2 July 2015

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Subject: Consultation paper: National Electricity Amendment (Retailer – Distributor Credit Support Requirements) Rule 2015

SA Power Networks welcomes the opportunity to respond to the Australian Energy Market Commission's **(AEMC)** rule change consultation paper on the National Electricity Amendment (Retailer – Distributor Credit Support Requirements) Rule 2015, issued on the 28th May 2015.

In a prior submission[1] to the AEMC dated 11th December 2014, SA Power Networks supported the Council of Australian Government's Energy Council's **(COAG Energy Council)** submission of a rule change request to the AEMC seeking an amendment to the National Electricity Rules **(NER)** to allow distribution network service providers **(DNSP)** to recover foregone revenue, in the form of distribution network charges, for the provision of direct control services, which are unpaid because a retailer has become insolvent.

The COAG Energy Council considered the proposed rule change was required in order to better reflect the original policy intent of the provisions drafted to implement the National Energy Customer Framework **(NECF)**, which was to provide a mechanism in the NER for DNSP's to recover unpaid network charges following a Retailer insolvency event without a materiality threshold being applied.

We note the AEMC's commentary regarding your decision, pursuant to section 107 of the National Electricity Laws (NEL), to extend the time period for making a draft rule determination for the COAG Energy Council's rule change request to 18 February 2016.

Key messages

SA Power Networks:

- Supports the COAG Energy Council proposed rule change to include a 'no materiality' requirement for a cost pass-through in the case of a retailer becoming insolvent. This rule change reflects the COAG Energy Council's policy intent;
- Rejects the rule change made by AGL the rule change proponent;

[1] SA Power Networks response to *AEMC National Electricity Amendment (Retailer Insolvency events – cost pass through provisions) Rule 2015*.

SA Power Networks considers that the following should be used to guide the development and assessment of an effective rule for managing the risk of a retailer default:

- The rule allocates appropriate risks to the parties that have the information, ability (provided that the party is provided with the tools and not constrained by the rule) and incentives to best manage each risk in order to minimise the long-term costs to consumers.
- The rule takes into account and allocates the risk to the beneficiaries of increased retail competition. Noting that the beneficiaries of increased retail competition are customers.
- The rule takes into account the risk of retailer default and the impact of default. In addition treats retailers in an equitable manner.
- The rule takes into account the trade-off between flexibility and regulatory certainty.
- The rule takes into account the impact on barriers to entry for retail businesses.
- The rule takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles.
- The rule is cognisant of the NEO and NGO in that the long term benefits to customers out weighs the costs of a retailer default.

SA Power Networks considers that the existing NECF credit support arrangements along with the COAG Energy Council's proposed rule change meet the above requirements.

SA Power Networks has provided responses to some of the questions posed within the Consultation Paper as detailed in Attachment 1.

Should the AEMC require further clarification of any of our comments, please contact Mr Paul Erwin, our Retail Relations Manager, on (08) 8404 9486.

Yours sincerely,

Sean Kelly

General Manager Corporate Strategy

Attachment 1 – details

Question 1	Current credit support requirements
(a)	Do distributors request credit support in all circumstances permitted under the current arrangements?
(b)	If not, why not?
(c)	What issues have been identified by distributors and/or retailers in the implementation of the current credit support requirements?

The National Energy Customer Framework (**NECF**) commenced in South Australia on 1 February 2013. Since that time SA Power Networks has determined credit support requirements for Retailers under the NECF rules[2]. Since the NECF began in South Australia, SA Power Networks has conducted monthly assessments of Retailer credit support requirements and has strictly applied the rules as they exist under the NECF. No Retailer in the South Australian market, since NECF commencement, has breached the NECF credit support rules whereby SA Power Networks would be able to request credit support.

The rules for credit support that currently exist have a design flaw. Under the current Rule by the time a DNSP's can call for credit support, the Retailer in question is already exhibiting signs of potential financial instability. In many cases the ability for a non investment grade Retailer to secure the required credit to meet their credit support requirements will not occur. The failure of Jackgreen in the Retail Electricity market in December 2009 is one such example. Jackgreen were contacted in the months leading up to the suspension of their Retail licence on several occasions by SA Power Networks to provide credit support. This contact commenced prior to and following the lapsing of Jackgreen's bank guarantee in 2009.

Jackgreen's repeated response was to advise that they were not in a financial position to provide any credit support. Prior to SA Power Networks being able to lodge a formal dispute over the matter, Jackgreen were the subject of a Retailer of last resort **(RoLR)** event, leaving SA Power Networks with real losses, which were unrecoverable under the previously applied materiality threshold.

The NEM opened to very large customers in the late 1990's, flowing on to full retail contestability **(FRC)** in South Australia in 2003, with eastern states, adopting FRC slightly earlier. The failure of one Retailer in the market so far inside 12 to 15 years conflicts with the suggestion that a Retailer failure is a possibly rare event.

Customers gain benefit from greater competition in the South Australian Market. However, SA Power Networks gains no benefit from greater competition but its risk increases significantly due to greater chance of Retailer failure due to the saturation of non investment grade Retailers in South Australia.

Currently there are nine non investment grade Retailers operating in South Australia, representing 26% of Retailers, with a combined exposure of total distribution network charges (**DNC**) of $176M for the 12 months to the end of March 2015.

[2] Contained within chapter 6B of the NER

Question 2	**Identification of Appropriate Principles**
(a)	**Are these principles appropriate for designing a rule for managing the risk of retailer default?**
(b)	**Are there other factors market participants would expect to be considered in an effective rule for managing the risk of retailer default?**

SA Power Networks considers that the principles proposed in the Consultation Paper on page 14, as amended in our covering letter are appropriate. In particularly the principles that:

- *"The rule takes into account the risk of Retailer default and the impact of default";*
- "T*he rule takes account the risk of retailer default and the impact of default. In addition treats retailers in an equitable manner*"; and
- "*The rule takes into account and allocates the risk to the beneficiaries of increased retail competition. Noting that the beneficiaries of increased retail competition are customers.*",

*s*hould provide an opportunity to further review the rules to support greater stability in the NEM environment.

The review of these rules should include a review of the current structure of credit allowances. SA Power Networks considers the provision of any form of consideration or credit allowance to a Retailer who has a credit rating of BB- or lower, (i.e. those with Dun and Bradstreet dynamic risk score of high, very high or severe risk of default) may not be in the best interests of customers in the NEM. Consequently, if a credit allowance is to be provided to these retailers it must be on the basis that the perceived benefit to customers, by way of increased retailer competition, offsets the risk to customers in the event of retailer default.

In highlighting this concern, we question whether financial institutions would provide credit to companies that have credit ratings of BB- or lower without any form of security. Further, would end use customers consider the actions of rule makers, whilst acting to stimulate competition and potentially reduce prices, have been financially prudent and financially responsible in providing a credit allowance to Retailers in this category.

SA Power Networks has seen the market grow significantly from the commencement of NECF in South Australia and resultant change in credit support requirements that were introduced. The SA Market has increased from 23 active Retailer's (ie being billed distribution use of system charges (DUoS)) prior to NECF commencement on 1 February 2013, to 35 active Retailers in the market as at June 2015.

Only three Retailers in the SA Market have a credit rating at BB- or below, which would be of a greater risk of retailer default. Consequently if these retailers were not provided with a credit allowance, we do not consider this would significantly impact retailer competition.

Question 3 Risks and impacts related to retailer default

Have all of the risks faced by distributors related to retailer default been outlined above? If not, what other risks do parties face in relation to network charges due to the risk of retailer default?

SA Power Networks agrees with the risks as proposed by the AMEC's Consultation paper. In addition, SA Power Networks would like to highlight that the current regime prevents DNSPs from appropriately managing the risk where a retailer's credit rating is downgraded but this downgrading does not result in their Network Charges Liability (NCL) exceeding their amended credit allowance.

Under the AGL proposal a BBB- rated retailer would not be required to provide credit support to DNSP no matter the quantum of their NCL. This is despite a BBB- rated retailer being at four times the risk of defaulting than an A- rated retailer (ie a BBB- rated company has a 0.30% chance of default compared to an A- company who has a 0.08% chance of default)[3]. In accordance with the current Rules a DNSP is able to revoke a retailer's credit allowance where that retailer is more than 25 business days late in paying a DNSP's network charges invoice. The DNSP can immediately request that retailer provide a bank guarantee for the quantum of their NCL. The retailer then has 10 business days to provide the request credit support in full. If that retailer then fails to provide the credit support to the DNSP, then the DNSP would apply to the AER to enact a RoLR event. The time period for this process could easily exceed 50 calendar days, giving a maximum network charges liability of 140 days (ie 90 plus 50) or 38% of a DNSP's annual network charges. SA Power Networks consider that this would create severe financial stress on a DNSP which may even result in the failure of the DNSP. Consequently, we consider that it is inappropriate for a BBB- rated retailer not to provide credit support under certain circumstances (eg large market share).

SA Power Networks is concerned with the one percent materiality threshold which currently applies under the current Rules for a retailer insolvency event. All DNSP's are currently required to provide a credit allowance to retailers with accredit risk of B+ or lower (or a Dun and Bradstreet rating of "very high" to "severe" risk of failure). Under the current rules some DNSPs are expected to "wear" the revenue loss (ie loss less than materiality threshold) despite not being able to manage or mitigate this risk. SA Power Networks considers that the one percent materiality threshold in these circumstances is against the NEL revenue and pricing principles, specifically that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing direct control services.[4]

SA Power Networks is also concerned that certain retailers use a Dun and Bradstreet credit rating to provide a greater credit allowance than if their parent company was the retailer with an S&P rating which would provide a lower credit allowance. It would be expected that the parent company's rating should better reflect the risk of that retailer defaulting. SA Power Networks considers that there should be regular updates to the credit support arrangements as changes occur to credit ratings risk of default and how credit rating agencies rate companies.

[3] See Standard & Poor's Rating Service 2014 RatingsDirect Annual Global Corporate Default Study And Rating Transitions Table 26 p. 58 30 April 2015.

[4] NEL s 7(A)(2)(a).

Question 4 Management of risk to reduce costs (a) Do the costs imposed on retailers by the current rules (or potentially by the proposed rules) lead retailers to take actions to better manage their risks in order to reduce their costs? (b) Do the costs imposed on gas retailers under their access arrangements (or potentially by the proposed rules) lead retailers to take actions to better manage their risks in order to reduce their costs? (c) Do the risks borne by electricity distributors under the current rules (or potentially by the proposed rules) lead distributors to take actions to better manage the risk of retailer default? (d) Do the risks borne by gas distributors under their access arrangements (or potentially by the proposed rules) lead distributors to take actions to better manage the risk of retailer default? (e) Do the costs imposed on consumers by the current rules (or potentially by the proposed rules) lead consumers to make informed decisions about purchasing electricity or gas from their retailer?

SA Power Networks considers that the current credit support rules in conjunction with the COAG Energy Council provides sufficient incentives for DNSPs to manage the risk a retailer default, as a DNSP must be able to demonstrate to the AER satisfaction that it has acted prudently to mitigate its loss as the result of a retailer default. Otherwise the AER is empowered to reduce the amount the DNSP can recover from customers.

Question 6 Purpose of Rule (a) Is this the correct approach to consider the level of protection to be provided by a rule to manage the risk of retailer non-payment? (b) Are there any other protections provided by a rule to manage the risk of retailer non-payment?

SA Power Networks supports the development of effective rules to manage the risk of Retailer default which consider protection for the distributor against the risk of retailer default:

- In proportion to each Retailers share of a distributors revenue; and
- Adjusted for any additional cascading risk from a large Retailer default

Question 7 Changes in the calculated amount of credit support required

(a) How often do retailer-distributor credit support requirements currently change?

(b) What would be market participants' preferred frequency of changes to the required level of credit support provided by retailers to distributors?

(c) How do frequent changes in credit support requirements affect retailers?

(d) How could other approaches to a rule for managing the risk of retailer default improve regulatory certainty or flexibility?

SA Power Networks proposes that the rules governing frequency of changes in credit support should remain unchanged. That is, those rules that currently exist within the Rules, namely Division 5 "Other rules relating to credit support", specifically NER section 6B.B5.1 and 6B.B5.2 should continue to apply. The frequency should not be governed by a timeline, more so they should be governed by the variation as permitted in the rules, as there is no retail licence condition that prevents Retailers from acquiring any number of customers, of any value within a defined period. Consequently credit risk can increase significantly in a very short period of time.

Question 9 Balance of credit risk and impact risk

(a) Is AGL's proposal an improvement over the current credit support requirements?

(b) Given your answer to a), explain why or why not.

AGL's proposal treats all investment grade retailers in regard to the provision of credit support in the same manner despite the greater risk of a BBB- retailer failing compared to an A- rated retailer. A BBB- retailer has four times the risk (ie the failure risk of a A- retailer is 0.08% compared to 0.30% for a BBB- rated retailer)[5] of failure when compared to an A- rated retailer. In addition, the AGL proposal creates a barrier to entry for any non-investment grade retailer as they are required to provide a percentage of their Network Charges Liability (NCL) as credit support to a DNSP. This has the potential to reduce retailer competition in energy markets.

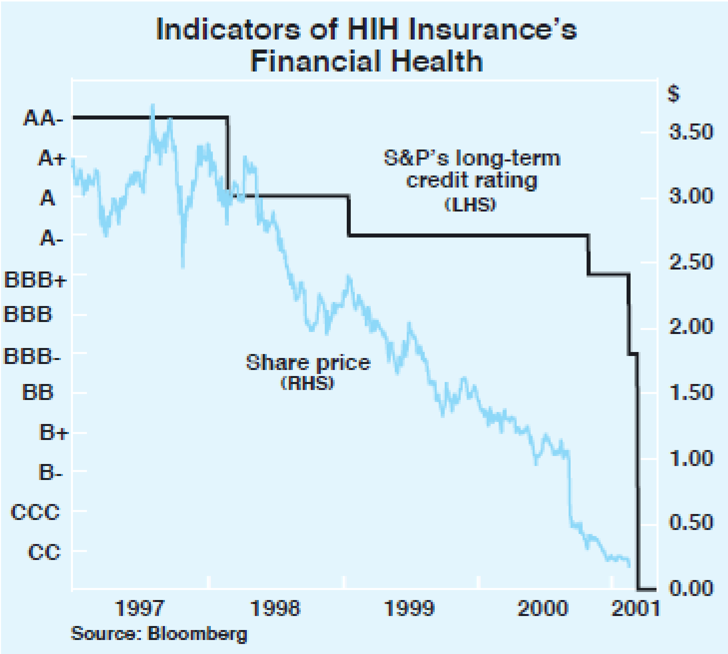
In addition, AGL's proposal for changes regarding current credit support requirements supports Retailers with investment grade credit ratings. We consider any deviation from the current rules that results in apportioning greater risk to another market participant, ie the DNSP, should not be considered, which is the case with AGL's proposal.

1. The financial exposure to DNSP's is significant in that credit ratings, particularly for investment grade Retailers can often lag behind real time activity. For example, HIH Insurance was considered one of Australia's largest insurance firms with $8 billion in assets, prior to its collapse in 2001. The Reserve Bank of Australia released a paper titled "Credit Ratings and Market Dynamics", in 2004, which observed this event in which it stated;

[5] See Standard & Poor's Rating Service 2014 RatingsDirect Annual Global Corporate Default Study And Rating Transitions Table 26 p. 58 30 April 2015.

"HIH Insurance had an investment-grade rating only a few weeks before it became insolvent (Graph 1). Such concerns have prompted some observers to question the value of the rating agencies, and to suggest that their opinions do not contain information beyond what is already available to debt and equity market participants"

Graph 1



2. The current rules are not being followed or enforced Origin Energy's credit rating was downgraded from BBB to BBB- on 22 April 2015, as indicated on its Internet site. Pursuant to NER rule 6B.B3.39 (c) Origin Energy has the following obligation;

   6B.B3.39 (c) - "A Retailer must advise a DNSP of any change to its credit rating immediately on becoming aware of that change"

   At the time of writing this letter, SA Power Networks has received no advice from Origin Energy as to this change in their credit rating.

3. We do not support any proposed rules that increases the exposure to a DNSP by a Retailer default. To create rules that reduce the credit support requirements of Retailers with a credit rating of less than BBB- with a market share of at least 20%, with the associated financial risk, in comparison with the current arrangements, is unacceptable.

SA Power Networks manages its business as financially lean and financially efficient as possible. Our experience with the Retailer failure of Jackgreen in this market has so far seen SA Power Networks exposed to real unrecoverable losses. As per our position in the opening paragraph's of the covering letter this can only be mitigated as a result of a rule change that provides a DNSP with the ability to access a full pass through for a Retailer failure with no materiality threshold.