



Australian Energy Market Commission

CONSULTATION PAPER

National Electricity Amendment (Retailer insolvency events - cost pass through provisions) Rule 2015

Rule proponent
COAG Energy Council

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RULE
CHANGE

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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1 Introduction

On 20 March 2014, the Council of Australian Governments Energy Council submitted a rule change request to the Australian Energy Market Commission. The rule change request seeks to amend the National Electricity Rules to allow a distribution network service provider to recover its revenue, in the form of distribution network charges, for the provision of direct control services to a retailer, which are unpaid because the retailer has become insolvent.

If made, the effect of the proposed rule would be that if a distribution network service provider cannot recover its charges in full following the insolvency of a retailer, the unrecovered revenue would be collected from the distribution network service provider's customer base, thus keeping the distribution network service provider whole.

The COAG Energy Council considers that the proposed rule is required to correct drafting errors in the amending rules to the National Electricity Rules that implemented the National Energy Customer Framework in 2012, and in the implementation of the *Economic regulation of network service providers, and price and revenue regulation of gas services* rule, in 2012.¹

It considers that the proposed rule would better reflect the original policy intent of the provisions drafted to implement the National Energy Customer Framework. This was to provide a mechanism in the National Electricity Rules for distribution network service providers to recover their unpaid, and otherwise unrecoverable, network charges following a retailer insolvency event.

If made, the proposed rule would amend Chapters 6 (economic regulation of distribution services), 10 (glossary) and 11 (savings and transitional rules) of the National Electricity Rules.

The rule change request seeks to make amendments to the National Electricity Rules that relate to matters that were implemented under the National Energy Customer Framework. Therefore if made, the rule will only affect jurisdictions that have implemented the National Energy Customer Framework. Currently these are New South Wales, the Australian Capital Territory, South Australia and Tasmania. It will apply in Queensland from 1 July 2015,² and in Victoria from 31 December 2015.³

¹ Australian Energy Market Commission, *Economic regulation of network service providers*, rule determination, AEMC, 29 November 2012.

² The Queensland Government announced that the National Energy Customer Framework will commence in that state on 1 July 2015, pending the passage of legislation in the Queensland Parliament. See Department of Energy and Water Supply, 20 June 2014, Department of Energy and Water Supply, Queensland, viewed 27 October 2014, <<http://www.dews.qld.gov.au>>.

³ On 13 October 2014 the Victorian Government announced that its retail energy regulatory arrangements will transition to the National Energy Customer Framework by 31 December 2015. See Department of State Development, Business and Innovation, *Victoria's Energy Statement*, Victoria, 13 October 2014, p. 20.

This consultation paper has been prepared to facilitate public consultation and to seek stakeholder submissions on the rule change request.

This paper:

- sets out a summary of, and a background to, the rule change proposed by the COAG Energy Council; and
- identifies a number of questions and issues to facilitate the consultation on the rule change request.

Submissions

Submissions on this rule change request are to be received by 11 December 2014. Details on how to lodge a submission are contained in Chapter 6 of this consultation paper.

2 The rule change request

2.1 COAG Energy Council's proposal

This rule change request relates to the ability of distribution network service providers (DNSPs) to recover revenue for the provision of direct control services, which have not been paid by a retailer due to that retailer becoming insolvent.

The existing cost pass through provisions in Chapter 6 of the National Electricity Rules (NER) allow DNSPs to recover the *costs* they would incur from retailer insolvency events. These costs would be passed through to, and recovered from, customers. The Council of Australian Governments Energy Council (COAG Energy Council, formerly the Standing Council on Energy and Resources) considers that these provisions may not facilitate the full recovery of *foregone revenue* for DNSPs following a retailer insolvency event. The proposed rule seeks to amend this apparent deficiency of the NER.

To achieve full revenue recovery by DNSPs following a retailer insolvency event, two key amendments to Chapter 10 have been proposed. These are:

- the insertion of a new and separate limb within the current definition of a positive change event to include the occurrence of a retailer insolvency event. This would allow for the costs arising from a retailer insolvency event to be passed through, without being subject to the materiality threshold that is applied to other cost pass through events; and
- the insertion of a new definition for retailer insolvency costs, which would specifically include revenue foregone to DNSPs as a result of a retailer insolvency event. This would allow DNSPs to use the cost pass through mechanism established in the NER to recover unpaid revenue, and not just the relevant additional costs incurred, following the occurrence of such an event.

For the purposes of drafting consistency, secondary amendments would also be needed to italicise the term "retailer insolvency costs" where it appears elsewhere in the NER. These secondary amendments are located in Chapters 6 (economic regulation of distribution services), 10 (glossary) and 11 (savings and transitional rules) of the NER.

2.2 COAG Energy Council's rationale

The COAG Energy Council has stated that both limbs of its proposed rule are necessary to correct inadvertent omissions made in the previous drafting of amendments to the NER. In particular:

- The original draft of the rules to amend the NER for the implementation of the National Energy Customer Framework (NECF) included an amendment to provide that a retailer insolvency event is a positive change event. This reflected

the intention of the then Ministerial Council on Energy (MCE)⁴ that retailer insolvency events would not be subject to the materiality threshold that is imposed on other types of cost pass through events.

During the implementation of the *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 No.9*, (Network Regulation Rule)⁵ the proposed NECF amendment was erroneously omitted.

- In relation to the proposed definition for retailer insolvency costs, it was originally intended by the MCE that this definition be a part of the initial rules implementing the NECF at its commencement on 1 July 2012.

The definition was erroneously omitted from the relevant amending rule, the *National Electricity (National Energy Retail Law) Amendment Rule 2012*.

The COAG Energy Council considers that the current provisions of the NER limit the ability of DNSPs to manage the commercial risk associated with some retailers:

- Under the NER, DNSPs have a mandatory obligation to provide direct control services when these are requested.⁶ They are therefore unable to withhold, or otherwise restrict, the supply of these services to retailers that might be perceived as being a commercial risk.
- Because the revenue derived from the provision of direct control services is subject to economic regulation, DNSPs may not make adjustments to the prices charged for these services to account for any higher risk in dealing with some retailers.
- The ability of DNSPs to manage this risk through the requirement of credit support from retailers is limited by the regulation of these arrangements under the NER.

Consequently, the COAG Energy Council has sought to address the current limitations and clearly provide DNSPs with a mechanism to manage retailer insolvency risks.

The COAG Energy Council's rule change request includes a proposed rule.

⁴ The Ministerial Council on Energy (MCE) is referenced in the AEMC's governing legislation and is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011 the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated Council is now called the COAG Energy Council.

⁵ AEMC, *Economic regulation of network service providers*, rule determination, 29 November 2012.

⁶ Clause 6.1.3 of the NER.

3 Background

This chapter provides context and background information relevant to the issues raised by the rule change request. It provides an explanation of the particular risk faced by DNSPs, the nature of economic regulation that they are subject to and the influence of this regulation on management and allocation of the risk, and how DNSPs might currently manage this risk under the NER.

3.1 The nature of the risk

The risk of a retailer becoming insolvent and defaulting on its payments is a credit risk faced by a DNSP.

DNSP network charges to retailers are ultimately recovered from end use customers through the retailers' billing processes. Generally, as consumption is volatile over time, it must be measured before it can be invoiced. DNSP network charges are therefore usually billed, and paid, a month in arrears. The lag between the provision of services and the payment for those services creates the credit risk. Depending on the size and growth of a retailer's customer base, and the volume of consumption during a billing period, these payments may be substantial. This may require the retailer to have ongoing access to considerable cash flow or cash reserves to meet these payments to the DNSP.

Credit risk is a commercial risk that is common to service providers in a competitive market, particularly where services are provided before payment is made. In such a market, a service provider might choose to manage its credit risk in a variety of ways: through the use of credit terms, by imposing credit limits, requiring full or partial prepayment, seeking insurance, or by simply choosing not to provide services to perceived high risk customers.

The regulatory framework established under the NER influences both the extent of a DNSP's retail credit risk and its ability to manage that risk. In particular, the range of options available to a DNSP to manage any exposure to credit risk is constrained under this framework.

Specifically, the effect of Chapter 6 of the NER is to both to:

- impose an obligation on DNSPs to provide direct control services to any person when requested; and
- remove DNSPs' ability to make fully independent decisions to manage the risk of counter-party default. For example, the price cap control mechanism prevents some DNSPs from pricing or factoring in the risk of transacting with retailers they perceive to be a potential credit risk.

While the NER allows DNSPs to require credit support from retailers, it also regulates when it may be used and how it is calculated. This may lead to an outcome where the

available credit support may be insufficient to cover all of the credit risk to which a DNSP is exposed.⁷

3.2 Economic regulation of distribution services under the NER

DNSPs are subject to economic regulation under the NER. Broadly, this involves the making of a regulatory determination by the Australian Energy Regulator (AER) which applies for a defined regulatory control period, usually five years. It is the primary means of revenue recovery for DNSPs.⁸ The framework for this process is established under Chapter 6 of the NER.

Under this framework, the AER is required to determine the revenue requirements of DNSPs to enable each to recover its efficient costs of providing regulated services, and receive an appropriate rate of return on the investment in the infrastructure, having regard to the riskiness of the business. However, while DNSPs typically provide a range of services, only those services that the AER classifies as "direct control services" are subject to full economic regulation.⁹

The objective of the proposed rule is to allow DNSPs to recover revenue associated with the provision of direct control services. Whether a DNSP would seek recovery by a cost pass through may, however, depend on the control mechanism that is applied to those services, and this may vary between DNSPs.¹⁰

Currently the form of control mechanism applied to direct control services is typically either a revenue cap or a weighted average price cap. An outline of these forms of control mechanism is provided below.

3.2.1 Revenue caps

A revenue cap sets a limit on the revenue that can be derived from the provision of particular services. The AER does this by determining the maximum allowable revenue that a DNSP can earn from those services during the regulatory control period. The DNSP is then permitted to recover revenue up to the maximum allowable revenue over that period. It achieves this by forecasting its demand for the next regulatory year

⁷ Although it should be noted that the provision of credit support does not alter the allocation of credit risk, which remains with DNSPs. The operation of the credit support provisions is discussed in more detail in Chapter 5.2 of this consultation paper.

⁸ Clause 6.3.2(b) of the NER; Australian Energy Regulator, *State of the energy market 2013*, AER, 2013, p. 64.

⁹ A service is classified as a direct control service if the distributor is a natural monopoly provider of the service. See AER, *Stage 1 framework and approach paper – NSW DNSPs*, March 2013, p. 15; *Final framework and approach for SA Power Networks - Regulatory control period commencing 1 July 2015*, April 2014, pp. 9-12.

¹⁰ The control mechanism defines how prices, for the service being regulated, will be determined. See AER, *Final framework and approach for SA Power Networks - Regulatory control period commencing 1 July 2015*, April 2014, p. 12.

and setting prices for that year such that the expected revenue is up to the total maximum allowable revenue.

At the end of each regulatory year, the DNSP is required to report its actual revenues to the AER. Differences between the actual and expected revenue are then accounted for in the future years of the regulatory control period. That is:

- if actual revenue is greater than the allowed revenue for that year, the DNSP is required to "give back" that additional revenue by lowering its prices in the following year(s); or
- if the actual revenue is lower than the allowed revenue for a year then the DNSP will be able to increase its prices in the subsequent year(s) to recover the previous under-recovery.

This process occurs through an "overs and unders" account, from which any over or under-recovery is deducted from, or added to, the maximum allowable revenue in future years.¹¹

3.2.2 Weighted average price caps

An alternative regulatory control mechanism is the weighted average price cap. Under this mechanism, prices for regulated services are based on the weighted average of prices for individual services, within a specified "basket" of services. The mechanism caps the average increase in prices for services in the basket from one year to the next. DNSPs may adjust the prices for different services each year by different amounts. This means that, within the basket of services, some prices may rise while others may fall subject to meeting the overall requirements of the weighted average price cap.¹²

One of the consequences of using a weighted average price cap is that the volume risk is carried by the DNSP. This means that the actual revenue received by a DNSP depends on actual demand. Therefore, while a DNSP may benefit from higher than expected revenues if actual demand exceeds what was forecast, it must bear the reduced revenue if demand is lower than forecast.¹³ There is no overs and unders type of adjustment available so that total expected regulated revenues are met.

3.3 Options for recovery

There are currently several options for DNSPs to manage the financial impact of, and seek revenue recovery following, a retailer insolvency event. These are set out below.

¹¹ AER, *Matters relevant to the framework and approach, ACT and NSW DNSPs 2014–2019*, discussion paper, April 2012.

¹² AER, *Final framework and approach for SA Power Networks - Regulatory control period commencing 1 July 2015*, April 2014, p. 40.

¹³ AER, *Final framework and approach for SA Power Networks - Regulatory control period commencing 1 July 2015*, April 2014, p. 47.

3.3.1 Recovery through credit support

The rule change request identified the regulation of the credit support arrangements as a factor contributing to the restrictions on the ability of DNSPs to manage credit risk. The operation of these arrangements provide relevant context to the consideration of issues arising from the rule change request.

Part B of Chapter 6B of the NER sets out the credit support arrangements between retailers and DNSPs. These provisions establish the minimum level of credit allowance that DNSPs must grant to retailers.¹⁴ They also specify that DNSPs can require credit support from retailers only for the amounts above this minimum level of credit.¹⁵

The credit support arrangements apply between a DNSP and a retailer in respect of:

- shared customers, that is a "person who is a customer of the retailer and whose premises are connected to the distributor's distribution system";¹⁶ and
- charges for services for which the retailer pays the DNSP.¹⁷

DNSPs have discretion on whether or not to require the provision of credit support from retailers but where it is required, retailers are obliged to provide it.¹⁸ Chapter 6B specifies when a DNSP may require credit support from a retailer, the method of calculation of credit allowance and credit support for a retailer, and the form in which it must be provided.¹⁹ It also specifies that a DNSP may not require a retailer to provide credit support except in accordance with these rules.²⁰

Once a DNSP has invoiced a retailer, the retailer is required to pay the amount in full and in an acceptable form, within ten business days from the date the invoice was issued.²¹ Retailer insolvency is not a pre-requisite for the DNSP to apply or draw on the credit support. Provided there is no unresolved dispute about the liability for payment, if an amount which is due and payable remains outstanding,²² a DNSP may apply or draw on the credit support by giving not less than three business days' notice of its intention to do so.²³

14 Clauses 6B.B3.1 - 6B.B3.3 of the NER.

15 Clause 6B.B4.1(b) of the NER.

16 See s. 2 of the National Energy Retail Law.

17 Clause 6B.A2.4 of the NER.

18 Clause 6B.B4.1(a) of the NER.

19 Part B of Chapter 6B of the NER.

20 Clause 6B.B2.1 of the NER.

21 Clauses 6B.A2.5 and 6B.B4.1(b) of the NER.

22 Although the NER do not specify the point at which an unpaid amount becomes outstanding, this is taken to mean any date after the due date for payment.

23 Clause 6B.B5.3 of the NER.

Any credit support that is available to the DNSP would be taken into account by the AER in considering a cost pass through for a retailer insolvency event.²⁴

3.3.2 Recovery through the regulatory determination process

Another method to manage the exposure to, and the potential losses from, retailer insolvency is by incorporating some consideration for the risk into DNSPs' allowed revenues through the regulatory determination process.

Where a DNSP elects to purchase commercial insurance against the financial impact of a retailer insolvency event, the cost or premium paid for this insurance would be incorporated into the DNSP's operating expenditure forecast.²⁵

The effect of commercial insurance would be to transfer the risk from the DNSP, as policy holder, to the insurance company which may be better able to manage the risk by pooling it with the risks of other policyholders, and by holding appropriate capital reserves.²⁶

However, risks that relate to low probability but potentially high impact events may be difficult to commercially insure. That is, they may only be partially insurable, incur such high premiums as to make them uneconomical to insure against, or be uninsurable altogether in conventional insurance markets. In such circumstances, self-insurance may be a more appropriate option.

Under a self-insurance regime, the risk would remain with DNSPs, with the intention that the money collected would be ring-fenced until such time as a retailer insolvency event occurs, after which it may be drawn down to cover the costs incurred.²⁷

The AER's regulatory determination process has historically made allowance for self-insurance as a component of operating expenditure, to the extent that such risks are not:

- able to be efficiently covered by insurance;
- already remunerated through other elements of their regulatory regime, such as inclusion in capital expenditure or in the weighted average cost of capital; or
- recovered through the pass-through mechanism.²⁸

²⁴ Clause 6.6.1(l) of the NER.

²⁵ AER, *Victorian electricity distribution network service providers, distribution determination 2011-2015*, Appendices, June 2010, Appendix L, p. 315.

²⁶ Frontier Economics, *Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia*, July 2013, p. 45.

²⁷ Frontier Economics, op. cit. p. 55.

²⁸ Frontier Economics, *Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia*, July 2013, p. 71.

The AER has also considered it to be necessary for the particular risk to have been historically incurred, in order to be able to use the commonly accepted method of calculating self-insurance premiums.²⁹

3.3.3 Recovery under the cost-pass through mechanism

An alternative to managing a risk through the revenue determination process is to use one of the revenue adjustment mechanisms provided for in the NER.

Actual revenue for a DNSP may deviate from its expected regulated revenue due to the occurrence of exogenous events that are not within the reasonable control of the DNSP. The regulatory framework makes provision for managing the impact of uncertain exogenous events on revenues through different adjustment mechanisms, depending on the nature of the event. These mechanisms include contingent projects, capital expenditure re-openers and cost pass throughs.³⁰

This rule change request is specifically concerned with the application of the cost pass through mechanism. This section provides an overview of its operation.

Operation of the cost pass-through mechanism

When an exogenous event occurs within a regulatory control period that materially increases a DNSP's costs, the DNSP may apply to the AER to approve a pass through of the increase in costs under the cost pass through provisions.³¹

There are a certain requirements to be met before a cost pass through will be considered:

- The exogenous event must be a "pass through event", that is, it must come within one of the pre-defined events in clause 6.6.1(a1)(1)-(4) of the NER. This clause includes a retailer insolvency event.³² Alternatively, under clause 6.1(a1)(5), DNSPs may nominate additional pass through events at the time of its distribution regulatory proposal to the AER for the forthcoming regulatory control period.
- The pass through event must be a "positive change event". This is defined in Chapter 10 of the NER as one that imposes a material increase in the costs of providing a regulated service. Materiality, in these circumstances, is further

²⁹ AER, *Victorian electricity distribution network service providers, distribution determination 2011-2015*, Appendices, June 2010, Appendix M, p. 457.

³⁰ Revenue capped DNSPs also have the option of adjusting their prices to manage their revenues, following the occurrence of an exogenous event.

³¹ These provisions are set out in clause 6.6.1 of the NER. For expediency, this document discusses the operation of the cost pass through mechanism where there has been a material increase in costs to the DNSP. The NER also provides a broadly similar process for dealing with material decreases in a DNSP's costs arising from a nominated event.

³² Retailer insolvency events were added as part of the legislative package introduced to implement the NECF in 2012.

defined in Chapter 10 as being one per cent of a DNSP's annual revenue requirement. Increased costs arising from a pass through event that do not meet this threshold cannot currently be recovered under this mechanism.

- The operation of the cost pass through mechanism allows only for the material change in *costs* to be passed through: the definition of “materially” explicitly excludes "the revenue impact" of an event.

A DNSP has 90 business days following the occurrence of a pass through event to submit its cost pass through application to the AER for approval.³³ The application must include the additional information required under clause 6.6.1(c)(6)(iii), such as evidence of a DNSP's entitlement to payment under any relevant credit support arrangement. The AER then has 40 business days to determine whether a positive change event has occurred, the amount that can be passed through and the period over which the pass through will apply.

If approved, the increase in costs incurred by a DNSP arising from the pass through event is passed through to, and recovered from, customers in the form of increased prices. In this way the mechanism shifts the risk associated with that pass through event from the DNSP to customers.

Previous AEMC decisions on cost pass throughs

The AEMC has previously considered the cost pass through mechanism on a number of occasions. A summary of the relevant portions of these decisions is included in Appendix A of this paper.

3.3.4 Recovery through the insolvency process

A DNSP that is unable to recover in full the money owed to it by an insolvent retailer³⁴ retains the option of joining a general corporate insolvency procedure as an unsecured creditor³⁵ under the *Corporations Act 2001 (Cth)*.

The precise details of the various insolvency procedures are outside of the scope of this consultation paper. It is sufficient to note that, unless the debt has been secured, recovery depends on a number of factors including whether there is money available to make any payments at all, or whether there is a specific order of payment that must be followed. Where a DNSP's claim sits in the order of creditors will affect its entitlement to payment.³⁶

³³ Clause 6.6.1(c) of the NER.

³⁴ A company is considered to be insolvent when it becomes unable to pay its debts when they fall due for payment.

³⁵ An unsecured creditor is one that does not have a charge, such as a mortgage, over the debtor's assets to secure the debt owed.

³⁶ Australian Securities and Investments Commission website, viewed on 20 August 2014, <<http://www.asic.gov.au>>.

The NER requires that the amounts that the DNSP is *likely* to receive on the winding up of the insolvent retailer are to be excluded from the eligible pass through amount approved by the AER as a cost pass through.³⁷ Otherwise the NER provides little guidance as to how the timing of, and recoveries under, these separate processes are to be reconciled.

³⁷ Clause 6.6.1(1) of the NER.

4 Assessment framework

The Australian Energy Market Commission's (AEMC or Commission) assessment of this rule change request must consider whether the proposed rule promotes the national electricity objective (NEO) as set out under s. 7 of the National Electricity Law (NEL).

Section 7 of the NEL states:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to -

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system.”

The NEO captures the three dimensions of efficiency: productive (efficient operation), allocative (efficient use of) and dynamic efficiency (efficient investment).³⁸

In assessing the rule change request against the NEO, the AEMC will consider the likely long term costs and benefits of adopting the proposed rule compared to the counterfactual of not making the proposed rule. It will assess whether making the proposed rule satisfies the rule making test in that it will, or is likely to, contribute to the achievement of the NEO. This assessment will also take into account the revenue and pricing principles contained in s. 7A of the NEL. For this rule change request, the relevant principle is s. 7A(2):

“A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in -

- (a) providing direct control network services; and
- (b) complying with a regulatory obligation or requirement or making a regulatory payment.”

The purpose of the rule change request is to provide revenue certainty to DNSPs following retailer insolvency events by allowing them to recover revenue for direct control services provided, but which remain unpaid following a retailer insolvency event. Revenue certainty and the rate of return are influential factors in DNSPs' decisions to invest in and maintain their network assets.

³⁸ Productive efficiency means goods and services should be provided at lowest possible cost to consumers; allocative efficiency means that the price of goods and services should reflect the cost of providing them, and that only those products and services that consumers desire should be provided; dynamic efficiency means arrangements should promote investment and innovation in the production of goods and services so that allocative and productive efficiency can be sustained over time, taking into account changes in technologies and the needs and preferences of consumers.

If made, the proposed rule would transfer the risk and financial impact of retailer insolvency events from the DNSPs to customers, leading temporarily to higher prices. In assessing this rule change, the Commission will therefore be required to balance the need for revenue certainty against the need to minimise costs to consumers.

In assessing this rule change request against the NEO, the Commission will inform its decision by considering, in particular, the likely impact of the proposal on the following elements:

- ***The appropriate allocation of risk in relation to retailer insolvency events***

An appropriate allocation of risk is generally achieved when that risk is borne by the party that has the greatest control over the risk, is best able to avoid or minimise the risk, and can thus minimise the resulting costs of the risk.³⁹ This is also an efficient outcome.

The rules should provide an appropriate balance between competing interests and provide market participants with adequate incentives to make efficient decisions, minimising the overall costs to the market.

Where, in the long term interests of consumers, the regulatory framework imposes risks on specific parties, the framework should also ensure that those parties are not unreasonably impeded in their recovery of efficient costs and are still able to earn an appropriate return, commensurate with the riskiness of the business. This is particularly important where the risks that are imposed are beyond the control of those parties to manage.

The issue of risk allocation is more problematic where it is not clear that one party is better placed than another to bear that risk. In such circumstances, it might be appropriate to spread the risk across a broad group, such as a DNSP's customer base. It may also be necessary to consider other factors that could mitigate the impact of the risk on those ultimately required to bear it.

- ***The principles of best practice regulation***

As a form of direct intervention, the economic regulation of DNSPs should reflect the principles of best practice regulation. Characteristics of good regulation include that it should properly target the issue to be addressed, and should be integrated and consistent with the other rules, and the policy principles that underpin them.⁴⁰

Rules will be well targeted if they address the concern identified while minimising adverse consequences for other participants in the market (including consumers) or the efficiency of the market more broadly.

³⁹ AEMC, *NEM financial market resilience*, first interim report, 4 June 2013, p.10.

⁴⁰ Productivity Commission website, *Principles of best practice regulation*, viewed on 20 August 2014, <<http://www.pc.gov.au>>.

5 Issues for consultation

The matter at the core of this rule change request is whether DNSPs should be able to recover lost revenue from customers following a retailer insolvency event.

Taking into consideration the assessment framework, a number of issues that are relevant to this rule change request have been identified for consultation. Stakeholders are invited to comment on these issues as well as any other aspect of the rule change request or this paper.

5.1 Reallocation of credit risk to customers

The proposed rule seeks to address DNSPs' risk exposure by reallocating the risk of retailer insolvency to customers through the cost pass through mechanism.

Consideration of the appropriate allocation of risk requires balancing different interests, and the effect of this on different market participants. Reallocating the risk in the manner proposed by the rule change request raises the question of whether, and how, customers are better placed than DNSPs to manage or bear retailer credit risk.

It may be argued that DNSPs, as corporate bodies with regulated revenues and access to financial services, may have a greater capacity to absorb these short-term losses compared to their customers. This may be particularly the case as retailer insolvency events are expected to arise only infrequently, and revenue foregone in such events may only be a small proportion of a DNSP's total regulated revenue.

However, DNSPs' ability to manage this risk is constrained by the NER. In addition, the financial impact of the proposed revenue recovery on an individual customer could be relatively small compared to their annual bill.

It is also noted that the rule change request does not address the issue of whether the *additional* costs incurred by DNSPs, following a retailer of last resort event,⁴¹ should be separately recoverable under the cost pass through provisions.

An alternative view is that where no individual party can manage a particular risk more efficiently than another, then it may be appropriate for the risk to be shared across a broad section of electricity consumers. This could be achieved by making the proposed rule. Another option might be that, given that neither party can manage the risk, both consumers and DNSPs should share the impact of retailer insolvency events.

Question 1 Allocation of risk

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?

⁴¹ For example, the costs of transferring customers from the failed retailer to the retailer of last resort.

5.2 Recovery of revenue

5.2.1 Recovery of efficient costs

Section 7A of the NEL establishes the revenue and pricing principles that the Commission must take into account in considering the regulation of network system revenue and pricing.⁴² In particular, s. 7A(2) provides that a transmission or distribution network service provider should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing network services, and in complying with a regulatory obligation or requirement or making a regulatory payment. When network service providers meet their service obligations at least cost, productive efficiency is maximised and the costs to consumers are minimised.

For DNSPs, the recovery of efficient costs is primarily achieved through the recovery of the regulated total revenue which is calculated on the basis of forecasting the efficient cost of providing the regulated services for the next regulatory control period.

In addition, and provided the particular requirements are met, the NER provides for the recovery of other costs not incorporated into the revenue allowances, such as the imposition of new taxes, through other adjustment mechanisms such as the cost pass through mechanism.

5.2.2 Revenue impacts

Central to the cost pass through mechanism is the emphasis on the material change in *costs* that impacts on the DNSP from the occurrence of a pass through event.

A core element of the proposed rule is to provide for the recovery of *revenue foregone*. That is, amounts that have been billed by the DNSP but not recovered due to the retailer becoming insolvent. In these circumstances, the DNSP would have incurred costs in relation to the provision of services but would not, in the normal course of events, have incurred any additional and unexpected costs. The failure to recover for billed services is more in the nature of a "bad debt", and is a revenue impact for the DNSP.

While allowing for the recovery of foregone revenue as a cost pass through would provide DNSPs with revenue certainty, this represents a fundamental shift away from the traditional concept and framework of the cost pass through mechanism.

The COAG Energy Council has stated that the recovery of revenue foregone following a retailer insolvency event is appropriate given that, under the NER, DNSPs are subject to a mandatory obligation to supply regardless of the risk profile of the party requesting that supply. DNSPs are also restricted in how they can manage that

⁴² Section 88B of the NEL.

counter-party risk and although Chapter 6B provides for credit support, these arrangements are also highly prescribed.⁴³

However, the need to manage retailer insolvencies is not a new issue for DNSPs. In particular, it is noted that the obligation on DNSPs to supply direct control services predates the implementation of NECF. This means that DNSPs have had to manage the risk of retailer insolvency to date.

Nevertheless, there has been some change in the commercial environment faced by DNSPs. The retail market has historically been dominated by large, state owned businesses, which often operated in conjunction with a state owned network business. Over time, a greater number of comparatively smaller sized, second-tier retailers have entered the market. As a result, DNSPs are now required to transact with a greater range of retail businesses than in the past.

Question 2 Recovery of revenue

- (a) Is it appropriate to recover revenue forgone resulting from retailer insolvency through the cost pass through mechanism?**
- (b) What distinguishes retailer insolvency events from other pass through events that would justify the recovery of revenue, rather than just costs?**
- (c) Has the level of risk faced by DNSPs increased, or changed, such that allowing recovery of revenue in the manner proposed is warranted?**

5.3 Removal of the materiality threshold

The COAG Energy Council has proposed that DNSP revenue recovery for retailer insolvency events should not be subject to the materiality threshold that is usually applied to cost pass through events.

The Commission has previously approved the removal of the materiality threshold in relation to a specific tax imposed on SP Ausnet.⁴⁴ However, it has also commented more generally that the imposition of a materiality threshold for cost pass through applications is important to promote stability and predictability for both the AER and the service provider.⁴⁵

⁴³ See the discussion in Chapter 2 of this consultation paper.

⁴⁴ This related to the payment of the easement land tax by SP Ausnet, as required by the Victorian Government. In this case the Victorian Government had given a commitment to SP Ausnet that the tax would not have a negative impact on its business. See AEMC, *Easement land tax pass through*, rule determination, 27 November 2008.

⁴⁵ AEMC, *Economic regulation of transmission services*, rule determination, 16 November 2006, p. 104; *Economic regulation of network service providers*, rule determination, 29 November 2012, p. 187. These comments were in relation to the subjective application of a materiality threshold by the AER, in the absence of the rules explicitly specifying a threshold.

The Commission has also indicated that the imposition of a materiality threshold was a necessary device to remove the incentive for DNSPs to submit multiple applications that may, or may not, be trivial in nature.⁴⁶ The COAG Energy Council itself notes that:⁴⁷

“The pricing regime embodied in Chapter 6,...is intended to incentivise [DNSPs] to manage cost risks wherever possible rather than passing them through to consumers. Therefore, tests and constraints are placed around the use of pass-through applications under 6.6.1 (j).”

Subjecting cost pass through events to a materiality threshold has therefore been, and continues to be, a fundamental part of the cost pass through mechanism. The threshold is currently set at one per cent of a DNSP’s annual revenue requirement. Accordingly, removal of the threshold for retailer insolvency events would be likely to require some justification.

This may be that, a key element of the materiality threshold is to provide an incentive for distributors to self-manage the consequences of a cost pass through event, to the extent of the threshold. However, in relation to retailer insolvency events, the possibility of any reasonable control being taken by the distributor may be limited. In such circumstances the application of such an incentive may be ineffectual.

In addition, removing the materiality threshold for retailer insolvency events would not directly add to any uncertainty or increase in costs for either the DNSP or the AER. This is because the proposal is not to revert to a subjective assessment of materiality, but rather to specify that a materiality threshold would not apply at all. Such an arrangement is quite clear and provides certainty. DNSPs would need only to provide evidence of the event occurring and its cost impact for the cost pass through application to be valid.

Related to the threshold issue is that a retailer insolvency event is defined with reference to a single retailer becoming insolvent.⁴⁸ If several retailers became insolvent as a chain of insolvency events then, under the existing rules, a DNSP would need to make a separate cost pass through application for each. The operation of the materiality threshold under the current NER could have the effect of disqualifying some of these individual events from consideration. In such circumstances a DNSP may be unable to recover all of its costs even if, in total, the costs exceed the materiality threshold. Under the proposed rule, a DNSP would be able to recover costs and foregone revenues, whether arising from a single, small retailer insolvency or a chain of retailer insolvencies.

⁴⁶ AEMC, *Economic regulation of network service providers*, rule determination, 29 November 2012, p. 188.

⁴⁷ COAG Energy Council, rule change request, 20 March 2014, p. 4.

⁴⁸ See the definition for "retailer insolvency event" in Chapter 10 of the NER.

Question 3 Removal of the materiality threshold

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

5.4 Options for recovery

Currently under the NER, the form of the control mechanism that is applied to a DNSP will be an influencing factor in the certainty of revenue recovery following a retailer insolvency event. DNSPs subject to a revenue cap are effectively able to reduce the risk they face and recover the foregone revenue from customers, through the adjustment of prices to meet the maximum allowed revenues determined by the AER.

DNSPs under a price cap do not have this option. If there is no other way of recovering their foregone revenue, price capped DNSPs must absorb the revenue loss. These DNSPs may therefore be at a comparative disadvantage in recovering their expected regulated revenue in these circumstances.

This section explores other options available to DNSPs for managing risk and/or recovering losses following a retailer insolvency event, under the current framework. These options would be generally available to all DNSPs, regardless of the form of regulation to which they are subject under the NER.

Implementation of any of these options may give rise to a range of consequences and have impacts on other parts of the market, such as the retail electricity market. If stakeholders consider that one, or more, of these alternative approaches is more appropriate than the cost pass through mechanism then the information on these expected impacts would be regarded as relevant.

5.4.1 Recovery through credit support arrangements

The NER makes provision for credit support arrangements between DNSPs and retailers.⁴⁹ These arrangements do not alter the allocation of the credit risk, which remains with DNSPs; nor do these arrangements mitigate the risk that a retailer may become insolvent.

Where provided, the effect of the provision of credit support is to limit the financial exposure of a DNSP to credit risk, by capping the amount of the debt to be recovered to the amount of the credit allowance. This limits the extent of losses to be either absorbed or recovered by the DNSP. It may therefore also limit the ultimate financial exposure to customers.

⁴⁹ The imposition of credit support is not mandatory under the NER. Nevertheless, in terms of the latter, where the DNSP requests a retailer to provide credit support in accordance with the NER, the retailer is obliged to provide it: see clause 6B.B4.1(a) of the NER.

The arrangement to limit the amount of credit support is aimed at safeguarding against the possibility that DNSPs set the amount of credit support at such a level that it could potentially create a barrier to entry into the retail electricity market.⁵⁰

This is balanced against the necessity of providing certainty of revenue recovery for DNSPs to encourage ongoing efficient levels of investment in the provision of network services.

Question 4 Recovery through credit support

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?

5.4.2 Recovery through the regulatory determination process

Inclusion of the cost of commercial or self-insurance premiums into a DNSP's forecast operating expenditure over a regulatory period may be possible. However, in practice, such approaches may have a number of drawbacks:

- As an ex-ante allowance, there is potential for the value placed on this risk to be inaccurate. By its nature the risk of retailer insolvency, its potential impact and possible timing are all difficult to estimate. As a result, determining a value to include in operating costs would be problematic.
- Bundled as part of the overall price for network services, there would be less transparency in the amounts recovered and allocated to retailer insolvency. In addition, recovery of funds nominally for retailer insolvency costs and lost revenues would take place regardless of whether an event actually occurs. This would increase the risk of the recovery being inefficient.
- Including the risk of retailer insolvency in the total regulated revenue of a DNSP removes the risk of price shock that may otherwise result from an ex-post recovery of costs and/or revenues lost following a retailer insolvency event. However, inclusion in total revenue may result in users paying higher prices than necessary.

Nevertheless, spreading the impact of the risk over time in this manner may be desirable to some customers that would prefer not to be impacted from time to time by significant price rises following a retailer becoming insolvent.

⁵⁰ It is noted that retailers may also be required to provide separate credit support to the Australian Energy Market Operator, under Chapter 3 of the NER, in order to participate in the wholesale market.

Question 5 Recovery through the regulatory determination process

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?

5.4.3 Recovery under the cost pass through mechanism

An alternative approach for a DNSP to recover its additional costs arising from events that are not within its control is to use the cost pass through mechanism. These events may be foreseeable but, at the time of the regulatory determination, they are uncertain as to timing and/or scale.

The proposed rule seeks to amend the existing cost pass through provisions in the NER to clearly accommodate retailer insolvency events and allow DNSPs to recover all costs and unrecovered revenues resulting from an event.

The cost pass through mechanism operates to reallocate a risk from DNSPs to their customers, in circumstances where this is considered to be appropriate. By its nature it is an ex-post mechanism, allowing recovery of actual costs after an event has occurred. This provides transparency regarding the recovery of the costs in comparison to including an allowance in the total regulated revenue.

Under the cost pass through mechanism:

- cost recovery must be linked to a specific and identifiable event; and
- the amount to be recovered must be measurable and assessed independently against any relevant criteria, providing a safeguard against over-recovery or inaccurate claims.

Once approved, the recovery of cost pass through amounts is spread across the DNSP's customer base, minimising the overall impact on individual customers. All customers, to whom the cost is passed through, would face increases in their charges, albeit on a temporary basis.

However the *actual* impact on particular customers may vary depending on their individual circumstances. Accordingly, some customers may pay for services that they have already paid for, while other customers may be paying for services that have not been supplied to them, but to others.

The cost pass through event may also have a significant impact on those customers whose energy costs constitute a high proportion of their expenses, such as manufacturing businesses or low income households. For these customers, removing the risk of price volatility by incorporating an allowance into the total regulated revenue may be preferred.

Question 6 Recovery under the cost pass through mechanism

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

5.4.4 Recovery through the corporate insolvency processes

In addition to any recovery processes under the NER, DNSPs retain the option of pursuing the recovery of debts from an insolvent retailer, through the insolvency process under the *Corporations Act 2001 (Cth)*.

The operation of an insolvency process would be uncertain for a DNSP in terms of the timing and extent of recovery of money owed.

The rights of a DNSP, and its process of recovery under corporate insolvency procedures, would be indistinguishable from that of any other unsecured creditor in the process. In particular, there is no guarantee that it would recover its debt in full, or at all. If, for example, the retailer enters into liquidation payment of the liquidator's fees and costs and payment to priority creditors, employees and secured creditors, are prioritised before the remaining monies are distributed to unsecured creditors. Each category of creditor is paid in full before the next category is paid. If there are insufficient funds to pay a category in full, the available funds are paid on a pro rata basis.⁵¹

The insolvency process is a discrete statutory process that would proceed on a timetable independent of the NER. It is therefore possible that the lodgement and assessment of a cost pass through application may be commenced, and completed in accordance with the NER, independently of any insolvency process.⁵²

By comparison, and depending on the particular process followed and how far it progresses, there may be a considerable amount of time before an insolvency process under the *Corporations Act* is finalised and creditors' claims are met.

This raises the question of whether there is potential for a DNSP to double recover the unrecovered revenue or costs arising from a retailer's insolvency.

⁵¹ Australian Securities and Investments Commission 2011, Australian Securities and Investments Commission, Australia, viewed 29 September 2014, <<https://www.asic.gov.au>>; Australian Restructuring Insolvency and Turnaround Association 2014, Australian Restructuring Insolvency and Turnaround Association, Sydney, viewed 29 September 2014, <<http://www.arita.com.au>>; Rapsey Griffiths, Insolvency and Advisory 2014, Rapsey Griffiths, Newcastle, viewed 29 September 2014, <<http://www.rapseygriffiths.com.au>>.

⁵² See clause 6.6.1 of the NER.

Question 7 Recovery through the corporate insolvency processes

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?

6 Lodging a submission

The Commission has published a notice under s. 95 of the NEL for this rule change request inviting written submissions. Submissions are to be lodged online or by mail by 11 December 2014 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the AEMC's guidelines for making written submissions on rule change requests.⁵³ All submissions are published on the AEMC's website, subject to a claim of confidentiality.

All enquiries on this project should be addressed to Tina Wong on (02) 8296 7800.

6.1 Lodging a submission electronically

Electronic submissions must be lodged online via the AEMC's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ERC0172. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, a confirmation email will be issued. If this confirmation email is not received within three business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

6.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0172.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission a confirmation letter will be issued.

If this confirmation letter is not received within three business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

⁵³ This guideline is available on the AEMC's website.

Abbreviations

AEMC	See Commission
AER	Australian Energy Regulator
COAG Energy Council	Council of Australian Governments Energy Council
Commission	Australian Energy Market Commission
DNSPs	distribution network service providers
MCE	Ministerial Council on Energy
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEO	national electricity objective
NER	National Electricity Rules

A Previous Commission decisions in relation to the cost pass through mechanism

The cost pass through mechanism has been considered by the Commission in previous rule changes and reviews. This appendix provides a summary of the projects that are relevant to this current rule change request.

Role of the cost pass through mechanism in the regulatory control framework

The importance and role of the cost pass through mechanism as part of the overall regulatory framework was clarified by the Commission, in the context of transmission network service providers.⁵⁴ It considered that the mechanism was necessary to provide transmission network service providers with a degree of protection from the impact of unexpected changes in costs which are outside of its control, and which are not otherwise compensated for in the regulatory determination process.⁵⁵

Nevertheless, the Commission also considered that the cost pass through mechanism is one of a range of processes for passing costs through to customers, all of which differ in nature and degree of regulatory scrutiny.⁵⁶ Within this range, the cost pass through should be the last option that transmission or distribution network service providers utilise in order to recover their costs for the provision of direct control services.⁵⁷

A pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of the risks between transmission or distribution network service providers and their customers.⁵⁸

This is because the Commission considered that the mechanism provides a relatively weak incentive for the promotion of economic efficiency in the provision of direct control services. In particular, the operation of this mechanism should not be at the expense of the incentive mechanisms that operate under the building block approach to revenue determination. These incentive mechanisms help to ensure that prices for consumers are no more than necessary to provide an appropriate level of service.⁵⁹

Importance and purpose of the materiality threshold

The Commission has also recognised the importance of the materiality threshold as a component of the cost pass through mechanism on several occasions.

⁵⁴ AEMC, *Economic regulation of transmission services*, rule determination, 16 November 2006.

⁵⁵ AEMC, *op. cit.*, p. 140.

⁵⁶ AEMC, *DNSP recovery of transmission-related charges*, rule determination, 24 March 2011.

⁵⁷ AEMC, *Cost pass through arrangements for network service providers*, rule determination, 2 August 2012.

⁵⁸ AEMC, *op. cit.*, p. 20.

⁵⁹ AEMC, *op. cit.*, p. 9.

In the context of cost pass throughs for transmission network service providers, the Commission considered the materiality threshold to be important to ensuring the stability and predictability of the revenue cap regime for both the regulator and the regulated business. It considered that removing it would lead to greater uncertainty and increase the administrative costs for the AER in determining what constitutes a material event.⁶⁰

This reasoning was subsequently applied by the Commission in relation to cost pass through mechanisms for DNSPs.⁶¹ In this context, the Commission considered that a materiality threshold provides for consistency, transparency, predictability and certainty of procedure.⁶² Not having a threshold would introduce an undesirable degree of subjectivity to cost pass through determinations and give unnecessary flexibility to DNSPs in the submission of applications, which may or may not be trivial in nature.⁶³

Further, incorporation of a materiality threshold is likely to limit the applications that may be made. This is consistent with the Commission's view that it is only substantive changes in costs that should be covered by the mechanism.⁶⁴

Nevertheless, the application of materiality threshold to cost pass through events has been waived in specific circumstances. In particular, the imposition of a materiality threshold was waived where its application would have contradicted assurances from the jurisdictional government that the cost imposed would not result in any negative impact on the business. In addition, allowing the waiver of the materiality threshold also enhanced the regulatory certainty with respect to the treatment of the pass through event, and provided for the consistent application of policy to the rule proponent.⁶⁵

⁶⁰ AEMC, *Economic regulation of transmission services*, rule determination, 16 November 2006, p. 106.

⁶¹ AEMC, *Economic regulation of network service providers and price and revenue regulation of gas services*, final position paper, 15 November 2012.

⁶² AEMC, *op. cit.*, p. 188.

⁶³ AEMC, *op. cit.*, p. 160.

⁶⁴ AEMC, *Review of the electricity transmission revenue and pricing rules*, rule proposal report, February 2006, p. 80.

⁶⁵ AEMC, *Easement land tax pass through*, rule determination, 27 November 2008, p. 8. This related to the recovery by SP Ausnet of the costs of the easement land tax incurred in Victoria. Prior to the introduction of Chapter 6A of the NER, SP Ausnet had been able to recover the exact amount of the easement tax payable.