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Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

By electronic lodgement

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Consultation Paper – National Electricity and Gas Amendments (Retailer-Distributor Credit Support Requirements) Rule 2015

Origin Energy Electricity Limited (Origin) welcomes this opportunity to respond to the Australian Energy Market Commission's (AEMC) Consultation on AGL's proposed change to credit support rules. As Australia's largest energy retailer, Origin has a strong interest in the proposed changes to credit support arrangements and the impact these changes will have upon customers and the retail energy market.

Origin agrees with the rule proponents that the current credit support rules are somewhat arbitrary with settings determined by a late change in policy, intended to promote retail competition to the detriment of cost reflectivity and market efficiency. Origin therefore welcomes the AEMC's consideration of the proposed rule change.

Origin notes that the AEMC is concurrently considering a rule change from the Council of Australian Governments Energy Council (COAG) that would have the effect of reducing the quantum of credit support required by networks by allowing networks to recover all costs of retailer insolvency through "cost pass through events". Origin understands that the two rule changes will be examined together and encourages the AEMC to ensure that final framework clearly reflects the quantum of support required by networks in light of the COAG proposed rule change.

Origin considers that the sole determinant of credit support should be the risk of retailer default. The current credit support rules are flawed as they also take into consideration the market share of a retailer in each network area.

The regulatory framework and network revenue allowance settings should be designed in concert to encourage strong commercial practices. Origin observes that normal commercial practice in the energy sector is not to require credit support arrangements from counterparties that are of investment grade standing. The current rules do not reflect this practice and so have the potential to lead to additional industry costs ultimately borne by customers.

Origin supports the proposed rule change and considers it is in the long term interests of customers on the basis that:

- it reduces ongoing costs to customers (all else being equal) while ensuring costs to customers in the unlikely event of large retailer default (passed through network charges) remain reasonable;
- it promotes market efficiency by better allocating costs to those entities responsible for the cost, aligning retailers' costs with their level of credit risk;

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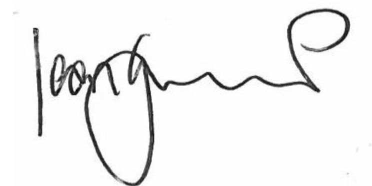
- it better reflects normal commercial practice by reducing the amount of credit support to be provided by businesses of strong financial standing;
- determines the quantum of credit support required based purely on a risk assessment relative to an investment grade retailer; and
- it promotes market stability by encouraging market entry and expansion by more financially stable entrants while avoiding material barriers to entry.

Origin notes the current rules have been drafted in a way that is open to multiple interpretations, particularly in terms of how (and how frequently) credit requirements are to be calculated. Origin encourages the AEMC to clarify the calculations to reduce the risk of dispute.

Origin responds to specific issues identified in the consultation paper in our response below. We welcome further discussion with the AEMC on any matter raised in this response.

Should you wish to discuss the contents of this response, please contact Caroline Brumby (Regulatory Strategy Manager) on (07) 3867 0863 in the first instance.

Yours sincerely



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Outlined below are Origin's responses to the specific issues raised in the Consultation Paper.

1. ASSESSMENT FRAMEWORK

1.1. Identification of Appropriate Principles

Q2: (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?

Origin broadly supports the principles identified by the AEMC in assessing appropriate credit support requirements. However, Origin believes caution should be exercised when considering the weighting given to credit support arrangements as a potential barrier to market entry relative to the need to avoid cross subsidy and encourage efficient market operation. New entrants face costs such as market set up costs, regulatory framework costs, prudential requirements and wholesale exposure that far exceed credit support costs.

To encourage participation in the retail market, credit support requirements should ensure that they are in proportion to a retailer's credit rating and outstanding network charges. Credit support rules should not seek to shift risk and cost from high risk entities to lower risk entities in order to promote market entry. The result would naturally be a higher level of risk in the market as a whole and would not be in the long term interest of consumers.

Origin believes that there are a number of other important factors the AEMC should consider when developing and assessing an effective rule for managing the risk of a retailer default for a distribution business:

- the rule should provide certainty, stability and predictability of obligations and requirements. The greater the ambiguity in the interpretation of the rules, the greater the uncertainty and potential for dispute in the market;
- the rule should support and recognise the true financial exposure of the networks from a retailer default. The incidence of retailer default to date has been low and the potential magnitude of the under recovery of network charges as a result of an event is low (in comparison to their total network charges);
- the rule should not hinder or mandate alternative means by which networks can manage their risks. The rule should support alternative solutions such as early billing or payments. Options should be available for businesses to enter into their own commercial agreements to manage their respective risks; and
- the rule should incentivise distributors to seek out the lowest cost solution for covering its credit risk and obtaining cost recovery in the event of a retailer failure including through the insolvency process and revenue cost-pass through mechanism.

In determining the most appropriate market framework for managing credit risk for a distributor, Origin would urge the AEMC to take into account the low likelihood of a major retailer insolvency event. It is to the market's detriment if customers are required to pay excessive premiums for an event which has a low probability of occurring.

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1.2. Risks & Impacts related to Retailer Default

Q3: Have all of the risks faced by distributors related to retailer default been outlined? If not, what other risks do parties face in relation to network charges due to the risk of retailer default?

Origin notes the AEMC has identified three potential risks to the distributor from a retailer default: [1]

1. cash flow risk as a result of retailers collecting network charges on behalf of the distributor;
2. revenue risk, as revenues are determined by a price cap. Foregone revenues potentially may not be able to be recovered through the cost pass-through mechanism; and
3. administration costs incurred by the distributor as a result of the retailer default. These costs may not meet the materiality threshold for a cost-pass through under a relevant network determination.

The National Electricity Rules (the Rules) (clause 6.5.10) provides for pass through events to cover unforseen expenses incurred by the distribution business. In particular, the Rules provide that a retailer insolvency event is a specific nominated pass through event and a distributor can recover its costs as part of such an event if it meets the materiality threshold.

As noted in the consultation paper, the COAG Energy Council has proposed a Rule change to remove the materiality threshold from the definitional requirements for a retailer insolvency event. This will mean that distributors will be entitled to recover foregone revenue it was entitled to for providing network services. If this Rule amendment is accepted, then the risks associated with lost revenue becomes irrelevant as distributors are able to recover accrued costs in full.

It is Origin's view that the only risk to the distributors from a retailer default is in relation to cash flow risk as a result of billing and collecting network charges on an accrued basis. Origin believes that distributors are well placed to manage a temporary cash shortfall given their strong asset base and existing funding arrangements. From previous retailer insolvency experience, a retailer of last resort would commence paying network bills for customers of the failed retailer fairly soon after the event minimising the cash flow risk to the distribution business.

1.3. Managing risk and reducing risk of non-payment

Q4:

(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?

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[1] AEMC, *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015, National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 – Consultation Paper*, 28 May 2015, p15.

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(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?

Q5:

(a) What operational decisions could retailers make to reduce the risk of their own default on payments to distributors?
(b) Would retailers undertake these operational decisions if the rule to manage the risk of retailer default did not impose a credit support requirement?

Origin understands that credit ratings are continually under review driven by market events and subject to annual reviews irrespective. Reviews may be more frequent for businesses depending on the agency that provides the credit rating. While credit support costs are potentially material for the business, it is unlikely to be the largest factor at play in determining a retailer's actions in relation to reducing the risk of default.

Energy retailers have significant funding requirements and devise their own risk management strategies to maximise value but also avoid payment default. There are strong incentives for retailers to prudently manage their operations consistent with their preferred risk and return objectives. Credit support obligations are thus likely to play a complementary role in this regard.

1.4 Purpose of Rule

Q6:

(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?

Origin believes the AEMC's summary of the relationship for credit support requirements is sound and reasonable. That is:

- retailers with equal credit ratings should provide a level of credit support in proportion to their own outstanding network charges; and
- retailers with a lower credit rating could be expected to provide a greater level of credit support as a proportion of their own outstanding network charges.

However, Origin is of the view that the risk of a distributor defaulting on payment is negligible. Distributors are likely to be only exposed to a cash flow risk and are likely to have the ability to eventually recover its costs through a pass through event (subject to the proposed COAG Rule change). Distributors have significant network assets and it is difficult to comprehend how a distributor could not obtain additional short term funding if required. Distributors often have substantial unexpected costs that are not recovered until subsequent regulatory periods. For example, ENERGEX has an $849 million[2] under recovery of revenue for the 2010-15 regulatory period which will not be passed through to customers until the next regulatory determination

[2] Made up of $477 million in Solar Bonus Scheme cost under-recovery and $372 million in network revenue under-recovery. See Energex Regulatory Proposal, pp. 212-215.

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period. Origin does not consider that a retailer insolvency should be considered any differently to other pass through events, such as the costs associated with a solar scheme.

Origin therefore suggests little weight should be placed on the additional cascading risk of network default when determining the most effective credit support arrangements for the distributors.

1.5 Changes in the calculated amount of credit support required

Q7:

(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?

As stated previously, credit ratings are continually under review for a retail business. Changes to ratings are largely driven by market events and are generally subject to annual reviews. Reviews may be more frequent for businesses depending on the agency that provides the credit rating. Credit rating can be provided by a number of different agencies with the most commonly used agencies being Standard and Poor's (S&P) and Dun and Bradstreet.

Origin notes that there are a number of circumstances, outside a retailer's credit rating, which can trigger the request for credit support from a retailer.[3] For example, if AEMO makes a claim for credit support in the wholesale market or if a retailer fails to pay three statements by the due date in a 12 month period.

These aside, the framework needs to provide operational certainty to retailers as to when and how credit support requirements can change and retailers need sufficient lead time to carry out the amendments. In particular, how often the network liability is calculated and amended. Origin supports the network liability reflecting the period of exposure for the relevant retailer and customer class rather than the use of annual average data based on historical data. This method will better represent the current situation of the retailer's network liability and reflect any seasonally relevant data. This will also ensure retailers are not providing higher or lower credit support than actually required.

1.6 Barriers to Entry

Q8:

(a) Are credit support requirements a barrier to entry or expansion for small retailers?

(b) What control do small retailers have over their credit support costs when entering the market?

(c) Would other ways of reducing a retailer's liability reduce the barriers to entry or expansion faced by small retailers?

[3] AEMC, *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015, National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 – Consultation Paper*, 28 May 2015, p6

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Origin recognises that credit support costs, like other funding requirements, pose a barrier to entry. However, experience to date, suggests these are not a significant barrier or detrimental to the development of retail competition. The market has seen new retailer entrants in recent years such as Lumo, QEnergy and Simply Energy and the AER contines to receive applications for the new retail authorisations including an application this week from 1st Energy. Origin believes AEMO's prudential requirements are likely to represent a more significant upfront cost and funding challenge for retailers than credit support requirements.

Origin does not consider that relaxing credit support requirements at a cost to other retailers and customers is an appropriate solution to reduce barriers to entry. Sound credit requirements help to protect customers from market disruptions that occur when a retailer defaults on payments to distributors. This helps to control costs to customers. The failure of retailers such as Jackgreen puts considerable pressure on the industry and is not in the long term interests of customers.

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2. ANALYSIS OF AGL's PROPOSED RULES

2.1 Balance of credit risk and impact risk

Q9:

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

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

Origin believes that AGL's proposal is an improvement over current arrangements as it:

- provides a more economically efficient outcome, better aligning costs with the risk of default;
- removes unnecessary costs to businesses that are not considered a credit risk. Under the current arrangements, businesses may be required to provide credit support when the risk of default is quite low. Credit support (ie bank guarantees) is expensive and results in a transfer of value from the energy sector to the financial services sector with an increase in customer costs;
- is consistent with commercial energy market practices whereby credit support is not required from investment grade businesses (S&P BBB- rated); and
- removes the current practice of requiring support from retailers based on market share. Given the risk of network default is low, even if a large retailer fails, there is not a case for charging a credit risk premium to retailers because they hold a high market share.

Origin agrees with AGL that these proposed amendments to the credit support market framework will promote more efficient investment, reduce overall costs to retailers of providing retail services and better align a retailer's contribution to credit support with their level of credit risk.[4]

[4] AEMC, *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015, National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 – Consultation Paper*, 28 May 2015, p11.

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3. ALTERNATIVE MECHANISMS TO ADDRESS THE RISK OF RETAILER DEFAULT

3.1 *Recovery through the regulatory determination process*

Q10: (a) What are the advantages of the regulatory determination process in terms of recovering revenue related to managing the risks associated with retailer default? (b) How does this mechanism compare to other alternatives available to distributors and/or retailers to manage risks associated with retailer default?

Origin acknowledges that network insurance (ex-ante cost recovery) could deliver additional cost certainty for customers reducing the extent of price shocks following the failure of a retailer.

However, an upfront assessment of costs for a retailer failure has a number of disadvantages. A retailer insolvency event in the energy market is unpredictable and has so many unknown variables. It would be difficult to accurately estimate the size of the retailer, the states it operates in, the number of customers (especially by customer class) or the market conditions surrounding the failure. While these costs can be estimated, the costs can be under or over recovered. Under recovery means the distributor would wear the costs and over recovery means that customers have paid a higher premium for a lower scale event. Distributors will naturally apply a premium to manage this risk.

Origin also questions the hypothesis as to whether the cost of insurance would be less than a retailer providing credit support.

Origin therefore considers that network Insurance (ex ante) is likely to lead to higher costs overall than having costs recovered by customers (ex post) in the event of a default. The level of price rise likely to accompany a retailer failure does not seem unreasonable in terms of price shock. For this reason network insurance is not supported.

3.2 Recovery through the cost pass-through mechanism

Q11: (a) What are the advantages of the cost-pass through mechanism in managing the risks associated with retailer default? (b) How does this mechanism compare to other alternatives available to distributors and/or retailers to manage risks associated with retailer default?

A cost pass through mechanism operates to reallocate a risk from distributors to their customers in circumstances where this is considered appropriate.

The regulatory framework has been established to broadly allow networks to recover costs that are beyond their control. It is therefore reasonable that they are able to recover the costs of retailer insolvency.

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Origin supports the COAG rule change proposal that no specific materiality threshold on an insolvency event should be set as:

- the notion of materiality is subjective and is difficult to define, particularly in isolation of other elements to which distributors and customers are exposed; and
- there will be a considerable cost associated with processing an application for a pass through event and one would think that distributors would not pursue this if the amount in question was immaterial. This should operate as an effective incentive to ensure only material differences become the subject of the pass through application.

For the reasons stated above, insignificant claims seem unlikely and customers are likely to pay for the actual costs of a retailer failure. It thus does not seem logical to apply a materiality threshold to retailer insolvency cost pass through applications for the distributors.

3.3 Recovery through the corporate insolvency process

Q12:

(a) What role does the corporate insolvency process play in providing a sufficiently effective and transparent means of managing retailer default?

(b) How does this mechanism compare to other alternatives available to distributors and/or retailers to manage risks associated with retailer default?

Origin supports distributors being obliged to demonstrate to the AER that they have sought to minimise retailer failure costs including through pursuing debts through the corporate insolvency process before being able to recover these through any pass through application a pass through item.

Origin acknowledges that the timing of a corporate insolvency process is likely to be protracted. However this can be addressed by ensuring networks reduce their revenue (a positive pass through event) if any default costs are subsequently recovered through insolvency action. Adjustments to a network’s revenue are commonly made as part of the ‘unders and overs’ process.

If this does not occur, customers will wear the costs of double recovery of costs.

3.4 Management of risk through the minimisation of network charges liability

Q13:

(a) What are the advantages of mechanisms to minimise a retailer's network charges liability in managing the risk of retailer default?

(b) How do these mechanisms compare to other alternatives available to distributors and/or retailers to manage risks associated with retailer default?

(c) Are there any practical considerations of developing and implementing mechanisms to minimise a retailer's network charges liability? If so, what are these considerations?

While more frequent network billing would reduce credit exposure, this mechanisms is only efficient to the extent the retailer can bill customers at a similar frequency. There is therefore a practical limit. If a distributor bills more frequently than a retailer is able to bill the customer then the retailer will incur higher working capital costs. This cost will exceed the cost of retailers carrying credit support and therefore is not likely to be in the long term interest of customers.

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3.5 Relationship between mechanisms to manage the risk of retailer default

Q14:

(a) How do the various mechanisms available to manage the risk of retailer default work to complement each other in ensuring that the risk of retailer default is managed in the most efficient manner?

(b) How should these different mechanisms be combined in a regime to manage the risk of retailer default to ensure an efficient outcome?

As set out in the consultation paper, there are a number of mechanisms for the distribution businesses to manage the financial risk of a retailer defaulting. These include requesting credit support from a retailer, through the regulatory determination process, insolvency process and recovery under the retailer insolvency cost-pass through mechanism. In particular, if the COAG Rule change is accepted, then the financial risk to the distributor of non-recovery of network charges is further reduced. It thus appears that the market frameworks adequately cover the distributors in the event of a retailer becoming insolvent.

Origin considers the credit support requirements are appropriate to cover the cash flow risk to the distributor with other regulatory risks associated with actual network losses and administration charges being covered by the cost pass through provisions.

Origin considers that credit support rules should remain as part of the risk framework as the absence of credit support requirements is more likely to encourage financially unstable entrants. This is not in the long term interests of consumers.

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