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26 November 2015

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

Lodged via www.aemc.gov.au

Dear Mr Pierce,

Reference ERC0183; GRC0032: Retailer-Distributor Credit Support Requirements – Options Paper

Simply Energy welcomes the opportunity to respond to the Retailer-Distributor Credit Support Requirements – Options Paper (the Paper).

Simply Energy is a leading tier 2 energy retailer servicing Victoria, South Australia, New South Wales and Queensland. Simply Energy operates in a highly competitive retail environment and welcomes proposals to improve credit support arrangements commensurate with risk exposures The Paper provides four options to address AGL's rule change requests (ERC0183 and GRC0032), the Council of Australian Governments Energy Council's (COAG) retailer insolvency cost pass-through rule change request (ERC0172), and Jemena's rule change request that proposes extending the COAG proposal to gas distribution (GRC0035). The Australian Energy Market Commission (AEMC) is seeking stakeholder responses to the options and its specific questions about each one. The AEMC has commissioned a report[1] from Promontory Australasia (Sydney) Pty Ltd (Promontory), which considers a range of options for managing the risk that credit support was developed to address.

In relation to the four options considered, the Promontory report makes the following linked recommendations, which Simply Energy supports:

- Implement the COAG and Jemena proposals to extend retailer default pass through provisions to include foregone revenue.
- Remove the current requirements for retailers to provide credit support to distributors.
- Introduce a requirement for distributors to maintain a committed liquidity facility.

Simply Energy supports these recommendations as a single reform package. Simply Energy does not support adoption of some individual components of this reform in the absence of related changes. Specifically, Simply Energy does not support adoption of the introduction of the committed liquidity facility without removal of the current credit support requirements.

In the event that credit support requirements are not removed, Simply Energy supports AGL's originally proposed changes to the credit support arrangements.

Additionally, Simply Energy does not support the arbitrary downgrading of Dun & Bradstreet Dynamic Risk Scores (DRS) in comparison to Standard & Poors (S&P) credit ratings. DRS scores should be available to retailers that do not have an S&P credit rating, and equivalence between the DRS and S&P ratings should be based on the default risk associated with each rating or DRS.

[1] Promontory Australasia (Sydney) Pty Ltd, Principles and Options for Managing Retailer Default Risk, Sydney, 2015

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Any departure from this approach needs to be justified by evidence relating to actual defaults of businesses that had been provided with each rating or DRS. An arbitrary adjustment in the absence of compelling evidence would further undermine the competitive environment.
Furthermore, Simply Energy considers that if changes are made to reallocate credit risk from DNSPs to customers then this should only be done if the changes ensure that customers do not pay twice for the risk. Specifically, the equity beta used to determine the DNSP return on capital should be reduced to reflect the transfer of some of the business risk (the credit risk) to customers. If this is not done the customers are likely to pay twice for this credit risk – firstly, through the DNSP return on capital and secondly, through the pass through.

The Promontory report overstates the risks posed by retailer default

Simply Energy considers that the Promontory report's summary overstates the risks posed by retailer default, which it sees as justifying consideration of costly changes such as the retailer default fund. In the body of the report Promontory concedes that there have been no experiences of retailer default that indicate that any default mechanism is likely to be used anything other than very infrequently. As a result, the risk of contagion to distribution network service providers (DNSPs) from retailer failure is a theoretical risk only. Notably, this issue has been largely explored in the AEMC's 'NEM financial market resilience' review and contagion is not considered an issue of concern for DNSPs.

Additionally, Simply Energy is not aware of any evidence that the credit risk faced by DNSPs has increased, and that the current credit support arrangements are insufficient, which would justify considering strengthening these arrangements. The current credit support arrangements have been widely consulted on and also reflect the experience of operating successfully under similar arrangements in Victoria for a number of years before the introduction of the national arrangements.

Assuming the revenue risk is addressed by pass through and 'unders and overs' processes, the remaining uncertainty that distributors face is the timing of the collection of the revenue, while the revenue impact of the timing uncertainty is addressed through provisions that take account of the time value of money. As a result, distributors affected by a retailer failure should be able to borrow money to enable them to pay their debts when they fall due, confident that they will be able to repay the borrowed money and the associated borrowing costs in due course.

Consequently, we are not aware of any 'wider risks' and 'cascading effects', and in particular we do not consider that evidence has been provided that a distributor's reliability will be impacted by failure of a large retailer. The Retailer of Last Resort provisions mean that another retailer is responsible for customers' network charges after failure of the first retailer. As well as providing consumers with continuity of supply this mechanism also provides distributors with certainty that a mechanism is in place to recover future network charges from customers of the failed retailer.

The pass through materiality threshold should be maintained

Simply Energy does not support the elimination of the materiality threshold in relation to retailer default cost (and revenue foregone) pass through. The materiality threshold is set at one per cent of a distributor's annual revenue. The materiality threshold should be retained to ensure that the costs of pass throughs (which are ultimately borne by consumers) do not exceed the benefits to consumers. Allowing distributors to incur the administrative costs (including those of the Australian energy Regulator (AER) and retailers) of non-material pass throughs is not in the interests of consumers. To conclude that removal of the materiality threshold is in the long term interests of consumers, the AEMC would need to determine quantitatively that the benefit to consumers from reduced distributor weighted average cost of capital would exceed the additional administrative costs of non-material pass throughs.

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Committed liquidity facility costs should be reflected in regulated revenues

The costs of maintaining the committed liquidity facility should be included in the distributor revenue requirement that is determined by the AER and is reflected in regulated network tariffs, rather than being recovered from each retailer individually. This is because the annual cost of the facilities (estimated by Promontory to be $15 million) is very low when compared to the total distributor revenues, such that the benefits of the incentives created by individual retailer charging are insufficient to justify the administrative costs of retailers and distributors managing a charging regime that has multiple and changing inputs.

Also, including the liquidity facility costs in the distributors' pricing proposals will enable the AER to ensure that only efficient costs of obtaining the facility are ultimately borne by customers. Gas regulations need to be amended to ensure that retailers are not required to enter into new contracts with distributors in order to cease providing credit support once the liquidity facilities are in place. Otherwise significant retailer and distributor resources will be expended developing, negotiating, and signing new contracts, solely to recognise a regulatory change.

Increased tariff change frequency is not warranted

Some of the options considered include distributors changing their network tariffs more than once every 12 months. Simply Energy does not support network tariff changes other than annually.

Network tariffs (including distributor metering charges) are approximately forty per cent of a small customer's electricity bill (once discounts are taken into account). This percentage means that retail tariffs are materially affected by most network tariff changes and as a result network tariff changes trigger retail price change events. This requires rates for thousands of tariffs to be updated that affect millions of customers across the National Electricity Market (NEM), including regulatory requirements to publish retail standing offer tariffs and update regulators' retail tariff comparison websites. The costs to retailers and regulators and the impacts on consumers outweigh any benefits to consumers of allowing more frequent distributor price changes, given the ability of distributors to recover the time value of money.

In the remainder of this submission, Simply Energy responds to the specific questions that the AEMC has raised in the paper.

If you have any questions concerning this submission, please contact James Barton on 03 8807 1171.

Yours sincerely

David Murphy
General Manager Commercial

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Responses to the questions the AEMC has raised

1. The option to retain existing arrangements

(a) What are the advantages of retaining the existing arrangements for both the credit support requirements and the cost pass-through provisions in terms of recovering revenue related to managing the risks associated with retailer default?

The pass through provisions are there to address the risk that distributors face for certain events beyond their control. A materiality threshold is required to ensure that costs are not passed on for inefficient amounts. Materiality thresholds reflect the administrative costs of preparing, assessing, and potentially approving and implementing pass throughs. These considerations apply to all sources of potential pass through including retailer insolvency.

Without a materiality threshold customers may (ultimately) bear the costs of administering a pass through process where the costs of the process outweigh the benefits of conducting it.

As regulated businesses, electricity and gas distributors actively seek to eliminate all risks to their cash flow and profitability. The current credit support rules (including the AGL proposal) reduce the risk to them of retailer default to very low or minimal levels, especially when regulated under a revenue cap or provided with a lost revenue pass-through. They need to retain some level of risk, in order to give them an incentive to effectively manage and assist in the event of a retailer default. The current cost pass through materiality threshold provides this and should be maintained.

(b) How does this option compare to the other options discussed in this options paper to manage the risks associated with retailer default?

The current rules require the provision of credit support by large retailers with very low levels of default risk. This adds cost that is ultimately borne by consumers, for no appreciable value to consumers. This is because the credit support requirement significantly exceeds the expected value of any loss that the distributor may incur, which would then be recovered from consumers. It is not in the interests of consumers to pay through their retail charges for a form of insurance that significantly exceeds the expected value of any losses.

Also, the current credit support arrangements increase the requirement for credit support as a retailer's market share increases: this acts as penalty on competitive growth and removing this disincentive is one of the improvements proposed in AGL's rule change. As a second tier retailer Simply Energy welcomes this aspect of the proposal.

A strong case can be made for the complete removal of credit support requirements: they add unnecessary costs to the customers of large retailers and act as a barrier to entry and expansion, which reduces the benefits of competition that all consumers share in.

As such, the recommended option to replace credit support arrangements with committed liquidity facilities is superior to existing arrangements.

It is unlikely that the retailer default fund and Promontory report option 2.3 (described as 'strengthening existing arrangements') provide greater net benefits than the existing arrangements, due to the high cost

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that consumers will pay each year for the default fund or option 2.3 (estimated by Promontory at $63 million to $65 million for electricity alone), and the lack of full quantification of the benefits.

2. The option to strengthen existing arrangements

(a) What are the advantages of strengthening the existing arrangements for both the credit support arrangements and the cost pass-through provisions in terms of recovering revenue related to managing the risks associated with retailer default?

It is in the interests of customers to expand the pass through provisions for price-capped distributors to include lost revenue.

Price regulation of primary distribution network services aims to provide networks with revenues that enable them to cover their efficient costs. This can be implemented by either revenue caps or price caps. In both cases the revenues do not include allowances that reflect unanticipated costs that are outside the network's control. The risk of these costs being incurred is instead taken by customers of the network, who will see higher charges through a pass-through, should such an event occur. This is considered the most efficient approach, due to the impracticality of valuing this risk and transferring it at a fair price from customers to the network business, and the concern that such a transfer may be ineffective in protecting customers from costs that are high enough to put the network business at risk.

A similar approach makes sense with respect to revenue risk (lost network revenues). Customers will pay more in the next period to recover lost network revenues under revenue cap 'unders and overs' processes, and a lost revenue pass through process (with a materiality threshold) will give similar outcomes for networks regulated under a price cap.

Simply Energy does not support changes to the existing credit support arrangements that incur costs that exceed the value of any benefits. As a result, we do not support the Promontory report's 'option 2.3'.

(b) Are there any other measures that would more effectively strengthen the retailer insolvency cost pass-through provisions and/or the retailer-distributor credit support provisions, which have not been outlined above?

The AEMC's earlier paper states that an effective rule should manage the risk of default in proportion to the retailer's share of the distributor's revenue, and adjusted for cascading risk from large retailer default. The risk to the distributor's revenue is the expected value of any loss: this is in proportion to the retailer's unbilled and unpaid network charges and the retailer's risk of default. Arrangements that reflect this risk are in the best interests of consumers. Potential cascading risks are addressed through revenue cap and lost revenue pass through provisions, and as a result it is not in the interests of consumers to increase credit support provision by large retailers for potential cascading effects.

The current regulatory requirements seek to provide a balanced way of managing the working capital requirements of the industry. These requirements require distributors to invoice retailers at reasonable frequency and provide them with payment terms that are similar to general commercial terms. Credit support requirements are included to address retailer counterparties that have been independently assessed to have a significant default risk. These arrangements are less costly for consumers than if retailers were required to pay in advance for network charges or if the payment terms extended to retailers were significantly shortened. This is due to the cost of additional retailer working capital requirements, which will ultimately be borne by consumers.

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Demand tariffs are currently used for large customers but are expected to be rolled out to small customers also, increasing the scope of the problem. Proposed small customer demand tariffs create strong seasonality in network charges for some networks. This adds complexity to credit support arrangements – either the cost and administrative burden of seasonal changes to credit support amounts, or a credit support amount that does not reflect retailer outstanding amounts.

(c) How does this option compare to the other options discussed in this options paper to manage the risks associated with retailer default?

Promontory report option 2.3 (described as 'strengthening existing arrangements') is the second most costly option considered. Table 4 of the Promontory report shows that it costs electricity customers $63 million each year. Promontory considers that option 2.3 partially addresses liquidity risk, equivalent to fifty five per cent of the benefit provided by the committed liquidity facility approach. Table 4 shows the cost to electricity customers of the committed liquidity facility approach as $15 million each year. Fifty five per cent of the benefit of this facility could therefore be valued at approximately $8 million.

Therefore option 2.3 costs electricity customers $55 million a year more than the committed liability facility approach, when adjusted for an equivalent liquidity benefit. The additional cost can be attributed to the benefits in relation to revenue risk. Table 6 of the promontory report shows that option 2.3 reduces post default costs to customers by $494 million ($891.8 million less $398.3 million) compared to the committed liability facility approach (option 4).

As a result, customers pay an additional $55 million a year for option 2.3 (compared to the committed liquidity facility approach), to reduce post-default costs by $494 million. This would only be rational if a retailer default of this scale is expected approximately once every 9 years. It is accepted in the Promontory report and also generally accepted that the risk of default of the largest retailers in the NEM has a very low probability, many orders of magnitude less than one in five. Hence option 2.3 is clearly inferior to the committed liquidity facility approach, because it adds costs that are orders of magnitude greater than the expected value of its additional benefits.

3. <u>Other credit support designs</u>

(a) What are the possible advantages or disadvantages of the other credit support designs outlined above?

The bulk of the other credit support designs outlined in the Paper are similar to the current credit support arrangements when modified by the changes proposed by AGL. For example, the New Zealand electricity and gas markets only require credit support from retailers below BBB- (S&P rating). Similarly, Alberta's electricity and gas markets reduce security deposit requirements for retailers with a BBB- (S&P rating) or above. This shows that there is a widely held view that more onerous and costly credit support arrangements (such as the Promontory report's option 2.3, with annual costs of $63 million for electricity distribution alone) are not required to deliver the best outcomes to consumers.

(b) How do these other credit support designs compare to the other options discussed in this options paper in relation to managing the risk of retailer default?

With the exception of the Australian Energy Market Operator (AEMO) requirements, the other designs considered are similar to the current credit support arrangements, modified for the AGL proposal. As such, they would be expected to provide similar results to the current arrangements with the AGL changes.

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The AEMO NEM wholesale market requirements are addressing a more significant risk than risks to distributors, because there is no 'unders and overs' or pass through mechanism to enable AEMO to obtain funds from consumers to replace unpaid amounts owed to generators. As a result, a more costly approach has more justification for the NEM wholesale market than for distributor risk of retailer default.

4. The option to establish a retailer default fund

(a) What are the advantages of establishing a retailer default fund in terms of recovering revenue related to managing the risks associated with retailer default?

Simply Energy does not support establishment of a retailer default fund. The Promontory report identifies the advantages of a retailer default fund as partially addressing revenue risk and fully addressing liquidity risk. These types of funds have a degree of popularity in risk discussions as a catch-all when eliminating risks becomes the policy driver, not maximising customer utility or market efficiency; however, they are rarely justifiable. Unfortunately they incur high costs and considerable complexity to address low-level risks. Further, it is likely to lead to wasted capital that could be better deployed in the sector to maximise benefits for consumers.

(b) How does this option compare to the other options discussed in this options paper to manage the risks associated with retailer default?

The retailer default fund is the most costly option considered. Table 4 of the Promontory report shows that it costs electricity customers $65 million each year. Promontory considers that the retailer default fund fully addresses liquidity risk, equivalent to the benefit provided by the committed liquidity facility approach. Table 4 shows the cost to electricity customers of the committed liquidity facility approach as $15 million each year.

Therefore the retailer default fund costs electricity customers $50 million a year more than the committed liability facility approach, for no greater liquidity benefit. Hence the additional cost must be attributed to the benefits in relation to revenue risk. Table 6 of the promontory report shows that the retailer default fund (option 3) reduces post default costs to customers by $240 million ($891.8 million less $651.8 million) compared to the committed liability facility approach (option 4).

As a result, customers pay an additional $50 million a year for the retailer default fund (compared to the committed liquidity facility approach), to reduce post-default costs by $240 million. This would only be rational if a retailer default of this scale is expected approximately once every 5 years. It is accepted in the Promontory report and also generally accepted that the risk of default of the largest retailers in the NEM has a very low probability, many orders of magnitude less than one in five. Hence the retailer default fund is clearly inferior to the committed liquidity approach, because it adds costs that are orders of magnitude greater than the expected value of its additional benefits.

Also, it will be difficult for the AER to put a robust process in place to provide a distributor with funds from the retailer default fund in time to meet any liquidity crisis faced by the distributor, whereas funds are immediately available under the committed facility approach.

(c) Are there any practical considerations of developing and implementing this type of retailer default fund? If so, what are these considerations?

A key implementation challenge will be for the AER to develop a robust process that releases funds to distributors in time to address a crisis.

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The main other challenges for developing this type of fund relate to governance and management of the fund. It is made up of funds that have ultimately been provided by consumers, and the governance and management of the fund must be established to ensure that the fund is run to benefit consumers. Oversight of such a fund can be a problem for regulators due to the lack of incentives for individual consumers to review the fund's operation to ensure it is operating in their interests.

(d) If a retailer default fund were established:

- *How should the size of the fund be determined?*
- *Over what period of time should the fund be built?*
- *How should the contributions into the fund be determined (e.g. based on creditworthiness, market share or some other measures)?*
- *How should the funds of the retailer default fund be replenished if the fund is called upon in the event of a retailer default?*

Simply Energy does not support establishment of a retailer default fund on any of the grounds identified thus far. Further, the AEMC has not presented a cost benefit analysis to justify the creation of such a fund.

If on the basis of rigorous economic analysis a fund is established then it should be sized to reduce to acceptable levels the risks it is targeting. The time taken to build such a fund is a trade-off between the increased charges to customers while the scheme is being built and the risk posed by an inadequate scheme during the building phase. Customer consultation will be needed to establish a sound basis for this trade-off if such a trade-off can be achieved. Simply Energy has significant doubts.

Contributions to the fund should be made in proportion to the risks that are being addressed. The risks from retailer default are proportional to the risk of default (creditworthiness) of the retailer and the scale of the retailer's outstanding distribution charges. These should therefore be the basis for contributions to the fund. However, smaller riskier retailers are unlikely to be able to make significant contributions that will enable the fund to grow and in any case their default is unlikely to create significant impacts for DNSPs. This again suggests the fund would not be fit for purpose and would need to be heavily levied on large financially sound retailers.

The funds of the retailer default fund should be replenished by the distributor who drew the funds, once the distributor has recovered its lost revenues and retailer default costs using the 'overs and unders' or pass through processes.

5. <u>The option to introduce a liquidity support scheme</u>

(a) What are the advantages of introducing a liquidity support scheme in terms of recovering revenue related to managing the risks associated with retailer default?

The Promontory report associates two risks with retailer default – revenue risk and liquidity risk. The report identifies the liquidity support scheme as fully addressing the liquidity risk. The liquidity support scheme requires each distributor to obtain a committed liquidity facility. This has the advantage of putting the means to address its liquidity risk in the hands of the distributor – it is not reliant on the AER to approve the release of funds, for example.

(b) How does this option compare to the other options discussed in this options paper to manage the risks associated with retailer default?

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The Promontory report does not consider that the liquidity support scheme addresses the revenue risk identified in the report. Therefore if the revenue risk is to be addressed then this requires other measures that complement the liquidity support scheme.

Table 4 of the Promontory report shows that the cost of the liquidity support scheme is significantly lower than the cost of the other options that the report considers to have a significant impact on liquidity risk.

It shows the liquidity scheme annual cost as approximately $15 million, whereas the retailer default fund costs approximately $65 million a year. Similarly, option 2.3 (the enhanced credit support regime) costs approximately $63 million and is considered to only provide 55% of the liquidity benefits of the liquidity support scheme.

However, it is not clear that the $15 million annual cost that the Promontory report estimates for electricity network committed liquidity facilities provides net benefits to customers, as the report does not quantify the cost to consumers of the risk that businesses will be unable to borrow efficiently against future revenue claims.

(c) *Are there any practical considerations of developing and implementing such a liquidity support scheme? If so, what are these considerations?*

Simply Energy is not aware of any practical difficulties that a distributor may face when obtaining a committed liquidity facility.

(d) *If a liquidity support scheme were established:*

- *How should the size of each distributor's liquidity support instrument be determined?*
- *How should the costs associated with the establishment fee and annual commitment fees be funded?*
- *If the establishment fee and annual commitment fees were to be collected from retailers, how should the costs be allocated amongst the retailers of that distributor?*

Each distributor's liquidity support instrument should be sized to reduce the risk, to an acceptably low level, of failure of the distributor from default of the retailer it is most exposed to.

The efficient costs relating to committed liquidity facilities (including establishment fees and annual commitment fees) should be funded from the regulated revenue provided to the distributor by the AER for provision of regulated services.

Simply Energy does not support collecting committed liquidity facility costs (including establishment fees and annual commitment fees) directly from retailers. However, if the AEMC decides that retailers should directly pay for committed liquidity facilities, then costs should be allocated amongst retailers based on the retailer's risk of default multiplied by the distributor's financial exposure to the retailer.

6. Relationship between the discussed options to manage the risk of retailer default

(a) *How do the various options discussed above, 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?*

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The Promontory report considers that there are two aspects to retailer default risk. These are revenue risk and liquidity risk. Revenue risk is the risk that the distributor will miss out on revenue that it is entitled to. Liquidity risk is the risk that it will have insufficient cash flow to meet its payment commitments.

Under all of the options considered, revenue risk is ultimately borne by consumers. Review of Table 4 and Table 6 of the Promontory report shows that the reduction in post-default costs borne by customers under options 2.3 and 3 is insufficient to justify the high annual cost of these options. As a result, revenue risk is most efficiently addressed by the 'unders and overs' process for revenue-capped distributors and a lost revenue pass through for price-capped distributors.

'Unders and overs' and pass throughs do not directly address liquidity risk. A complementary measure to address liquidity risk is the committed liquidity facility approach.

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

Simply Energy supports Promontory's recommended reform package that includes the following:

- Implement the COAG and Jemena proposals to extend retailer default pass through provisions to include foregone revenue.
- Remove the current requirements for retailers to provide credit support to distributors.
- Introduce a requirement for distributors to maintain a committed liquidity facility.

Simply Energy supports these recommendations as a single reform package. We do not support adoption of individual components of this reform, such as the introduction of the committed liquidity facility without removal of the current credit support requirements.

Also, Simply Energy does not support the elimination of the materiality threshold in relation to retailer default cost (and revenue foregone) pass through. Allowing distributors to incur the administrative costs (including those of the AER and retailers) of non-material pass throughs is not in the interests of consumers.

The costs of maintaining the committed liquidity facility should be included in the distributor revenue requirement that is determined by the AER and is reflected in regulated network tariffs, rather than being recovered from each retailer individually. Including the liquidity facility costs in the distributors' pricing proposals will enable the AER to ensure that only efficient costs of obtaining the facility are ultimately borne by customers. Additionally, gas regulations need to be amended to ensure that retailers are not required to enter into new contracts with distributors in order to cease providing credit support once the liquidity facilities are in place.

However, if the intention is to recover the committed liquidity facility costs from retailers based on creditworthiness, then this should be based on independent assessments of each retailer's default risk. Both S&P ratings and D&B Dynamic Risk Scores include a quantitative assessment of default risk, and this should be used for the creditworthiness assessment. It is not appropriate to arbitrarily down-rate the DRS in comparison to the S&P rating, as proposed in the Promontory report, unless supported by evidence of actual default rate differences for the same assessed default risk.

7. Options

(a) Are there other options for managing the risks associated with retailer default, which stakeholders feel the Commission should consider?

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Simply Energy has not investigated other options that have the potential to provide greater net benefits than the recommendation to replace credit support with committed liquidity facilities and more comprehensive lost revenue pass through arrangements.

Providing distributors with an ex ante allowance, as considered in the AEMC's earlier paper, is not in the interests of consumers. This is because the risk of large retailer default, which appears to be the focus of the review, has not occurred historically and is therefore difficult for insurers to price, and is also unable to be priced for self-insurance purposes.

This means that any ex ante allowance is likely to significantly exceed the expected value of any losses, based on retailer credit ratings and the levels of unpaid charges, given the unknowns that any insurer is faced with.

Additionally, it is unclear that providing a distributor with a self-insurance allowance for retailer default will effectively protect customers from price shocks in the highly unlikely event of a large retailer failure with 'cascading effects' on the distributor. This is because any ex ante allowances received will be dwarfed by the impact of the default, and the distributor's owners may be unable to provide the additional funding needed to manage the default. In these circumstances customers will end up bearing the costs.

This is confirmed on page 4 of the Promontory report, which states "commercial insurance is expensive and may not be readily available…self-insurance may not provide for sufficient funds when needed".

The first component of an efficient outcome is for the commercial relationship between distributors and retailers to be as close as possible to the commercial relationship that exists between businesses in competitive, negotiated outcomes.

This requires invoice periods and payment terms that are consistent with general commercial practice. Payments in advance and short invoice and payment periods are not consistent with general commercial practice. When they are used commercially it is because of high counterparty default risks.

General commercial practice also includes providing reasonable payment terms to businesses with independently-determined low default risks, such as investment grade businesses, without requiring credit support such as bank guarantees. This also reflects general commercial practice: suppliers do not expect their investment-grade customers to provide credit support.

A second component is an effective and equitable pass-through mechanism for lost revenues and increased costs due to retailer default.