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Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

via AEMC's website, [www.aemc.gov.au](http://www.aemc.gov.au)

Dear Mr Pierce,

### **National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015**

SA Power Networks welcomes the opportunity to provide a submission in response to the *National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015* Consultation Paper of the Australian Energy Market Commission (**AEMC**).

On 20 March 2014, the Council of Australian Governments' Energy Council (**COAGEC**) submitted a rule change request to the AEMC seeking to amend the National Electricity Rules (**NER**) to allow a distribution network service provider (**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 COAGEC considered that the proposed Rule change was required in order to:

- (a) correct drafting errors in the amending rules to the NER that implemented the National Energy Customer Framework (**NECF**); and
- (b) better reflect the original policy intent of the provisions drafted to implement the NECF, which was to provide a mechanism in the NER for DNSPs to recover unpaid network charges following a retailer insolvency event without a materiality threshold being applied.

SA Power Networks supports the proposed Rule change as it gives effect to what was always intended, namely, that DNSPs should have a mechanism to recover debts arising from a retailer's insolvency regardless of the magnitude of those debts, by correcting the errors that occurred in implementing the policy intent of the cost pass through provisions in relation to retailer insolvency events under the NECF.

## NECF consultation on initial legislative package

### ***Background to the NERL credit allowance, credit support and associated retailer insolvency pass through event***

As part of the consultations on the NECF legislative package, SA Power Networks and other DNSPs engaged in extensive discussions with government representatives. One of the major issues discussed, concerned the adoption of a similar credit support regime to that operating in Victoria at the time. Under that regime, DNSPs were required to provide higher credit risk<sup>1</sup> (HCR) retailers with a credit allowance for 'outstanding'<sup>2</sup> distribution charges based on their credit rating. This regime did not operate in the same manner in South Australia where HCR retailers had an obligation to provide a bank guarantee or a parent company guarantee as security for the performance of their obligations.

The provision of credit allowances by DNSPs to retailers was incorporated into the NECF. This was done so that smaller retailers would face similar costs to larger retailers, thereby facilitating the entry of smaller retailers into electricity markets and promoting increased competition amongst retailers for the benefit of customers through lower electricity charges. (The fact that some smaller retailers did not enter the SA electricity market until the NECF had commenced operation, seems to evidence the fact that the credit allowance does facilitate the entry of retailers into electricity markets.) The pre-NECF requirement in South Australia that a bank guarantee be provided for three months of forecast distribution charges, did not form part of the NECF. Instead, a more limited credit support regime was introduced into the NER.

However, the adoption of the credit allowance and credit support regime in the NECF alone, would have significantly increased DNSPs' risks associated with a retailer failing, with a resultant likely loss of revenue. It was therefore agreed, as part of the initial NECF legislative package, that DNSPs would also have access to a pass through event for the failure of a retailer, and that this pass through event would not be subject to a materiality threshold. But like all pass through events, an application was of course to be subject to AER approval to ensure that the DNSP had acted prudently to mitigate its loss.

This agreement was reflected in the initial NECF legislative package<sup>3</sup> accepted by the SA Minister, except that the definition of '*retailer insolvency costs*' and the fact that a materiality threshold would not apply, were both erroneously omitted from the package, as highlighted in the COAGEC's Rule change request.

### ***A pass through event without a materiality threshold, is not unique***

There are other examples of pass through mechanisms that are not subject to a materiality threshold, and so it would certainly not be creating a precedent for there not to be a materiality threshold for a *retailer insolvency event*.

Division 9 of Part 6 of the National Energy Retail Law (NERL) enables Retailers of Last Resort (RoLR) to recover costs that they incur as a result of being a RoLR from distributors, in accordance with a RoLR cost recovery scheme distributor payment determination. A payment that a distributor is required to make under such a determination is taken to be both a *regulatory change event* and a

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<sup>1</sup> A higher risk retailer being a retailer with a credit rating below BBB-.

<sup>2</sup> Distribution charges having been invoiced and paid after the service has been provided to the customer and, in the case of residential customers, have been provided up to three months earlier.

<sup>3</sup> The NECF legislative package included the new National Energy Retail Law and associated Regulations, National Energy Retail Rules and amendments to the NEL and the NER.



*positive change event* for the purposes of the NER, and that DNSP's distribution determination (or applicable access arrangement) is taken to be amended so that those payments are determined to be a *positive pass through amount* under the NER. This pass through mechanism does not have a materiality threshold.

SA Power Networks further notes that transmission network service providers have access to a *network support event* pass through mechanism under the NER that is not subject to a materiality threshold.

We consider that the existence of these other 'no threshold' examples provide further weight to the argument that there should be no materiality threshold for a *retailer insolvency event*.

## National Electricity Amendment (Economic Regulation of Network Service providers) Rule 2012 No.9

The AEMC, as part of the *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 No. 9 (Network Regulation Rule)*, amended the definitions of '*materially*' and '*positive change event*'.

The word '*materially*', which, so far as it related to pass through events for DNSPs had previously been given its ordinary meaning, was amended to mean one percent of a distributor's Annual Revenue Requirement (**ARR**). In addition, the third limb of the definition of '*positive change event*', which had previously stated that a '*positive change event*' included a '*retailer insolvency event*', was deleted.

The AEMC provided the following reasons for setting the materiality threshold for distributor pass through events as one percent of ARR:

- the materiality threshold for transmission was one percent of maximum allowed revenue (**MAR**);
- the AER had, as a matter of practice, applied a one percent of MAR threshold when determining if a pass through event had a material impact on a distributor;
- it reduced uncertainty and reduced administrative costs for the AER; and
- it provided consistency, transparency, predictability and certainty as to when the AER would be required to consider pass through applications.

The AEMC had consulted on the question of whether a materiality threshold, where it applies to a pass through event, should be set at one percent of ARR. The AEMC did not consult on whether a *retailer insolvency event* should have a materiality threshold and, if so, whether that threshold should be set at one percent of ARR. Consequently, it is unclear why the AEMC omitted the third limb from the definition of *positive change event* that existed in the NER (ie in versions 51 and 52 of the NER) prior to the NER amendments resulting from the Network Regulation Rule.

## AEMC Consultation Paper - questions

The Consultation Paper poses some questions with respect to the fundamentals of the NECF market model behind the NECF policy decisions and the NERL/NERR drafting regarding retailer failure impacts on DNSPs. SA Power Networks considers that the broad market model provides a workable approach to this matter that appropriately addresses the matters raised by the Consultation Paper.



Further, the NECF regime was attempting to provide a balanced framework for dealing with DNSP revenue risks. This not only included the retailer insolvency pass through provisions, but also the retailer credit support regime. To consider changing the balance by revising the retailer insolvency pass through provisions to a different model than that which was always intended, would potentially fail to meet the overall intent of the NECF with respect to a DNSP's credit risk.

### **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?**

This question appears to assume, incorrectly, that the current regulatory framework was meant to apply, which is clearly not the case as detailed in the COAGEC's proposed Rule change submission. The very clear policy intent of the initial NECF legislative package, was to assign the credit risk associated with a retailer failure to customers, not to DNSPs.

Customers are enjoying the benefits of retail competition<sup>4</sup> and the innovations and lower prices that retail competition offers. These benefits are partly driven by having a range of competing retail businesses, including some with different risk profiles. The Consultation Paper notes the COAGEC's statement that the recovery of revenue foregone following a retailer's insolvency 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 supply; and
- DNSPs are restricted in the manner in which they can manage that counterparty risk, and credit support arrangements are highly prescribed.

Hence DNSPs are limited in their ability to manage the risk of retailer insolvency in that they cannot choose to limit the 'bad debt' by ceasing to supply services to a failing retailer and its customers.

In contrast, a commercial business operating in a less critical market, would have the ability to decide whether to continue to deal with a particular counterparty, have the right to cease to trade with that counterparty as soon as they formed the view that they may not be paid or that the counterparty's business was failing, and would have no constraints to promptly limit the risk faced.

If retailer credit risk was to be allocated to DNSPs, then DNSPs would need to top up/carry extra working capital. If DNSPs (and possibly entities acting in the RoLR capacity) were to approach financial markets to top up working capital, it is likely that funds would be more expensive due to the risks perceived in the electricity market. The WACC applying to DNSPs would not reflect these types of market conditions. Further, as shareholder perception drives share prices, which in turn drives the capacity to raise funds, short lead time fundraising would not be perceived as a desirable feature by those investors interested in acquiring and holding shares in DNSPs. It is therefore not appropriate for DNSPs to bear the risk of retailer insolvency.

<sup>4</sup> The increase in retailer competition was highlighted by a few retailers only entering the SA market once the requirement for a retailer to provide credit support to distributors via a bank guarantee was eliminated once NECF was adopted in SA.



The Consultation Paper recognises that DNSPs (and TNSPs) should be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing network services and complying with regulatory obligations or making regulatory payments. SA Power Networks is of the view that this is best achieved by implementing the balance of risk that was decided by the policy makers at the time of the introduction of the NECF. We therefore agree with the COAGEC in its support for this to be implemented correctly in the NER.

## **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?**

The Consultation Paper notes that the risk of retailer insolvency pre-dates the NECF arrangements so DNSPs have had to manage this risk in the past. However, in the past, each jurisdiction had a mechanism to minimise this risk with either a distributor having the ability to seek guarantees from HCR retailers or having access to a similar revenue pass through event.

In South Australia, SA Power Networks held in excess of \$25M in guarantees for unpaid distribution charges from HCR retailers prior to the implementation of the NECF which enabled it to recover revenue foregone resulting from retailer insolvency. However, following the implementation of the NECF, SA Power Networks has not been able to request any credit support as there have been no instances in which a retailer's *network charges liability* have exceeded that retailer's *credit allowance*. Consequently, SA Power Networks' risk significantly increased on the implementation of the credit allowance and credit support regime as part of the NECF which did not (as it was intended to) include a mechanism under which SA Power Networks could recover revenue foregone as a result of retailer insolvency.

The Consultation Paper makes the point that the proposed *retailer insolvency event* pass through would be the only pass through provision which allows 'revenue' rather than 'costs' to be recovered and queries whether retailer failure has any special feature which makes this appropriate. In our view, it is unclear what event other than a retailer failure would lead to a distributor revenue shortfall. Accordingly, a revenue pass through is appropriate in this case as loss of revenue is the main impact (along with the potential costs of handling the event) arising from a *retailer insolvency event*.

## **Question 3      Removal of the materiality threshold**

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



The SA Minister prepared the initial NECF legislative package. That package specified that there would be 'no materiality requirement' associated with a *retailer insolvency event*. This was highlighted in the definition of *positive change event* in version 51 of the NER<sup>5</sup> and the third limb of that definition in particular. That definition was as follows:

**"positive change event**

- (a) For a *Transmission Network Service Provider*, a *pass through event* that *materially* increases the costs of providing *prescribed transmission services*, but does not include a *contingent project* or an associated *trigger event*.
- (b) For a *Distribution Network Service Provider*, a *pass through event* that *materially* increases the costs of providing *direct control services*.
- (c) For a *Distribution Network Service Provider*, a *retailer insolvency event*."

As the word '*materially*' was not included in the third limb but was included in the other two limbs, it was clear that no materiality threshold was intended to apply to a *retailer insolvency event*.

SA Power Networks considers that the AEMC erred when it deleted the third limb from the *positive pass through event* definition. As mentioned above in relation to the Network Regulation Rule, the AEMC consulted on removing the ambiguity for the AER by defining *materially* as being one percent of ARR. However, the AEMC did not consult on introducing a materiality threshold, which did not previously exist, for a *retailer insolvency event* and what that threshold should be. Consequently, the AEMC erred when it (presumably inadvertently) introduced a materiality threshold of one percent of ARR to a *retailer insolvency event*.

#### **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?**

This matter was addressed as part of the COAGEC's consultation on the introduction of the NECF legislative package, where continuation of the previous SA and Queensland regimes were compared to the then Victorian regime.<sup>6</sup> It was concluded that the National Electricity Objective would be best achieved by introducing a Victorian type regime, which removed a barrier for retailer entry to electricity markets. This would increase retailer competition and lower prices for customers.

The Consultation Paper suggests that the credit support regime in the NER limits the financial exposure of a DNSP to the credit risk by capping the amount of debt to be recovered to the amount of the credit allowance. However, this fails to recognise that, in practice, the regime does not allow SA Power Networks to require credit support from any retailer operating in the South Australia market.

The credit support regime implemented as part of the NECF only allows DNSPs to require a retailer to provide credit support where the *network liability charges* of that retailer exceed its *credit allowance*.

<sup>5</sup> Version 51 of the NER incorporated the NER amendments associated with the SA Minister's initial NECF legislative package.

<sup>6</sup> The regime that applied to Victorian DNSPs prior to the AER Victorian Distribution Determination for the 2011 to 2015 regulatory control period.





The NER set out how *network liability charges* and *credit allowances* are calculated. Applying these calculations has resulted in there having been no instances in which SA Power Networks has been entitled to require a retailer to provide any credit support.

In addition, the NER allows retailers to operate multiple retailer authorisations under separate entities which, in turn, can result in credit support arrangements being circumvented.

SA Power Networks considers that these credit support arrangements are not a sufficient means of managing the credit risk faced by DNSPs alone. However, the cost pass through mechanism (with appropriate credit support business practices) would provide sufficient means to manage this risk as financial institutions should be willing to invest or fund the electricity assets with this assurance.

The Consultation Paper recognises that there would be a customer impact arising from amounts passed through as a result of a *retailer insolvency event* as some, or nearly all, customers would have paid for the retail services. However, all customers would have benefited from the increased retail competition and the lower prices promoted by the NECF, so it is appropriate for customers to bear the pass through impacts arising as a result of a *retailer insolvency event*.

The impact of any cost pass through event on customers would also be managed in terms of the regulated component of customer retail tariffs. In establishing the mechanism for a pass through to customers, the Australian Energy Regulator (**AER**) would assess the network price impacts and seek to spread the risk in an appropriate manner.

#### **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?**

SA Power Networks considers that customers would pay a higher overall price for electricity if recovery for a *retailer insolvency event* was undertaken through the regulatory determination process (eg by incorporating an allowance for insurance against retailer insolvency).

SA Power Networks has previously examined insurance options instead of obtaining bank guarantees from retailers to cover the credit risk for non-payment of monthly distribution charges. It was found in practice that either there were too many caveats on the insurance to ensure recovery of the lost revenue or the cost of the insurance was excessive.

In addition, recovery through the regulatory determination process would, by definition, occur regardless of whether a *retailer insolvency event* was to actually occur or not. This would increase the risk of the recovery being inefficient.

Accordingly, recovering foregone revenue and costs associated with a retailer insolvency should not, in our view, be recovered from customers through the regulatory determination process.



**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?**

As discussed above, SA Power Networks considers that the cost pass through mechanism is the appropriate approach for managing the risk of a *retailer insolvency event*. This will ensure that high costs associated with insuring against those events are not passed on to customers and, in the long term, should lead to lower electricity prices for customers as retailer competition within electricity markets continues.

**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?**

As noted by the AEMC in its Consultation Paper, the operation of an insolvency process under the *Corporations Act 2001* (Cth) would be uncertain for a DNSP in terms of the timing, and there is no guarantee that a DNSP would be able to recover its debt in full, or at all, under this process.

The Consultation Paper suggests, however, that where a DNSP is able to recover some of the bad debt arising from a retailer insolvency through corporate insolvency processes in addition to the cost pass through provisions, there is a potential that the DNSP could double recover the foregone revenue arising from that retailer insolvency.

This concern can be dealt with by the AER incorporating a mechanism in an approved cost pass through to cater for the handing back of any such amount in the next annual tariff proposal. SA Power Networks considers that the AER has sufficient powers to ensure that double recovery does not happen by using such a mechanism.

SA Power Networks considers that the pass through provisions under the NER are adequate to take into account the corporate insolvency processes.

### **Additional NER definition amendments**

The proposed changes to the NER set out in the COAGEC's Rule change request, contains the following definition of '*retailer insolvency costs*':

***"retailer insolvency costs***

Amounts a *Distribution Network Service Provider* is entitled to be paid (but which are or will be unpaid as a result of a *retailer insolvency event*) for the provision of *direct control services* including the revenue impact a *Distribution Network Service Provider* sustains or will sustain as a result of those unpaid amounts."





That definition has been proposed in order to clarify the calculation (under clause 6.6.1(l) of the NER) of the *eligible pass through amount* in relation to a *positive change event* which is a *retailer insolvency event*.

The existing definition of '*retailer insolvency event*' in the NER is as follows:

***"retailer insolvency event***

The failure of a *retailer* during a *regulatory control period*, to pay a *Distribution Network Service Provider* an amount to which the service provider is entitled for the provision of *direct control services*, if:

- (a) an insolvency official has been appointed in respect of that retailer; and
- (b) the *Distribution Network Service Provider* is not entitled to payment of that amount in full under the terms of any credit support provided in respect of that retailer."

Therefore, although the DNSP will be entitled to seek to recover revenue not paid as a result of the *retailer insolvency event*, that will only be possible if an insolvency official has been appointed.

SA Power Networks considers that it is unreasonable to limit the right to seek recovery only to situations where an insolvency official has been appointed.

SA Power Networks is also concerned that the use of the phrase which limits recovery to where an insolvency official has been appointed leaves it unclear:

- whether recovery of unpaid revenue for the period before the insolvency official has been appointed, is recoverable; and
- in situations where an insolvency official is never appointed but revenue remains unpaid (eg a failed retailer's customer base is sold to another retailer but leaves behind unpaid network revenue), whether the unpaid revenue is still recoverable through the pass through mechanism.

Our understanding is that the original policy position at the time of the implementation of the NECF, was that DNSPs should be able to recover unpaid revenue in the case of a retailer insolvency. On that basis, the current definition of '*retailer insolvency event*' which requires not only insolvency (ie not meeting financial commitments) but also the appointment of an insolvency official, limits the application of that policy.

Accordingly, SA Power Networks considers that the definition of *retailer insolvency event* should be amended to make it clear that the unpaid revenue pass through arrangements apply in respect of revenue unpaid by a failed retailer including for the period before an insolvency official is appointed, or in the event that an insolvency official is never appointed.

In addition to the proposed amendments to the definition of '*positive change event*', SA Power Networks considers that, if the COAGEC proposal is to be approved, then the definition of '*materially*' should also be amended to make it quite clear to a reader that no materiality threshold applies to a *retailer insolvency event*. This can be achieved by amending the definition to read as follows (with the proposed amendment being shown in *red and italics*):

***materially***

For the purposes of the application of clause 6.6.1, an event (*other than a retailer insolvency event*) results in a *Distribution Network Service Provider* incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the



*Distribution Network Service Provider* has incurred and is likely to incur in any *regulatory year* of a *regulatory control period*, as a result of that event, exceeds 1% of the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year*.

For the purposes of the application of clause 6A.7.3, an event (other than a *network support event*) results in a *Transmission Network Service Provider* incurring *materially* higher or *materially* lower costs if the change in costs (as opposed to the revenue impact) that the *Transmission Network Service Provider* has incurred and is likely to incur in any *regulatory year* of a *regulatory control period*, as a result of that event, exceeds 1% of the *maximum allowed revenue* for the *Transmission Network Service Provider* for that *regulatory year*.

If you have any queries or require further information please contact Mr Grant Cox on 08 8404 5012.

Yours sincerely



Seán Kelly  
General Manager Corporate Strategy

