necessary funds or to go to the market to get the funds at a time of market instability and possibly lack of confidence.

The businesses note that the % credit allowance table, Table 1 in the NER, Chapter 6B may benefit from an update in the Dun and Bradstreet (D&B) %'s used. D&B have changed a number of aspects of their methodology for calculation of credit risk and there is benefit in refreshing the numbers in the table to bring them into line with current practice without changing the intent of the risk allocations between distributors and retailers. The businesses propose that this is a mechanistic update of the table as opposed to reopening all of the risk allocations.

Identification of Appropriate Principles

The principles also need to ensure that large retailers in the market have an incentive to spread retail competition and not seek to remain stapled to one network thus increasing the possible risk to that network business and its customers.

The principles need to include a proportionate approach that recognises that even large seemingly stable business could make poor decisions or have poor risk management and could fail. The businesses do not support that large retailers, investment grade retailers bear no possibility of credit support whilst small new entrant retailers do.

Retailers have entered the market so the Victorian or the NECF based approach have not been a barrier to entry.

As the energy reform seeks to open and create more competitive markets the business models of retailers will change, there is no ring fencing of the licenced/authorised activities from the other competitive activities and competitive markets may incur high entry costs, lower profitability or uptake and include longer life assets and infrastructure management. The business models of retailers is changing as is the environment that they operate in. The impact of the default on the network businesses cashflow and ultimately on customers must be considered within the principles of the risk based approach.

Risks and Impacts related to a retailer default

The businesses agree that there is a cash flow risk to the distributors, particularly where an event is drawn out and decisions to notify a ROLR event may also be lengthy. In relation to distributor risks to cash flow, impacts on banking debt covenants also needs to be considered for private businesses who may need to fund an extra 100m$ or so at relatively short notice.

Management of risk to reduce costs

The credit support arrangements may encourage retailers to improve their credit rating and to more evenly spread retailer competition and marketing in order to stay below the allowable credit thresholds. Retailers are better placed to manage their operational and financial risks and have the greatest control over their business profitability and payment practices.

The businesses consider that the credit support costs are overstated in the Consultation Paper. Retailers are able to bill customers based on meter reading and may even receive the customers payment before the meter read and network services are even billed to the retailer. Other customers might be on a monthly or quarterly meter reading cycle and hence network billing on a similar cycle, however retailers may be recovering fortnightly bill smoothing payments or monthly bill smoothing payments. In effect retailers have a significant amount of available funds from the distributors delayed recovery of network services. Frequency of billing, timing of billing and payment terms are all established by the regulator or rules with in effect little room for commercial negotiation that might reduce the distributor and ultimately customer exposure.

Purpose of the Rule

The Consultation Paper proposes that an effective rule protects the distributor (and ultimately customers) against the risk of retailer default. The proposed rule in relation to credit support eliminates the need for credit support from BBB- retailers and above. If one of these retailers were late paying, the ability to call for credit support is delayed and could double the financial risk exposure. The amendments to rule 6B.B3.1 are not supported.

The ability to call for credit support after a further 37 days and receive full credit support after a further 14 is little comfort. By this stage the retailer liability has doubled and the retailer is unable to meet its liabilities let alone provide a bank guarantee as credit support for the full network services liability. Whilst the clarity of being able to call for the full amount of credit support at this stage is welcome in 6B.B3.5, it will not ensure the ability of the retailer to fund the required full credit support.

It is not correct to suggest that the current credit support requirements protect distributor's cash flows against both the risk and impact of the retailer default. Even large investment grade companies can make poor decisions or manage business risks poorly, they not precluded from financial failure. The current rules are a risk based approach to credit support where the distributor has a significant amount of cashflow which may be impacted, with the potential that it may not be recovered for around 2 years.

A better protection for distributors and customers would be to reduce the late payment periods before credit support can be requested in order to reduce the impact of the financial failure. Retailers generally pay on time, late payments are usually limited to a processing or reconciliation issue at the retailer or network end and these issues are resolved with 1 or 2 days. Allowing 37 days for late payment before being able to ask for credit support is excessive.

Changes in the calculated amount of credit support required

Whilst the businesses review the need for credit support each month, the requirement to provide credit support rarely changes. Given that the retailers are under the allowable credit limits, there is not an onerous effort in requesting or amending bank guarantees. Query that there are onerous costs in the cost of the volatility in credit support obligations.

The proposal is more directly linked to network charges liability, where a retailer had a lower credit rating and credit support was required, the value of credit support would change across the year based on seasonal impacts and customer numbers. This could lead to additional costs to administer if more frequent changes to bank guarantees was required.

Providing credit support or bank guarantees is part of business as usual in the energy market, part of the normal risk management practice for settling the market and providing an essential service. The prudential requirements have always existed in the NEM.

Barriers to entry

New retailers are still entering the market, despite the fact that they have no financial history upon which to base a credit rating. Retailers need to make allowance for some credit support arrangements within their business plans, business plans and acquisition of customers need to be realistic. Even poorly graded businesses may be seeking retail licence/authorisations, distributors are unable to choose not to deal with these businesses, despite the fact that not dealing with them might be good commercial practice.

The businesses recognise that there is a significant cost in gaining Standard and Poors rating. D&B risk scores can be more readily gained for the small new entrants and should remain in the NER/NGR.

Balance of credit risk and impact risk

No the proposal is not necessarily an improvement over the current credit support requirements. It creates an incentive for retailers to have a good credit rating but it does nothing to incentivise the retailer to actively compete in the retail market across a number of distributors and diversify the risk to a distributor. The proposal benefits large market share retailers with a BBB- and above credit rating to the detriment of the distributor and customer should they fail. The proposal may also create increased barriers to BBB- and below retailers with lower market share as the credit support arrangements are higher under the AGL proposal.

Recovery through the regulatory determination process

The Consultation Paper suggests that the annual tariff arrangements under a revenue cap with the unders/overs could be used to recover the financial impact of a retailer failure. The businesses consider that a revenue cap is not really intended to recover high impact, low probability events in this manner. This type of approach is not as clear or transparent as a pass through mechanism and the timing constraints on network tariffs may afford less time for consideration.

Pass Through Events

The NER allow certain nominated or specified events to be cost pass through arrangements. COAG support a cost pass through mechanism for retailer insolvency unpaid revenue/costs after the event has occurred. This provides transparency regarding the recovery of the costs in comparison to including an allowance in the total regulated revenue for a low probability event of varying impact. Retailer insolvency is not an event that a distributor could reasonably prevent or mitigate the cost impact of the event as it cannot refuse to do business with a retailer even if considered not credit worthy.

Recovery through the corporate insolvency process

Recovery through insolvency processes is lengthy and the amount of money returned is minimal eg cents in the $. The business agree that there is no guarantee, it is highly unlikely that the debt would be repaid in full or at all. This is an exceedingly poor credit risk management control.

Any small amount of recovery received years later could be included in the unders/overs in the revenue cap tariff calculations to ensure there was no double recovery. Any funds recovered in this manner can be included on the same cost allocation basis as the costs were passed through.

Management of risk through the minimisation of network charges liability

The Consultation Paper proposes that more frequent network billing, reduced payment terms or billing in advance for network charges could all reduce the network charges liability and hence the possible exposure to financial risk of a retailer.

As noted earlier the cash flow arrangements in the electricity market allow retailers to recover and use funds, including from the network and transmission charges for a period before the monies are provided to the distributor as payment for network charges. Billing based on estimated charges or in advance is a significant change in the cash flows across retailers and distributors and would require new entrant retailers to have more significant funds available for start up.

The Consultation Paper proposes that these arrangements can be negotiated with retailers and with their consent they may provide more favourable payment arrangements to the distributor than those regulated. Whilst the businesses would be supportive of such arrangements, it is unlikely that retailers would agree to such measures that require greater cash liquidity on their part, particularly where those same retailers are seeking to increase their cash liquidity by eliminating the need for any bank guarantees that are already in place.

Different billing frequencies, payment terms and billing methods would be more complex and harder to manage across all of the retailers. This approach would also require changes to IT systems to enable such a flexible approach.

Relationship between mechanisms to manage the risk of retailer default

As noted at the start of this response, there is a suite of credit management arrangements that make up the credit risk management approach. Effective retailer insolvency cost pass through and timely ability to call for credit support in the event of late payments, competitive neutrality across retailers, provision of incentives to diversify risks across distributors etc.

Where retailers are experiencing payment difficulties, it is important that genuine ability to pay issues are dealt with in order to avoid increasing the impact of the financial failure. The ability to call for credit support and minimise the impact of a retailer failure could be better dealt with better in the NER. The businesses recognise these are significant policy and risk allocation decisions and should provide certainty and consistency for the businesses.