27 November 2015

Ms Anne Pearson
Senior Director
Australian Energy Market Commission

Sent electronically

Dear Ms Pearson

Options Paper – Retailer-Distributor Credit Support Requirements – ERC0183

Sumo Power welcomes the opportunity to comment on the AEMC 2015 Retailer-Distributor Credit Support Requirements options paper of 22 October 2015.

Sumo Power is a small energy retailer selling electricity to residential customers in Victoria. As a retailer that is currently examining new jurisdictions for possible market entry, we have a particular interest in the proposals to change the retailer-distributor credit support arrangements.

We make the following observations and comments in relation to the options paper:

- A distributor should be able to recover lost revenue and costs incurred in the event of a retailer default. Sumo Power supports the rule change requests proposed by the COAG Energy Council and Jemena Gas Networks, which address limitations in the current mechanisms for pass-through of costs to end-use customers.
- The likelihood of retailer default is remote. To the extent that a smaller retailer with a lower credit rating has a higher risk of default than a larger, incumbent retailer, the insolvency costs associated with its default are also significantly smaller.
- When weighing the relative costs and benefits of the different options presented in the options paper, a much greater weighting should be given to ongoing costs than post-default costs. This is because ongoing costs are certain, whereas post-default costs only arise when a retailer defaults, the likelihood of which is – particularly in the case of larger retailers – remote.
- Option 2.1 has no ongoing cost, and as such is our preferred option. It has the lowest overall cost, and a post-default cost that is comparable with most other options.
- While we don't support an approach that imposes ongoing costs to manage the risk of retailer default, if such an approach is adopted (for example, through insurance or a liquidity support scheme), it would be most appropriate for the ongoing costs to be incurred by the distributor and recovered through revenue and cost-recovery mechanisms. This is efficient because it requires fewer entities to seek to recover the costs (on the basis that there are fewer distributors than there are retailers) and spreads the costs over the largest possible number of customers.
- We do not support retaining any requirement on retailers to provide credit support to a distributor:
    - Credit support, typically provided in the form of a bank guarantee, needs to be backed by cash. This means that the retailer must put aside cash that could otherwise be used for other purposes. The provision of credit support

reduces the capital available to the retailer for growth or working capital purposes.

- The cost of capital for most retailers is relatively high – particularly for smaller retailers – when compared with that of distributors, and so the lost opportunity cost of providing credit support is also high. As such, the provision of credit support is an inefficient use of capital.
- When providing credit support, the retailer must also pay a fee to its financial institution to maintain the bank guarantee.
- A credit support arrangement that imposes a more onerous credit support requirement on retailers that have a lower credit rating will generally increase the relative costs for smaller, new entrant retailers, without adding materially to existing incentives on those retailers to manage their credit support. Retailers already have strong incentives to improve their credit rating. A retailer's credit rating impacts its competitiveness. A better credit rating improves the retailer's standing when seeking to raise capital for future growth or when negotiating credit terms for the procurement of third party goods and services. Moreover, strong financial, risk and capital management is core to an energy retailer's business. There is little to be gained by placing an additional incentive on retailers to manage their credit rating through the design of a scheme for managing retailer default risk.
- If a credit support arrangement is to be retained, it should include as a feature a retailer credit allowance (as is the case with the current credit support arrangements) to minimise any barriers to entry in the retail market, and to reflect the negligible impact that a small retailer default would have on a distributor's revenue and cash flow. From Sumo Power's perspective, a credit support arrangement that requires a new entrant retailer to provide credit support from day one would reduce the attractiveness of market entry.

* We do not support the use of a retailer default fund (option 3):
    - As with the provision of credit support, a retailer default fund requires retailers to set aside cash, in this case by paying it into an industry fund. Again, as with the provision of credit support, this would be an inefficient use of capital, and any mechanism to risk-weight retailer contributions to the fund based on the retailer's credit rating would impose relatively higher costs on smaller, new entrant retailers (representing a barrier to market entry) without a corresponding benefit in terms of additional incentives on the retailer to manage its credit rating better.
    - The Promontory modelling shows option 3 to have the highest ongoing cost. As stated above, a greater weighting should be placed on minimising ongoing costs than minimising post-default costs. It is our view that the lower post-default costs under option 3 do not offset the higher ongoing costs.
    - If, following a retailer default, the fund is to be replenished with contributions from the remaining retailers, this is likely to place adverse financial pressure on those remaining retailers. It would seem unfair to, in effect, 'penalise' the remaining retailers for the defaulting retailer's failure.
    - If, following a retailer default, the fund is to be replenished over time as the distributor recovers its funds through the corporate insolvency process or other statutory mechanism (cost pass-through or over and unders), then there would seem to be little incentive on the distributor to use those mechanisms to recover costs.

- We do not support the use of a liquidity support scheme (option 4):
  - The liquidity support scheme option addresses one of the issues presented by credit support arrangements and the retailer default fund, being the inefficient use of capital that results from a requirement on a retailer to put aside cash which can be drawn on by a distributor in the unlikely event of retailer default.
  - Although the modelling described in the Promontory report suggests option 4 has a lower ongoing cost than options 2.2 and 2.3, it still comes at a cost.
  - What this cost buys the distributor is access to funding to manage any short-term cash flow impacts if a retailer defaults. However, this is only a benefit if a retailer defaults and then only to the extent that the distributor would not otherwise have been able to access funding at that time. This scenario seems very unlikely. That is, it is unlikely that a distributor would face any difficulty securing funding to support its liquidity if and when a retailer fails, given that a distributor is a monopoly business servicing an essential service, and given regulated mechanisms – such as those proposed by the COAG Energy Council and Jemena – that enable it to recover insolvency costs (including lost revenue) in full.
  - Based on the Promontory modelling, a liquidity support scheme does not produce a lower post-default cost to customers when compared with option 2.1.
  - If a liquidity support scheme is to be introduced, the costs of the scheme should be recovered by the distributor as part of its regulated revenue through its network tariffs. As above for the credit support and retailer default fund options, we do not support a scheme that imposes a higher relative contribution on retailers with a lower credit rating as this would impose relatively higher costs on smaller, new entrant retailers (representing a barrier to market entry) and would not materially add to existing incentives on a retailer to manage its credit rating better.

We look forward to engaging further with the AEMC on this issue. Please contact me if you would like to discuss.

Yours sincerely

Alex Fleming
GM – Legal, Regulatory & Compliance