23 November 2015

Ms. Ann Pearson
Senior Director
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

AEMC Reference: ERC0172, GRC0035, ERC0183, GRC0032

Dear Ms. Pearson

RE: Retailer-Distributor Credit Support Requirements Options Paper

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (the Commission) Options Paper on retail-distributor credit support requirements.

About ERM Power Limited

ERM Power is an Australian energy company that operates electricity generation and electricity sales businesses. Trading as ERM Business Energy and founded in 1980, we have grown to become the fourth largest electricity retailer in Australia, with operations in every state and the Australian Capital Territory. We are also licensed to sell electricity in several markets in the United States. We have equity interests in 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, both of which we operate.

Preferred option

ERM Power's preferred option for addressing distribution businesses' risks in the event of retailer default is option 2.1 (to implement the COAG Energy Council and Jemena Gas Networks proposals with no credit support requirement).

Option 2.1 is the lowest-cost option, while shifting all costs to post-default. This is appropriate given the low likelihood of significant retailer failure. Option 2.1 also meets the competition principle – a fundamental requirement when seeking to contribute to the long-term interests of consumers. Options that do not meet this principle are likely to establish a competitive disadvantage to a class of retailers. This in turn could reduce the level of choice for consumers, and create a barrier to entry and expansion of retail businesses in the National Electricity Market. ERM Power recommends that the Commission rejects all options which fail to meet this competition principle, as assessed by Promontory in its report for the Commission.

The basis for our choice is outlined further in the submission that follows.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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Achieving acceptable risk mitigation at lowest cost

The likelihood of retailer default has an inverse relationship with the expected level of impact to the National Electricity Market. While the failure of a large retailer could result in significant financial instability, the likelihood of this occurring is low. A small retailer is far more likely to default, however recovering its smaller financial liabilities may have an immaterial impact to the market as a whole.

Given this inverse relationship, the Commission's objective for this rule change process should be to achieve an acceptable level of risk mitigation at lowest cost. In particular, ERM Power believes options that minimise ongoing costs to consumers, while establishing effective means of recovering lost revenue post-default, should be considered.

In their report for the Commission, consultants Promontory identified that an improved level of risk mitigation could be achieved at lower cost than the current arrangements. In particular, Option 2.1, which implements the COAG Energy Council and Jemena proposals to remove credit support requirements and allows forgone revenue to be passed through, is described as providing stronger revenue risk mitigation at lower cost. [1] Promontory's modelling shows that Option 2.1 would impose the lowest ongoing costs to electricity consumers and the equal-lowest ongoing costs to gas consumers. It is appropriate for post-default costs to be significantly higher than ongoing costs, given the low likelihood of significant retailer failure. Having said this, modelling revealed that the post-default costs of Option 2.1 were at a similar level to all other options with low ongoing costs.

ERM Power believes that, on the basis of cost minimisation, Option 2.1 is a desirable option.

Impact to retail competition

Effective retail competition is recognised by the Commission as promoting the long term interests of consumers.[2] Therefore, it is imperative that the approach to managing the risks associated with retailer default do not adversely impact the level of competition in the retail market.

Retailers are expected to recover the ongoing costs of each option from their customers through their energy tariffs. However, the allocation of these costs across retailers has implications for the effectiveness of retail competition. This is because disproportionate cost allocation to one class of retailers may mean their rates cease to be competitive with other retailers' rates. This competitive disadvantage could reduce the level of consumer choice, and create a barrier to new retailers entering and expanding their businesses in retail markets. The Commission's previous work on retail competition determined that the number and range of offers, as well as the rate of market entry and expansion, are indicators of the effectiveness of competitive markets.[3]

Retail market competition will ultimately be the post-default measure for whether the costs of a given option have been allocated equitably between retailers. ERM Power therefore believes this principle should be given particular weight when assessing each option.

In particular, ERM Power does not support options 2.3 and 4.2, which allocate costs to retailers based on a measure of creditworthiness that realigns Dun & Bradstreet risk scores with Standard & Poor's ratings. The cost burden that these options place on lower-rated retailers would result in a significant competitive disadvantage compared to higher-rated retailers.

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[1] Promontory, *Principles and Options for Managing Retailer Default Risk - Final Report*, 22 October 2015, p. 10
[2] AEMC, *2015 Retail Competition Review, Consultation Paper*, 31 October 2014, p.5
[3] AEMC, *2016 Retail Competition Review, Approach Paper*, 22 October 2015, p.10

Promontory identified that only options 1, 2.1 and 4.1 meet the competition principle. Of these options, option 2.1 is the lowest cost approach, as discussed above.

ERM Power therefore recommends that the Commission implement option 2.1.

Further incentives are not required

Retail businesses have a range of strong incentives to maintain their creditworthiness and financial risks today, aside from the current credit support requirements. Creditworthiness has direct implications for a retailer's wholesale market and trading activities, and is a requirement to retain retail authorisations. These requirements determine a retailer's capacity to operate at the most fundamental level. We therefore believe that any incentive created through options to address distributors' risks of retailer default would prove negligible when compared to these existing incentives. Such incentives would not enhance retailers' risk management beyond current practises.

The incentive principle is therefore not an instructive criterion for assessing these options, and should not be a deciding factor for the outcome determined by the Commission.

Option to increase level of risk mitigation

While option 2.1 is ERM Power's preferred option, we recognise that the Commission may also seek to increase the level of risk mitigation by considering options that can also address the liquidity risk to distributors between the time of retailer default and when lost revenue may be recovered through pass-through mechanisms. Promontory found that only options 3, 4.1 and 4.2 could effectively mitigate liquidity risk.

When assessing these options against the cost-minimisation and competition criteria discussed above, option 3 is clearly an undesirable option; it is high-cost and fails the competition principle. Options 4.1 and 4.2 would result in the same ongoing and post-default costs to consumers, however only option 4.1 would ensure there is no adverse consequences to retail market competition.

ERM Power therefore concludes that, should the Commission decide not to implement our preferred option (option 2.1), option 4.1 is the most appropriate option to address risks of retailer default.