RULE CHANGE

Australian Energy Market Commission

CONSULTATION PAPER

National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015

National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015

Rule Proponent

AGL

28 May 2015

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Reference: ERC0183; GRC0032

Citation

AEMC 2015, Retailer-Distributor Credit Support Requirements, Consultation Paper, 28 May 2015, Sydney

About the AEMC

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

Contents

1 Introduction

On 19 January 2015, AGL submitted rule change requests to the Australian Energy Market Commission (AEMC or Commission). The rule change requests seek to amend the retailer-distributor credit support requirements in the National Electricity Rules (NER) and the National Gas Rules (NGR). AGL has proposed changes to the current retailer-distributor credit support requirements that, in its view, will better reflect the actual risks faced by distributors from retailer default.[1]

Under the current arrangements in the NER and NGR, credit support may be requested by the distributor[2] when a retailer's network charges liability exceeds its credit allowance. The determination of the credit allowance is a function of both the distributor's annual network charges and the retailer's credit rating, with a higher credit rating equating to a higher credit allowance.

The effect of AGL's proposed rules would be that if a retailer's credit rating from Standard and Poor's (S&P) (or equivalent) is BBB- or better, the retailer would not be required to provide any credit support to the distributor. If the retailer has a credit rating below BBB-, then credit support would be required to be paid to the distributor by the retailer so that the value at risk to the distributor would be equivalent as if the retailer was rated BBB-.

AGL's rule change requests seek to amend provisions in the NER and NGR that were implemented under the National Customer Framework (NECF). The current provisions only apply in jurisdictions that have implemented the NECF; any amendments to them will also apply only in those jurisdictions.

The Commission has consolidated the Council of Australian Governments Energy Council's (COAG Energy Council) retailer insolvency cost pass-through rule change request (ERC0172) with AGL's rule change request related to amendments to the NER.[3] They will be treated as one rule change request for the purposes of Part 7 of the National Electricity Law (NEL). The consolidated rule change request and AGL's rule change request related to the retailer-distributor credit support requirements in the NGR will be examined together in a single process to facilitate consultation and analysis of the interrelated issues.

This Consultation Paper has been prepared to seek stakeholder submissions on AGL's rule change requests.

1 Retailer default for the purposes of this consultation paper refers to a retailer who is unable to pay its debts when they fall due.

2 The NER refers to a distribution network service provider and the NGR refers to a distributor. For the purposes of this paper, the term distributor is used throughout to refer to both a distribution network service provider and a distributor as those terms are defined in the NER and NGR, respectively.

3 The consolidation was approved pursuant to s.93 of the NEL. See section 2.4 for a discussion of the current status of the retailer insolvency rule change request.

This paper:

- sets out a summary of, and a background to, the rule changes proposed by AGL;
- identifies a number of questions and issues to facilitate the consultation on the rule change requests;
- outlines the AEMC's intended process for assessing AGL's rule change requests; and
- outlines the process for making submissions.

Submissions on the rule change requests are to be received by 2 July 2015. Details on how to lodge a submission are contained in Chapter 8 of this consultation paper.

2 Background

2.1 Risk of retailer default

All businesses, whether regulated or not, face commercial risks and determine the appropriate way to manage these risks including making a decision on whether a risk needs to be managed at all. Generally, if a business determines that a risk must be managed the business will balance the costs to the business of mitigating the risk and the exposure it faces from the risk if left unmitigated. This balancing, which may be explicit or implicit, occurs as market conditions and the individual business conditions change leading the business to determine the level of risk they are willing to accept at that time.

The main commercial risk faced by distributors is the failure of a retailer to pay its network charges. The charges are for network services provided to the shared customers of the distributor and retailer.[4] Retailers collect network charges on behalf of distributors. In the case of electricity, these network charges includes both distribution and transmission charges. In the case of gas, these network charges only include distribution charges.

Distributors are reliant on retailers to collect the network charges from their shared customers. The risk to the distributor of retailer default arises due to the time lag between when the network services are provided to the shared customers and when the payment for those services is made by the retailer.

In both electricity and gas, the distributor provides connection and supply of energy services to the retail customer directly. The retailer provides retail services directly to the retail customer and collects the distribution charges from its retail customers on behalf of the distributor.[5]

As distributors operate in a regulated environment and given their monopoly position, the mechanisms available to them to manage risk are not the same as for an unregulated business operating in a competitive market. The differences arise as a result of:

- distributors' obligations to provide connection services and supply to customers;[6]

4 Shared customer is defined in the National Energy Retail Law (South Australia) Act 2011, section 2. Shared customer, in relation to a distributor and a retailer, means a person who is a customer of the retailer and whose premises are connected to the distributor's distribution system.

5 The relationships and obligations of the distributor, retailer and retail customer are set out in Appendix B.

6 National Energy Retail Law (NERL) clause 66 provides that a distributor must provide customer connection services for the premises of a customer who requests those services, and whose premises are connected (or requested to be connected) to the distributors network. This obligation is tempered slightly for gas distributors where the distributor may inform the prospective customer that it cannot provide the requested service and the reasons why the requested services cannot be provided pursuant to section 112 of the NGR.

- distributors' reliance on retailers to collect the network charges incurred by their shared customers as they are prohibited from billing small customer directly and only permitted to bill large shared customers directly with the customer's consent;[7]
- the inability of distributors to refuse to provide services to a customer or to deal with a particular retailer; and
- the inability of distributors to price or factor in the risk of transacting with retailers they perceive to be a credit risk.[8]

However, a distributor, unlike unregulated businesses, has a regulated ability to recover an efficient return on its investment, subject to the overall incentive-based approach to regulation.

The risk of retailer default can be managed either through statutory mechanisms, including cost pass-through provisions, credit support requirements and the overs and unders process under the revenue cap regime, or through commercial mechanisms, such as third-party insurance or where available, negotiation between the parties.[9]

2.2 The credit support requirements under the NER and NGR

2.2.1 How to determine if credit support is required

The credit support requirements were introduced into the rules as part of the NECF in 2011. The credit support requirements are laid out in Chapter 6B of the NER and Part 21, Division 4 of the NGR and are substantively the same for electricity and gas.

Under the NER and NGR, a distributor may request credit support but is not obliged to do so. If a distributor requests credit support, the credit support requested must be determined in accordance with the credit support provisions, must be in a form acceptable to the distributor (usually a bank guarantee), and must be provided by the retailer within 10 days of the request.

Under the current requirements, credit support may be requested by the distributor when the retailer's network charges liability (billed (but unpaid) and unbilled charges over the outstanding period) exceeds its credit allowance. The determination of the credit allowance is a function of both the distributor’s annual network charges and the retailer's credit rating, with a higher credit rating equating to a higher credit allowance. For any given credit rating, as a retailer's market share increases, all else being equal,

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7 NERL, Section 72(b) and NER 6B.A2.2 and NGR clause 504.

8 The inability to price discriminate arises as a result of the revenue cap and price cap revenue determination process.

9 Generally, negotiation is available to gas distributors and gas retailers under an access arrangement where the NECF does not apply and may include risk mitigation mechanisms such as more frequent meter reading or billing, or payment in advance rather than in arrears.

its network charges liability increases, and the amount of credit support that may be required in excess of its credit allowance would increase.

Under the current credit support rules, credit support is calculated as follows:

> Credit Support = Network Charges Liability – Retailer's Credit Allowance
>
> Where:
>
> Retailer's Credit Allowance = Credit Allowance % x Maximum Credit Allowance
>
> Maximum Credit Allowance = 25 % of the Distributor's Total Annual Network Charges

Each element that is required for the calculation of the amount of credit support required, is described below.

Maximum credit allowance: the choice of a credit support design, including the use and level of a maximum credit allowance is a policy decision. Under the current credit support requirements the maximum credit allowance is set at 25 per cent of a distributor's total annual network charges.[10] For example, if a distributor has total annual network charges of $1000, the maximum credit allowance for any retailer in its distribution area would be $250 (equals 25 per cent of $1000).

Retailer's credit allowance: is set as a percentage of the distributor's maximum credit allowance in accordance with the retailer's credit rating. The higher the retailer's credit rating, the higher the credit allowance of the individual retailer.

For example, for retailers with an S&P credit rating of A- or above, their credit allowance is equal to 100 per cent of the distributor's maximum credit allowance or 25 per cent of the distributor's total annual network charges. As a retailer's credit rating goes down from A-, so does the percentage of the maximum credit allowance they receive. The percentage that applies to that retailer is based on their risk of default compared to the risk of default of an A- rated retailer. The percentages are specifically provided for in both the NER and NGR and are set out in Table A.1 in Appendix A.

Network charges liability: is the sum of the retailer's average billed (but unpaid) and unbilled network charges for each customer class.[11] For each customer class, this is based on the average network charges over the number of days' outstanding taking into account:

10 A distributor's total annual network charges are reported to and published by the Australian Energy Regulator (AER).

11 A customer class is defined as those shared customers of the distributor and retailer for which the maximum days outstanding is the same.

- how often the meters are read (e.g. monthly versus quarterly);
- how often the distributor bills the retailer (i.e. monthly or as otherwise agreed between the retailer and distributor); and
- the length of time taken to prepare the invoice and the time the retailer has to pay the invoice.[12]

The higher the number of days outstanding, the higher the retailer's network charges liability, and all else being equal, the more credit support that may be required.

Amount of credit support required: the extent that the network charges liability exceeds the retailer's credit allowance determines the amount, if any, of credit support that the retailer would be required to provide if the distributor requested it.

An example of how to calculate the credit support required under the current requirements is included in Appendix A.

2.2.2 Other requirements of the current credit support regime

Although credit support is generally calculated as set out above, there are certain triggers under the current credit support requirements where a distributor may be able to request credit support from a retailer for the retailer's full network charges liability irrespective of the credit rating of the retailer. These triggers include:

- if within the previous 12 months the retailer has failed to pay in full:
  - charges contained within three statements by the due date;
  - charges contained within two consecutive statements by the due date; or
  - charges contained within one statement within 25 business days of the due date; or
- if AEMO makes a claim on its credit support in the wholesale market from the retailer.[13]

The rules also prescribe when a distributor may call on the credit support provided by a retailer and state that:

- the distributor must provide notice at least three business days in advance of calling on the credit support;
- there must be an amount of network charges due and payable which remains outstanding; and

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12 Average outstanding network charges are calculated in accordance with the formula set out in the NER at 6B.B2.3 and the NGR at Part 21 Section 517.

13 NER, 6B.B3.5; NGR, Part 21, Section 522.

- there is no unresolved dispute relating to the amount that must be paid by the retailer for its network charges.[14]

If these three requirements are satisfied and the distributor holds credit support, it can then call on the credit support to satisfy the retailer's outstanding network charges.

Question 1 Current credit support requirements

(a) Do distributors request credit support in all circumstances permitted under the current arrangements?

(b) If not, why not?

(c) What issues have been identified by distributors and/or retailers in the implementation of the current credit support requirements?

2.3 Other options for recovery of network charges

The credit support regime is one mechanism available to manage the risk of non-payment of network charges as a result of a retailer default.

There are other mechanisms that may be employed to recover unpaid network charges resulting from a retailer default including the regulatory determination process,[15] the insolvency process, the overs and unders process under a revenue cap process and recovery under the retailer insolvency cost-pass through mechanism.

Where the NECF does not apply, the credit support requirements for gas are set out in the gas distributor's access arrangement and reflected in agreements made under the arrangement. Although the access arrangement prescribes the maximum amount of credit support a distributor may request from a retailer, it provides the distributor and retailer some flexibility to negotiate different solutions to address the risks associated with retailer default. Some of the other mechanisms which may be available include more frequent billing, more frequent meter reading and payment in advance rather than in arrears. These mechanisms serve to decrease a retailer's network charges liability. Also, they can be used in any combination with credit support to provide protection to the distributor from non-payment of network charges while providing flexibility for the parties to determine the option that is most appropriate for them.

These options are discussed further in Chapter 6 of this consultation paper.

14 NER, 6B.B5.3; NGR, Part 21, Section 528.

15 Note: in gas issues related to the recovery of unpaid network charges would be addressed under a distributor's access arrangement rather than through the regulatory determination process. However, for the purposes of the consultation paper, the reference to regulatory determination includes mechanisms included in an access arrangement, where applicable, as well as the regulatory determination process.

2.4 Retailer insolvency event cost pass-through rule change request

2.4.1 Summary of the retailer insolvency cost pass-through rule change request

The existing cost pass-through provisions related to the electricity markets, which are found in Chapter 6 of the NER, allow a distributor to recover the costs incurred from a retailer default. These costs would be passed through to, and recovered from customers, if the costs exceeded the materiality threshold (one per cent of the distributor's revenue requirement for that year). The COAG Energy Council considers that through the operation of the current definition of a retailer insolvency event and the requirement of the costs having to exceed the materiality threshold, a distributor may not be able to recover its forgone revenue in the event of a retailer default. As such, the COAG Energy Council submitted a rule change request. The COAG Energy Council's proposed rule seeks to amend this apparent deficiency of the NER by:

- defining retailer insolvency costs as payments a distributor is entitled to receive for providing network services, but which have not been paid as a result of retailer default, which definition will allow for the collection of forgone revenue; and
- stipulating that for a distributor, a retailer insolvency event qualifies as a positive change event under the NER and therefore, no materiality threshold would apply.

The COAG Energy Council submits that the rule change request will correct an omission in the definition of retailer insolvency costs that was intended to be included as part of the NECF when it was originally implemented.

2.4.2 Current status of the retailer insolvency cost pass-through rule change request

The Commission has published a consultation paper in relation to the retailer insolvency cost pass-through rule change request and the first round of consultation has been conducted and closed on 11 December 2014. Submissions received from various stakeholders in relation to the COAG Energy Council's rule change request indicate that stakeholders see a link between the retailer insolvency cost pass-through provisions and credit support requirements and raise the issue of whether the credit support requirements under the current rules are adequate.

A summary of stakeholder submissions received on the consultation paper for the retailer insolvency cost pass-through rule change request is provided in Appendix C.

On 17 February 2015, the Commission made a decision pursuant to section 107 of the NEL to extend the period of time for making a draft rule determination for the COAG Energy Council's rule change request to 18 February 2016.

3 Summary of AGL's rule change requests

3.1 Overview of AGL's proposed rules

AGL is proposing the same changes to the retailer-distributor credit support requirements under both the NER and NGR. Under AGL's proposed rules, the concept of the maximum credit allowance is removed. No credit support would be required from retailers with an S&P (or equivalent) credit rating of BBB- or better, irrespective of the size of their market share. For a retailer rated below BBB-, credit support would be determined so that the distributor's risk-weighted exposure to the retailer's default (the effective loss) would be the same as if that retailer was rated BBB-. Refer to AGL's rule change requests for an example of the effective loss calculation.[16]

The credit support levels are based on a percentage of the retailer's total network charges liability and have been determined to equate the value at risk to a distributor for a retailer rated below BBB- to the amount that would be at risk if that retailer was rated BBB-. AGL proposes to specifically include the percentages in its proposed rules.

The percentage of the retailer's total network charges liability required as credit support as proposed by AGL are set out in Table A.5 of Appendix A.

Under the proposal, AGL is relying on the concept that the risk of default for an investment grade retailer (BBB- or better) is the level of risk that a distributor, and by consequence, a customer, is comfortable with bearing without requiring any form of credit support. As a retailer's credit rating falls below BBB-, the level of risk that a distributor would bear proportionally decreases with the increase in the risk of default of that retailer.

The network charges liability would be calculated under AGL's proposed rules in the same way as it is currently calculated under the NER and NGR.

An example of the calculation of credit support required under AGL's proposal is included at Section A.5 in Appendix A.

3.2 Rationale for AGL's rule change requests

In its rule change requests, AGL provides its rationale for the proposed changes to the NER and NGR. AGL's main concern stems from the level of the maximum credit allowance and the change in the level from 33.33 per cent to 25 per cent that was made between the time of the second exposure draft and the final version of the NECF being enacted. AGL is of the view that the change was made to increase levels of credit support overall in light of the global financial crisis and increases in the wholesale price of electricity, while maintaining the level of credit support required for retailers rated below investment grade. According to AGL, this was done in part to prevent barriers to entry and increase competition. AGL provides that the current credit

16 AGL rule change request, p.9.

support arrangements result in a shift of the burden of credit support from low-rated retailers to high-rated retailers and does not reflect the true risk faced by distributors.

AGL puts forward several arguments for why the current credit support requirements under both the NER and NGR are flawed, including that:

- The concept of a maximum credit allowance is arbitrary and not well established. The level, either at 33.33 per cent or 25 per cent, was not clearly justified.
- Credit ratings already incorporate efficient and dynamic measures of risk and so the impacts of the global financial crisis and wholesale electricity price fluctuations are accounted for and any further adjustments are not necessary.
- Credit support may be a barrier to entry and limit competition if large amounts of credit support are required from new entrants but it does not, in and of itself, promote competition and there are other more efficient mechanisms available to promote competition.
- Larger retailers cannot cross-subsidise smaller retailers under the scheme as credit support can only be drawn on in relation to the retailer who provided the credit support and as a result, the distributor's exposure to the risk of default from lower rated retailers is not reduced by requiring increased credit support from higher rated retailers.
- The relative cost of the misalignment of risks under the existing arrangement is material. The estimated costs of the difference between the existing and proposed arrangements include:
  - direct costs well in excess of $4 million per annum (representing two per cent of the value of the guarantees);
  - facility commitment fees well in excess of $3.1 million per annum (representing roughly one and a half per cent of the value of the guarantee); and
  - a reduction in funds available for re-investment in the electricity and gas markets of between $250 and $450 million.[17]

3.3 AGL's assessment of the proposed rule

AGL provides, in terms of both the National Electricity Objective (NEO) and the National Gas Objective (NGO), that the rule change requests will:

- promote efficient investment in the electricity and gas markets by freeing up capital that is currently inefficiently tied up servicing poorly targeted policy objectives;

17 AGL Rule change request, p.8.

- better align a retailer's contribution to credit support with their level of credit risk, encouraging them to make prudent decisions with respect to their payment practices and reducing risk overall, which will promote reliability of supply; and
- reduce costs to retailers of providing retail services, which will result in lower prices for consumers.

4 Assessment Framework

This chapter sets out the requirements under the National Electricity Law (NEL) and National Gas Law (NGL) that the AEMC must satisfy in considering the rule change requests, and provides a proposed approach for assessing the rule change requests.

4.1 Requirements under the National Electricity Law and National Gas Law

The Commission's assessment of the rule change requests must consider whether the proposed rules are likely to contribute to the achievement of the NEO and the NGO.

The NEO[18] is:

> "to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to-
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

The NGO[19] is:

> "to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.""

The Commission considers that the relevant aspects of the NEO and NGO to this rule change are the "efficient operation" of electricity or gas services with respect to price and reliability.[20] The principles expanded on below in section 4.3 all affect the price or reliability of electricity or gas services.

4.2 Approach

The issues raised in the rule change requests will be considered by examining the risks associated with retailer default and how the costs associated with managing these, including the possible recovery of a distributor's forgone revenue due to retailer default, could be allocated to parties in order to best promote the NEO and NGO.

18 As set out under section 7 of the National Electricity Law (NEL).

19 As set out under section 23 of the National Gas Law (NGL).

20 While there are implications for retailers, there are no changes proposed to the National Energy Retail Rules (NERR) so the rules do not have to contribute to the National Energy Retail Objective (NERO). Any impact on the retail markets is considered in the context of the "long term interests of consumers."

The rule change requests alter the mechanisms that help to manage the risk of retailer default. The proposed approach is to develop a set of principles that should be taken into consideration for an effective rule for managing the risk of retailer default. The rule change requests will be examined in light of these underlying principles, rather than just examining the impacts of the specific requests. The principles will guide the development of a rule that is in the long term interests of consumers. The range of possible rules is referred to collectively as 'a rule to manage the risk of retailer default'.

4.3 Principles for an effective risk management rule

The retailer-distributor credit support rule change requests and the retailer insolvency cost pass-through provisions rule change request affect a distributor's revenue and cash flow risks from retailer default and therefore the costs incurred by retailers and distributors to manage that risk. The risk of retailer default may cause various market participants to incur a number of costs including:

- financing or risk management cost (if required by a rule) as discussed in section 4.4.1 below;
- rate of return (due to revenue and pricing principles expanded on in section 4.4.5 below); and
- pass-through cost (if pass-through is available) and any additional network charges (through the overs and unders process for distributors with revenues determined under a revenue cap) when a retailer default occurs.

Some of these costs are incurred directly as a result of a rule to manage the risk of retailer default (for example, the cost of procuring credit support). Other costs are incurred in the (possibly rare) event of retailer default. The overall risk management cost varies with the level of risk associated with a retailer default. A rule to manage the risk of retailer default will affect how and which market participants bear the responsibility and costs of managing the revenue and cash flow risks to the distributor from retailer default.

The current credit support requirements reduce a distributor's exposure to revenue and cash flow risks from retailer default by allowing the distributor to call on credit support (where it is provided) in the event the retailer defaults. Some of the distributor's remaining exposure to revenue and cash flow risk may eventually rest with consumers:

- If the distributor's revenue determination uses a revenue cap, then the revenue forgone by retailer default may be recovered from all consumers through the overs and unders process.
- If any additional costs are incurred by the distributor as a result of the retailer default and the size of these costs are greater than the materiality threshold, these may be recovered from consumers through the cost pass-through provisions.

- If the distributor's revenue determination uses a price cap it is not clear whether forgone revenue would be recovered from the cost pass-through mechanism as expanded on in section 6.2.

The costs to the distributor are shared by all customers in its distribution area while the costs to the retailer are shared only by customers of that retailer. The overall expected long term cost to customers is based on the likelihood of retailer default and the size of each retailer's outstanding network charges as well as the implementation and ongoing operational costs of a rule to manage the risk of retailer default.

If a distributor is unable to recover forgone revenues or appropriate costs incurred as a result of the retailer default then this risk may be expected to be reflected in the regulated rate of return. The regulated rate of return should reflect the risks faced by the distributor given the regulatory framework as specified in the rate of return objective and the revenue and pricing principles, expanded on in section 4.4.5 below.

It is proposed that the following principles guide the development and assessment of an effective rule for managing the risk of retailer default:

- The rule allocates appropriate risks to the parties that have the information, ability and incentives to best manage each risk in order to minimise the long-term costs to consumers.
- The rule takes into account the risk of retailer default and the impact of default.
- The rule takes into account the trade-off between flexibility and regulatory certainty.
- The rule takes into account the impact on barriers to entry for retail businesses.
- The rule takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles.

These will form the basis of the assessment framework, explained below.

Question 2 Identification of Appropriate Principles

(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?

4.4 Proposed assessment framework

A rule for managing the risk of retailer default provides incentives for retailers to manage cash flow risk for distributors as well as protecting distributors from the potential impact of a retailer default. In assessing this rule change the Commission will, therefore, consider whether the benefits provided by these incentives offsets the cost of various alternatives to manage the risk of retailer default.

To determine whether a rule for managing the risk of retailer default, if made, is likely to achieve the NEO and NGO, the following matters may be considered as part of the assessment:

4.4.1 The allocation of risk to parties best able to manage each risk in order to minimise the long-term costs to consumers

A rule to manage the risk of retailer default changes the risk and financial impact of retailer default for distributors and customers. The risks to distributors include:

- a cash flow risk due to retailers collecting network revenue on behalf of distributors;[21]
- a revenue risk for distributors with revenues determined by a price cap if forgone revenues cannot be recovered through the cost pass-through mechanism;[22] and
- a cost risk for distributors where any costs incurred as a result of a retailer default are below the materiality threshold required for a cost pass-through.

There may also be wider risks (to a distributor's reliability) and costs if a large retailer fails due to a risk of cascading effects.

Question 3 Risks and impacts related to retailer default

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

Imposing a rule to manage the risk of retailer default creates incentives for parties to reduce the risk of retailer default and its corresponding costs. To the extent that costs vary, both distributors and retailers may be incentivised to make operational decisions that reduce their costs and the overall risk.

For example, the credit support rule may give retailers an incentive to maintain or improve, as far as possible, their credit rating in order to minimise credit support requirements and costs as well as an incentive to avoid default and the consequences that are incurred if a distributor draws upon a defaulting retailer's credit support. Similarly agreements between gas distributors and retailers may include provisions that provide both parties with an incentive to reduce exposure to the risk of retailer default. For instance, they may negotiate to bill or pay in advance, thereby reducing the

21 As discussed in Appendix B.

22 While a distributor with revenues determined by a revenue cap may also be unable to recover forgone revenue through the cost pass-through there is no revenue risk because revenue could alternatively be recovered eventually through the overs and unders process.

amount of credit outstanding and, as a result, reducing the need for a mechanism such as credit support.

If riskier retailers face higher costs than less risky retailers, due to a rule to manage the risk of their default, this would impact a risky retailer's profitability and prices. This may incentivise consumers to choose less risky retailers and incentivise retailers to reduce their risk of default.

However, the costs to consumers of a rule to manage the risk of retailer default will only reduce over time if the party bearing the cost has the information and ability to manage its risks and reduce its costs. Mechanisms that could reduce the risk of, and the distributor's exposure to, retailer default may include:

- a retailer's credit rating;
- the ability for customers to choose their retailer; and
- the period of outstanding network charges.

Efficient outcomes are promoted when risks and corresponding costs are borne by the party with the greatest control over the risk and the information required to make prudent operational decisions. If risks are allocated appropriately, market participants have the incentive and ability to make operational decisions that reduce the overall risk of default and the expected cost of retailer default including any implementation costs as a result of the rule.

Question 4 Management of risk to reduce costs

(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?

(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?

When a party is required to manage the risk of retailer default there are additional costs for managing those risks. In the case of credit support, this is the margin imposed by a credit provider, or in cases where businesses manage the risk themselves, this could be the cost of self-insurance. While a credit support regime provides incentives for retailers to reduce risks and costs, the risk management cost incurred may be substantial. Furthermore, retailers and distributors could also incur substantial administrative costs to meet any regulatory obligation to manage the risk of retailer default. An effective rule should aim to minimise the overall long term costs of retailer default including taking account of any additional risk management costs, administrative costs and incentives to reduce costs over time.

Alternatively, a regime with no credit support requirement may also carry costs for all consumers, in the event that a retailer defaults, via the cost-pass through mechanism, the overs and unders process or the effect of revenue and pricing principles.[23] The expected cost of default in the long term would be based on the likelihood of retailer default and the size of each retailer's outstanding network charges.

Irrespective of any rule to manage the risk of retailer default, the retailer also already has a number of incentives and obligations to prudently manage its payments and avoid default. To the extent that these incentives already encourage a retailer to avoid defaulting on network charges, the incentives imposed by a rule for managing the risk of retailer default may offer little additional incentive to change operational decisions.[24] As a result, any rule may simply impose ineffective incentives and unnecessary costs on consumers.

The assessment should consider the trade-off between the long term cost to consumers from retailers managing those risks (including the incentives to reduce risks over time) and the expected costs to consumers bearing the impact of retailer default via the pass-through mechanism, overs and unders process or the effect of the revenue and pricing principles. While it is difficult to quantify the long-term outcomes, this principle would be considered on the basis of the expected costs of a rule to manage retailer default, including the likelihood and impact of default and the extent of retailer's incentives and ability to reduce costs under various rule alternatives.

Question 5 Reducing risk of non-payment

(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?

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23 As discussed in section 4.4.5.

24 Among other incentives, retailers have to meet certain requirements to register as an electricity retailer and to maintain their registration, as well as incentives to avoid default in their wholesale market activities. These incentives already encourage the retailer to make operational decisions that maintain a satisfactory credit rating and avoid default. A rule to manage the risk of retailer default may have limited additional impact on a retailer's operational decisions.

4.4.2 The risk of retailer default and the impact of default

The current credit support requirements aim to protect distributors' cash flow and/or revenue risk against both the risk and impact of retailer default as discussed in section 4.4.1 above.

A small retailer with a higher risk of default may have a small impact on a distributor's cash flow but the probability of default is considerably higher. Therefore, the expected cost of a default event is also considerably higher than for a similarly sized retailer with a low risk of default.

Alternatively, a large retailer would have a large impact on a distributor's cash flow if a retailer default were to occur. Therefore, the expected cost of a retailer default could also be considerably high, even if the probability of its occurrence is very low.

Both of these would suggest a straightforward relationship for credit support requirements:

- 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.

A prudent and efficient network business may also have an aversion to any cascading risk from a large retailer default. A distributor that has a large portion of its revenues from a single retailer may face a cascading risk that if the large retailer were to default, any delay or inability to recover revenue might risk the network business also defaulting on other payments. This could be a substantial risk for distributors such that there could be additional costs in order to avoid the cascading risk of the distributor defaulting on payments in the event of a large retailer default as raised in the AEMC's NEM financial market resilience review.

Overall, an effective rule to manage the risk of retailer default should consider protection for the distributor against the risk of retailer default:

- in proportion to each retailer's share of a distributor's revenue; and
- adjusted for any additional cascading risk from a large retailer default.

Question 6 Purpose of Rule

(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?

4.4.3 The trade-off between flexibility and regulatory certainty

As discussed in Chapter 2 and explored further in Chapters 5 and 6, changes in credit support requirements may be triggered by changes in a retailer's credit rating or market share.

A rule for managing the risk of retailer default is able to accurately reflect changes in the underlying risk of retailer default faced by market participants if a retailer's obligations change with the retailer's liability. The benefit of this flexibility allows a retailer to provide the distributor with only a level of protection that is necessary to protect the distributor against the risk of the retailer's default, meaning consumers are not paying more than necessary. For example, a retailer's activity in the wholesale market can lead to large swings in a retailer's outstandings in that market and frequent recalculation of the retailer's prudential requirements. While this volatility may lead to costs and risks faced by retailers, the requirement relatively accurately reflects the wholesale market's exposure to that retailer's activities.

Despite the benefits of a flexible rule for managing the risk of retailer default, the frequency of any change in requirements for retailers also incurs an administrative cost for both retailers and distributors and can increase uncertainty for market participants. This uncertainty could also lead to costs for market participants to manage a risk that credit support requirements could change.

A rule that provides a retailer with certainty in its obligations reduces the administration cost for a retailer but may mean that the protection provided by the rule does not reflect the underlying risk of retailer default that is actually faced by a distributor.

An effective rule to manage the risk of retailer default, should consider balancing the benefit provided by flexibility against the cost of volatility in credit support obligations.

Question 7 Changes in the calculated amount of credit support required

(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?

4.4.4 The impact on barriers to entry in the retail market

Costs imposed by a retailer's entry to a market may deter some retailers from entering. While these costs may be considered barriers to entry, it may be appropriate for a retailer to bear those costs if it leads to retailers making better decisions about whether to enter the retail market.

For instance, if the cost imposed by a rule to manage the risk of retailer default is an accurate reflection of the riskiness of the retailer (and therefore the costs imposed on consumers if the retailer defaults), then this may be considered an appropriate cost for the retailer to incur in order to protect consumers from unnecessary costs. Imposing such costs may also lead retailers to take actions that reduce their riskiness in order to minimise their cost of entry.

If the cost imposed by a rule to manage the risk of retailer default is higher than an accurate reflection of the riskiness of the retailer, then further entrants may be deterred from entering the market and consumers could pay more than necessary for energy services. Alternatively, if the costs of a rule to manage the risk of retailer default were lower than an accurate reflection of the riskiness of the retailer, thereby not discouraging risky retailers from entering the market, this could impose greater risks than necessary on distributors and greater costs than necessary on consumers.

A small business may face difficulties in understanding and credibly communicating its creditworthiness.[25] If a rule to manage the risk of retailer default imposes costs on small retailers based on their credit rating, these businesses may incur higher entry costs than necessary for the risks imposed by their entry because financial market participants may perceive small retailers as riskier than they actually are. Therefore, the ability to obtain credit may sometimes unnecessarily disadvantage small businesses that would otherwise be able to enter the market without imposing additional risks on the distributor or consumers.

Small retailers may also face other significant hurdles to enter the retail market, beyond any rule for managing their default, such as licensing or requirements for participating directly in the wholesale market. After overcoming these hurdles, a small retailer may not face this same problem or to the same extent. Even so, requirements for small firms to procure finance to cover an entrant's liabilities with distributors, might disadvantage small businesses entering the retail market.

Not all entrants to energy retail markets are small businesses. For example, many entrants to the retail electricity market are branches of large generators and entrants to the retail gas market are often an expansion of a business's existing energy market activities. The cost of credit for these large businesses, who are able to credibly communicate their creditworthiness and procure sources of financing at a cost that reflects the risks imposed by their entry, should still be considered an appropriate cost of entry.

25 This type of problem is commonly referred to in the economics literature as the "market for lemons".

An effective rule for managing the risk of retailer default should consider the trade-off between unnecessarily subsidising appropriate entry costs for large businesses newly entering a retail electricity or gas market and not disadvantaging small businesses without the ability to gain a credit rating that is an accurate reflection of the risks imposed by their entry.

Question 8 Barriers to Entry

(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?

4.4.5 The impact on consumers of changes in network revenue as a result of the revenue and pricing principles

Any change to the rules for managing the risk of retailer default could change the costs and risks faced by a distributor. As a result, changes to these costs and risks could affect the AER's determination of a distributor's revenue. Section 88B of the NEL and section 293 of the NGL require the Commission take into account the effect of the revenue and pricing principles.[26] The revenue and pricing principles are contained in section 7A of the NEL and section 24 of the NGL. Two of these principles (subsections 2 and 5 of section 7A of the NEL or section 24 of the NGL) are relevant to consideration of a rule for managing the risk of retailer default.

Firstly, networks should be provided with a reasonable opportunity to recover at least the efficient costs in providing services and complying with regulatory obligations. Therefore, the distributor should be allowed to recover the costs of a retailer default and forgone revenue or any prudent operating costs (that an efficient operator may require) as a result of managing any remaining cash flow or revenue risk.

Secondly, if any risks remain after accounting for efficient operational decisions then this risk could be expected to be considered when estimating the regulated rate of return.

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26 This applies to rule changes for any matter contained in items 15 to 24 and 25 to 26J of Schedule 1 the NEL and items 40 to 48 of the NGL. These generally refer to the AER's regulation of revenues, prices and investment by electricity transmission and distribution or gas transmission and distribution.

5 Analysis of AGL's proposed rules

This chapter provides an assessment of the changes in credit support requirements and distributor exposure to retailer default that would occur through the changes proposed in AGL's rule change requests.

5.1 Comparison of retailer credit support requirements

The effect of credit support on the distributor is to limit the financial exposure it faces to credit risk associated with retailer default by capping the amount of the debt to be recovered to the level of the credit allowance. This limits the extent of losses that will either be absorbed or recovered by the distributor.

The determination of the level of the credit allowance has implications for the allocation of the costs of managing the risk of retailer default between the retailer and the distributor.

The proposed changes to the credit support requirements would alter the level of the credit allowance provided to retailers of different credit ratings and market shares. These changes to the credit allowance would impact the amount of credit support required of retailers, which may shift the costs of managing the risk associated with retailer default between retailers and distributors.

Figure 5.1 provides a graphical representation of the level of credit support required to be provided under the current arrangements from a retailer with 90 days' of outstanding (billed (but unpaid) and unbilled) network charges.[27] The graph reflects the amount of credit support required per $1000 of a distributor's annual network charges.

It can be seen that a retailer with an A- credit rating, with 90 days' outstanding network charges, would not have to provide any credit support, even at 100 per cent market share. Credit support then increases with lower credit ratings and also increases linearly with market share.

27 For the purposes of this consultation paper, the following assumptions have been made in relation to the calculation of the number of days outstanding: (1) the retailer only serves residential customers whose meters are read by the distributor every 90 days; (2) the distributor bills the retailer every 30 days, in respect of the customers' meters the distributor read over the preceding 30 days; and (3) the retailer has 30 days to pay the distributor's invoice. It is recognized that by using 90 days outstanding, other customer classes, meter reading and billing intervals are not taken into consideration.

Figure 5.1 Credit support requirements at 90 days outstanding

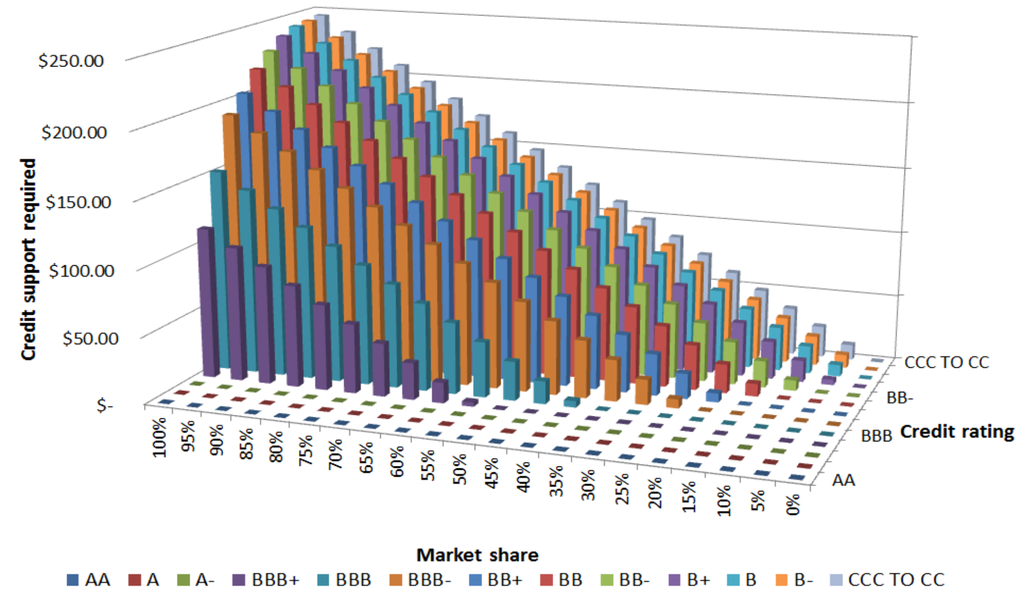
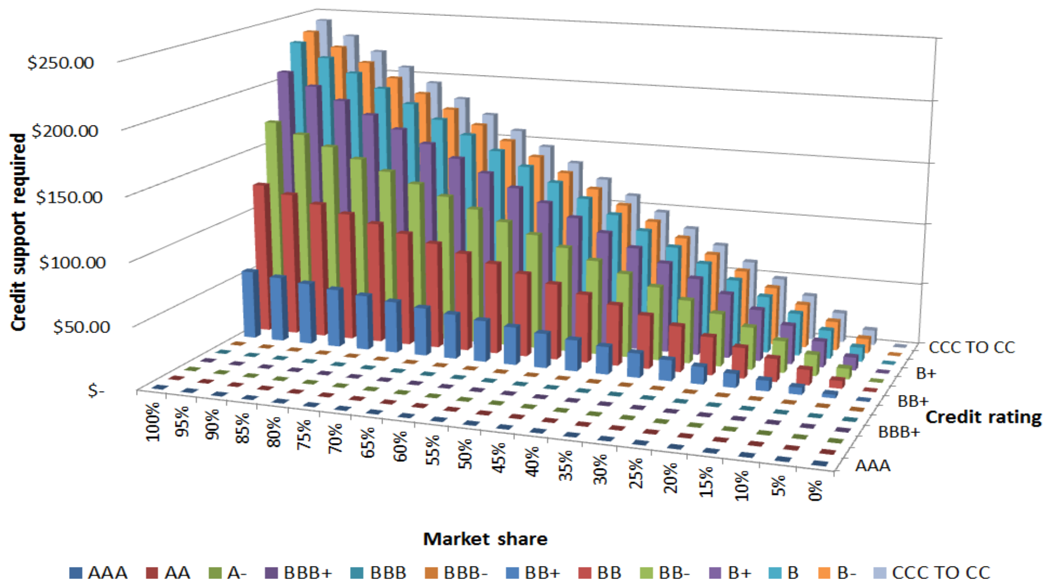


Figure 5.2 provides a similar representation of credit support requirements under AGL's proposed rules. The graph reflects the amount of credit support required per $1000 of the distributor's annual network charges.

Figure 5.2 Credit support requirements at 90 days outstanding under AGL's proposed rules



There are a number of observations that can be made from a comparison of the credit support requirements under the current arrangements and AGL's proposed rules:

- For retailers rated A- and above, both the current arrangements and AGL's proposed rules do not require credit support and so there is no change in the allocation of risk management costs between retailers and distributors.

- For retailers rated BBB-, BBB or BBB+, AGL's proposed rules increase the exposure of the distributor to retailer default, as these retailers would no longer be required to provide credit support at any market share.

- For retailers rated below BBB- with market share up to 20 per cent, the proposed rules reduce the exposure of distributors to retailer default by increasing credit support requirements in comparison to current arrangements.

- For retailers rated below BBB- with market share greater than 20 per cent, the proposed rules increase the exposure of distributors to retailer default by decreasing credit support requirements in comparison to current arrangements.

5.2 Effect of retail market composition

AGL's proposed rules have the potential to change the level of credit support required to be provided by retailers according to their credit rating and market share. Figure 5.3 through to 5.6 show credit support obligations for small and large retailers under the current and proposed rules as a percentage of each retailer's annual network charges.[28] Credit support as a percentage of a retailer's annual network charges indicates the burden that credit support places on retailers in terms of each retailer's individual liability to the distributor.

Figure 5.3 compares the credit support that can be required under the current requirements and AGL's proposed rules for a retailer with a 30 per cent market share. It can be seen that the reduction in credit support required from large retailers under AGL's proposed rules is relatively small in aggregate and especially where the retailer's credit rating is below BB-.

Figure 5.3 Comparison of credit support requirements for large retailer

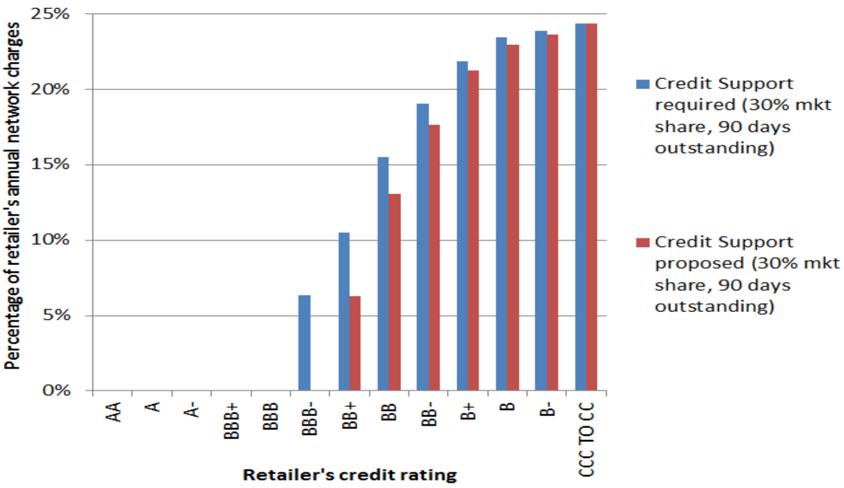
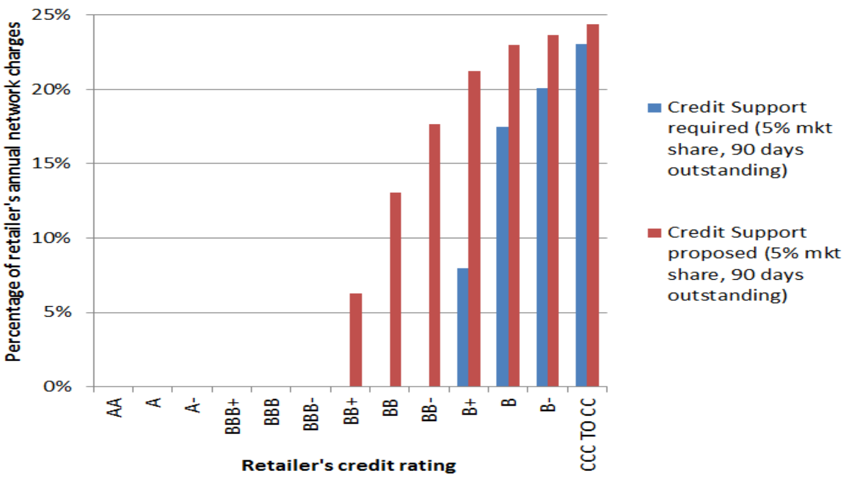


Figure 5.4 compares the credit support requirements for a small retailer with a five per cent market share under the current requirements and AGL's proposed rules. It can be

28 Assuming that the distributor has an average of 90 days' outstanding network charges with each retailer.

seen that the amount of credit support required from small retailers under AGL's proposed rules is substantially increased in comparison to the credit support required under the current requirements. Further, as a percentage of the retailer's total network charges liability, the reduction in the burden of the credit support required from large retailers is relatively small in comparison to the potential increase in the burden associated with the credit support required by small retailers under AGL's proposed rules.

Figure 5.4 Comparison of credit support requirements for small retailer



The change in the level of credit support required to be provided by different retailers has an impact on the costs to the various retailers of providing credit support and the exposure of distributors to retailer default. As discussed in section 4.4.2, the current credit support requirements protect distributors' cash flow against both the risk and impact of retailer default.

Figure 5.5 shows that the current credit support requirements place a relatively large obligation on retailers with a large market share (30 per cent and over) to provide credit support. The current credit support requirements relate the credit support required to both market share and creditworthiness (only once a retailer has reached a certain market share).

Figure 5.5 Credit support requirements under the NER and NGR

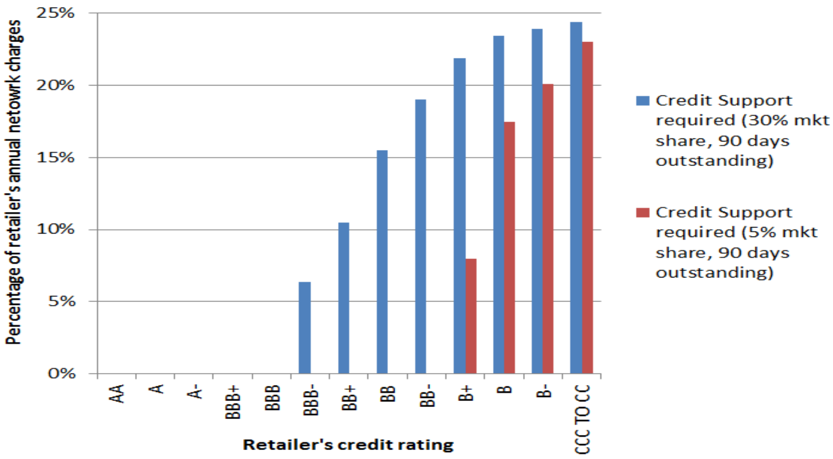
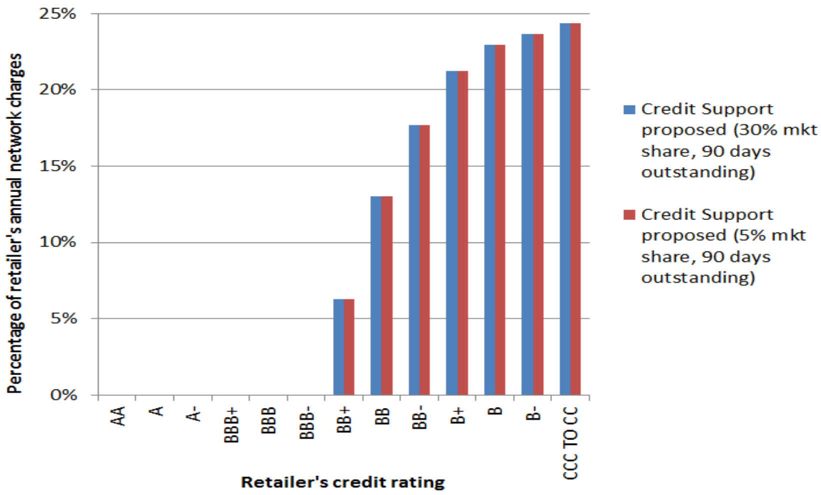


Figure 5.6 shows that AGL's proposed rules would align retailers' obligations to provide credit support purely on the basis of their credit rating using BBB- as the baseline measure for creditworthiness. Under AGL's proposal the credit support requirements no longer take account of a retailer's market share in determining if credit support may be required.

Figure 5.6 Credit support requirements under AGL's proposed rules



The consequent impact on distributors from AGL's proposed changes will therefore depend on the composition of retailers (both in terms of market share and credit rating) on their respective networks.

Question 9 Balance of credit risk and impact risk

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

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

6 Alternative mechanisms to address the risk of retailer default

As discussed in section 2.3, the credit support requirements are one mechanism available to manage the risk of non-payment of network charges as a result of retailer default.

While credit support reduces the exposure of the distributor to non-payment by retailers, distributors that are subject to a revenue cap arrangement are effectively able to recover forgone revenue from customers through the adjustment of prices to meet the maximum allowed revenues determined by the AER.

Distributors under a price cap arrangement do not have this option and must absorb the revenue loss in the event of retailer default. However, there are other options available to distributors for managing risk and/or recovering losses following a retailer default.

This chapter provides a discussion of each of these options. In each case, the AEMC welcomes stakeholders' views on the effectiveness of the approach in addressing the risk of retailer default, and the extent to which the approach meets the principles for an effective risk management rule that are set out in Chapter 4.

6.1 Recovery through the regulatory determination process

One method to manage the exposure to retailer default is by incorporating some consideration for the risk into distributors’ allowed revenues through the regulatory determination process.

Where a distributor elects to purchase commercial insurance against the financial impact of a retailer default, the cost or premium paid for this insurance could be incorporated into the distributor’s operating expenditure forecast and the AER, as part of its regulatory determination, would make a decision on whether the expenditure would be an allowable cost.[29]

The effect of commercial insurance would be to transfer the risk from the distributor, as policy holder, to the insurance company which may be better able to manage the risk by pooling it with the risks of other policyholders, and by holding appropriate capital reserves.[30]

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

30 Frontier Economics, *Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia*, July 2013, p.45.This report is available at: http://www.aer.gov.au/sites/default/files/Frontier%20Economics%20-%20Assessing%20risk%20when%20determining%20the%20appropriate%20rate%20of%20return%20-%20July%202013%20-%20Draft%20rate%20of%20return%20guideline.pdf

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

Under a self-insurance regime, the risk would remain with distributors, with the intention that the money collected would be ring-fenced until such time as a retailer default occurs, after which it may be drawn down to cover the costs incurred.[31]

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

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

The AER has also considered it to be necessary for the particular risk to have been historically incurred, in order to be able to use the commonly accepted method of calculating self-insurance premiums.[32]

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

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

31 Frontier Economics, *Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia*, July 2013, p.55.

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

inclusion in total revenue may result in users paying higher prices than necessary.

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

Question 10 Recovery through the regulatory determination process

(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?

6.2 Recovery through the cost pass-through mechanism

An alternative to managing the risk of retailer default through the regulatory determination process is to use one of the revenue adjustment mechanisms provided for in the NER or NGR.

Actual revenue for a distributor may deviate from its expected regulated revenue due to the occurrence of exogenous events that are not within the reasonable control of the distributor. The regulatory framework and/or access arrangement makes provision for managing the impact of uncertain exogenous events on revenues through different adjustment mechanisms, depending on the nature of the event. These mechanisms include contingent projects, capital expenditure re-openers and cost pass-throughs.[33]

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

Under the current retailer insolvency cost pass-through provisions, a distributor is able to seek recovery of increases in costs from a retailer default (not forgone revenue), where the costs exceed the materiality threshold of one per cent of the relevant distributor's revenue requirement for that year. If the distributor's application for a cost pass-through is approved, the increase in costs incurred by a distributor arising from the retailer default is passed through, and recovered from, customers in the form of increased prices.

The COAG Energy Council has submitted a rule change request in relation to the retailer insolvency cost pass-through provisions in the NER. The proposed rule change would remove the materiality threshold and allow distributors to claim forgone

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

revenue (ie unpaid network charges) as part of the retailer default. The proposed rule seeks to amend the existing cost pass-through provisions in the NER to clearly accommodate retailer insolvency events and allow distributors to recover all costs and unrecovered revenues resulting from a retailer default.

The AEMC has consolidated the COAG Energy Council's rule change request as part of its assessment of AGL's rule change request on retailer-distributor credit support requirements under the NER.

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

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

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

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

Question 11 Recovery through the cost pass-through mechanism

(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?

6.3 Recovery through the corporate insolvency process

In addition to recovery processes under the NER and NGR, a distributor that is unable to collect unpaid network charges owed to it by an insolvent retailer may join a general corporate insolvency procedure as an unsecured creditor under the *Corporations Act 2001 (Cth)*[34].

The recovery of debt that is not secured depends on a number of factors including whether there is money available to make any payments at all, or whether there is a specific order of payments that must be followed. Where a distributor's claim sits in the order of creditors will affect its entitlement to payment.

The NER and NGR require that the amounts that the distributor is likely to receive on the winding up of the insolvent retailer are to be excluded from the eligible pass-through amount approved by the AER as a cost pass-through.[35] Beyond this, there is very little guidance as to how the timing of, and recoveries under, these separate processes are to be reconciled.

The operation of an insolvency process would be uncertain for a distributor in terms of the timing and extent of recovery of money owed. There is no guarantee that it would recover its debt in full or at all. If, for example, the retailer enters into liquidation, payment of the liquidator’s fees and costs and payment to priority creditors, employees and secured creditors are prioritised before the remaining monies are distributed to unsecured creditors. Each category of creditor is paid in full before the next category is paid.

The insolvency process is a discrete statutory process that would proceed on a timetable independent of the NER or NGR. It is therefore possible that the lodgement and assessment of a cost pass-through application may be commenced, and completed in accordance with the NER or NGR, independently of any insolvency process.[36]

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

This raises the question of whether there is potential for a distributor to double recover the unrecovered revenue or costs arising from a retailer default.

34 The distributor may join a general corporate insolvency procedure as an unsecured creditor under the Corporations Act 2001 (Cth) when it is owed money by an insolvent retailer (a retailer is considered to be insolvent when it becomes unable to pay its debts when they fall due for payment). The precise details of the various insolvency procedures under the Corporations Act 2011 are outside of the scope of this consultation paper.

35 Clause 6.6.1(1) of the NER and Part 21; section 531 of the NGR.

36 See clause 6.6.1 of the NER and Part 21, section 531 of the NGR.

Question 12 Recovery through the corporate insolvency process

(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?

6.4 Minimising a retailer's network charges liability

A potential alternative to managing the distributor's exposure to a retailer through the provision of credit support may be to reduce the retailer's network charges liability through more frequent billing or the retailer paying its network charges in advance.

A retailer's network charges liability with respect to a given distributor is based on the distributor's estimate of the retailer's average billed (but unpaid) and unbilled network charges across the retailer's customers served by that distributor. For each customer class, this is based on the average network charges over the number of days outstanding taking into account:

- how often the meters are read (eg monthly versus quarterly);
- how often the distributor bills the retailer (ie monthly or as otherwise agreed between the retailer and distributor); and
- the length of time taken to prepare the invoice and the time the retailer has to pay the invoice.

The higher the number of days' outstanding, the higher the retailer's network charges liability, and all else being equal, the more credit support that may be required to reduce the distributor's exposure to the risk of the retailer defaulting on its payment obligations.

An increased frequency of billing would have the effect of reducing credit risk by decreasing the time lag between the provision of network services to shared customers and the payment of revenue by the retailer. There are two different mechanisms that may be implemented in relation to frequency of billing to reduce the credit risk. The first relates to how often the distributor bills the retailer. Currently, a distributor must bill a retailer every 30 days but may bill more frequently with the retailer's consent. In both electricity and gas, there appears in practice to be some circumstances where a distributor bills a retailer more frequently than monthly, however, this alternative is only available when both parties are in agreement to the more frequent billing interval. The second mechanism relates to the frequency upon which the distributor determines the usage data for its shared customers with the retailer. The frequency could be reduced and therefore, the number of days outstanding reduced, if the meter is read more frequently. Alternatively, monthly usage could be based on estimates that are reconciled at a later time when the meter is read, which is undertaken quarterly for most small customers.

Alternatively, if a retailer, based on an estimate of its network charges, paid in advance rather than arrears, its network charges liability will be reduced to almost zero. This would reduce the risk faced by distributors to the difference between the actual and estimated network charges incurred by the retailer.

These options would require greater cash liquidity on the part of the retailer to fulfil its payment obligations, which may have the effect of increasing costs to the retailer. However, a greater frequency of billing or a retailer paying in advance would not suffer from the potential inefficient costs that may arise through incorporating potentially inaccurate ex ante estimations of the cost of retailer default in regulatory determinations. It would also potentially minimise the cash flow risk associated with other forms of revenue recovery processes in the NER or NGR where the cost of retailer default may not be recovered until some time after the event.

Question 13 Management of risk through the minimisation of network charges liability

(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?

Question 14 Relationship between mechanisms to manage the risk of retailer default

(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?

7 Process for the consideration of the rule change requests

AGL's rule change proposals related to the retailer-distributor credit support requirements for the NER and NGR are being considered in a single process. The issues raised in the rule change requests have been found to be sufficiently complex and as a result, the Commission has determined that the standard time frames prescribed in the NEL and NGL should be extended in relation to the rule change requests.[37]

In addition, the Commission has consolidated the retailer insolvency cost pass-through rule change request with AGL's retailer-distributor credit support rule change request for the NER.[38]

Consultation will be of importance throughout the process given the complexity of the issues and the opportunity for a material financial impact on stakeholders based on the outcome of the assessment of the rule change requests.

The Commission intends to prepare and publish an options paper for stakeholder comment prior to the preparation of the draft determination. In addition, at least one public forum will be held prior to the publication of the draft determination to discuss, among other things, the various options being considered as part of the options paper process.

On this basis, the time frame for publishing of the draft determinations for the retailer-distributor credit support rule change requests has been extended to 18 February 2016.

In addition, the issue of the adequacy of the current credit support regime was raised both in the response to the consultation paper on the retailer insolvency cost-pass through rule change request and as part of the AEMC's National Energy Market (NEM) financial market resilience review. In response to submissions received relating to the adequacy of retailer-distributor credit support requirements, the Commission indicated that the issues raised would be more appropriately addressed through the rule change process related to AGL's rule change requests. As such, any submissions received as part of the NEM financial market resilience review will be considered as we move forward through this rule change request process.

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37 National Electricity Law, section 107; National Gas Law, section 317.

38 The Commission has made a decision pursuant to s.93 of the NEL, that it is necessary or desirable that the retailer insolvency cost pass-through rule change request and AGL's retailer-distributor rule change request for the NER be dealt with together and treated as one request for the purposes of Part 7 of the NEL.

8 Lodging a submission

The Commission invites written submissions on this rule change proposal.[39] Submissions are to be lodged online or by mail by 2 July 2015 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on rule change proposals.[40] The Commission publishes all submissions on its website subject to a claim of confidentiality.

All enquiries on this project should be addressed to Shari Boyd on (02) 8296 7800.

8.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code "ERC0183". The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

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

8.2 Lodging a submission by mail or fax

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

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

The envelope must be clearly marked with the project reference code: ERC0183

Alternatively, the submission may be sent by fax to (02) 8296 7899.

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

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

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39 The Commission published a notice under section 95 of the National Electricity law and section 303 of the National Gas Law to commence and assess this rule change request.

40 This guideline is available on the Commission's website.

Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
COAG Energy Council	Council of Australian Governments Energy Council
Commission	See AEMC
NECF	National Customer Framework
NEL	National Electricity Law
NEM	National Energy Market
NEO	National Electricity Objective
NER	National Electricity Rules
NERL	National Energy Retail Law
NERO	National Energy Retail Objective
NERR	National Energy Retail Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
S&P	Standard and Poor's

A How to determine if credit support is required

Under the current credit support rules, credit support is calculated as follows:

> Credit Support = Network Charges Liability – Retailer's Credit Allowance
>
> Where:
>
> Retailer's Credit Allowance = Credit Allowance % x Maximum Credit Allowance
>
> Maximum Credit Allowance = 25 % of the Distributor's Total Annual Network Charges

Each element that is required for the calculation of the amount of credit support required, is described below.

A.1 Determining the maximum credit allowance

The choice of a credit support design, including the use and level of a maximum credit allowance is a policy decision. Under the current credit support regime it was determined that the maximum credit allowance should be set at 25 per cent of a distributor's total annual network charges.[41]

For example, if a distributor has total annual network charges of $1000, their maximum credit allowance would be $250 (equals 25 per cent of the $1000).

A.2 Determining a retailer's credit allowance

A retailer's credit allowance is set as a percentage of the distributor's maximum credit allowance in accordance with the retailer's credit rating. The higher the retailer's credit rating, the higher the credit allowance of the individual retailer.

For example, for retailers with an S&P credit rating of A- or above, their credit allowance is equal to 100 per cent of the distributor's maximum credit allowance or 25 per cent of the distributor's total annual network charges. As a retailer's credit rating goes down from A-, so does the percentage of the maximum credit allowance they receive. The percentage that applies to that retailer is based on their risk of default compared to the risk of default of an A- rated retailer. The percentages are specifically provided for in both the NER and NGR and are as follows:

41 A distributor's total annual network charges are reported to and published by the AER.

Table A.1 Credit support allowance percentages under the NER and NGR

Standard and Poor's/ Fitch credit rating	Moody's credit rating	Dun and Bradstreet dynamic risk score	Credit allowance (% of maximum credit allowance)
AAA	Aaa		100%
AA+, AA, AA-	Aa1, Aa2,Aa3	Minimal	100%
A+, A, A-	A1, A2, A3	Very Low	100%
BBB+	Baa1	Low	52.9%
BBB	Baa2	Average	37.5%
BBB-	Baa3		22.0%
BB+	Ba1		17.0%
BB	Ba2	Moderate	11.0%
BB-	Ba3	High	6.7%
B+	B1	Very High	3.3%
B	B2		1.4%
B-	B3	Severe	0.9%
CCC/CC	Caa, Ca, C		0.3%

Based on our example where the maximum credit allowance is $250, a retailer's credit allowance would be calculated by applying the percentage associated with its credit rating to the maximum credit allowance, as follows:

Table A.2 Example of retailer credit allowance calculation

S&P credit rating	Credit allowance %	Retailer credit allowance (maximum credit allowance x credit allowance %)
AAA	100%	$250 x 100% =$250.00
AA+, AA, AA	100%	$250 x 100% =$250.00
A+, A, A	100%	$250 x 100% =$250.00
BBB+	52.9%	$250 x 52.9% =$132.25
BBB	37.5%	$250 x 37.5% =$93.75
BBB-	22.0%	$250 x 22.0% =$55.00

S&P credit rating	Credit allowance %	Retailer credit allowance (maximum credit allowance x credit allowance %)
BB+	17.0%	$250 x 17.0% =$42.50
BB	11.0%	$250 x 11.0% =$27.50
BB-	6.7%	$250 x 6.7% =$16.75
B+	3.3%	$250 x 3.3% =$8.25
B	1.4%	$250 x 1.4% =$3.50
B-	0.9%	$250 x 0.9% =$2.25
CCC/CC	0.3%	$250 x 0.3% =$0.75

A.3 Determining a retailer's network charges liability

A retailer's network charges liability is the sum of the retailer's average billed (but unpaid) and unbilled network charges for each customer class.[42] For each customer class, this is based on the average network charges over the number of days outstanding for that class taking into account:

- how often the meters are read (e.g. monthly versus quarterly);
- how often the distributor bills the retailer (i.e. monthly or as otherwise agreed between the retailer and distributor); and
- the length of time taken to prepare the invoice and the time the retailer has to pay the invoice.

The higher the number of days outstanding, the higher the retailer's network charges liability, and all else being equal, the more credit support that may be required.

We can continue our example for two retailers, one with a 30 per cent market share and one with a five per cent market share, both with 90 days' average outstanding network charges:

Table A.3 Example calculation of network charges liability

	30 % market share retailer	5 % market share retailer
Annual network charges	$1000 x 30 % = $300.00	$1000 x 5 % = $50.00
Average daily billed and unbilled network charges	$300/365 = $0.822	$50/365 = $0.137

42 Average outstanding network charges are calculated in accordance with the formula set out in the NER at 6B.B2.3 and the NGR at Part 21 Section 517.

	30 % market share retailer	5 % market share retailer
Network charges liability (daily network charges over the outstanding period)	$0.822 x 90 days = **$73.97**	$0.137 x 90 days = **$12.33**

A.4 Determining the amount of credit support required

The extent that the network charges liability exceeds the retailer's credit allowance determines the amount, if any, of credit support that the retailer is required to provide.

Carrying our previous example forward, we can calculate, the amount of credit support required.

Table A.4 Example calculation of credit support required

S&P credit rating	Credit allowance %	Retailer credit allowance	Credit support required from 30 % market share retailer	Credit support required from 5% market share retailer
AAA	100%	$250.00	None	None
AA+, AA, AA-	100%	$250.00	None	None
A+, A, A-	100%	$250.00	None	None
BBB+	52.9%	$132.25	None	None
BBB	37.5%	$93.75	None	None
BBB-	22.0%	$55.00	$73.97 - $55.00 = $18.97	None
BB+	17.0%	$42.50	$73.97 - $42.50 = $31.47	None
BB	11.0%	$27.50	$73.97 - $27.50 =$46.47	None
BB-	6.7%	$16.75	$73.97 - $16.75 = $57.22	None
B+	3.3%	$8.25	$73.97 - $8.25 = $65.72	$12.33 - $8.25 = $4.08
B	1.4%	$3.50	$73.97 - $3.50 = $70.47	$12.33 - $3.50 = $8.83
B-	0.9%	$2.25	$73.97 - $2.25 = $71.72	$12.33 - $2.25 = $10.08
CCC/CC	0.3%	$0.75	$73.97 - $0.75 = $73.22	$12.33 - $0.75 = $11.58

A.5 Determining the amount of credit support required under AGL's proposal

So carrying out previous example forward ($1000 total annual network charges, network charges liability of $73.97 for a retailer with a 30 per cent market share and network charges liability of $12.33 for a retailer with a five per cent market share) under AGL's proposed rules we find the following levels of credit support would be required:

Table A.5 Credit support requirements under AGL's proposed rules

S& P Credit Rating	Credit support required as a % of network charges liability	Credit support required with a 30 % market share	Credit support required with a 5 % market share
AAA	0%	None	None
AA+, AA, AA-	0%	None	None
A+, A, A-	0%	None	None
BBB+	0%	None	None
BBB	0%	None	None
BBB-	0%	None	None
BB+	25.58%	$73.97 x 25.58% = $18.92	$12.33 x 25.58% = $3.15
BB	52.94%	$73.97 x 52.94% = $39.16	$12.33 x 52.94% = $6.53
BB-	71.68%	$73.97 x 71.68% = $53.02	$12.33 x 71.68% = $8.84
B+	86.15%	$73.97 x 86.15% = $63.73	$12.33 x 86.15% = $10.62
B	93.23%	$73.97 x 93.23% = $68.96	$12.33 x 93.23% = $11.50
B-	95.96%	$73.97 x 95.96% = $70.98	$12.33 x 95.96% = $11.83
CCC/CC	98.81%	$73.97 x 98.91% = $73.16	$12.33 x 98.91% = $12.20

B Source of obligations between distributors, retailers and retail customers

In assessing the efficient allocation of costs to manage or mitigate the risks associated with retailer default, it is important to examine the responsibilities and obligations of the various parties to one another in the retail relationship.

B.1 Flow of services

The responsibilities and obligations of the distributor, retailer and retail customer are created through a combination of contractual arrangements and regulatory requirements. The starting place in examining these relationships is the NERL and NERR.

Under the NERR, a distributor (whether electricity or gas) provides connection and supply services to a customer under a customer connection agreement. Supply services include the distributor's network use of system services which is a service for the conveyance of electricity or gas. The customer connection agreement is in the form of a deemed standard connection agreement, an AER approved deemed standard connection agreement, or a negotiated connection agreement.

The model terms and conditions for deemed standard connection agreements are provided for in Schedule 2 of the NERR and apply to both electricity and gas. The model terms and conditions contained within the deemed standard connection agreement create a contractual relationship between the distributor and the retail customer. Under the model terms and conditions, the retail customer agrees that the distribution charges incurred will be billed under the retail contract the customer has with the retailer.

A retailer is only permitted to provide customer retail services to a small customer under either a standard retail contract, or a market contract.[43] Schedule 1 of the NERR provides the model terms and conditions for standard retail contracts. These model terms and conditions, amongst other things, provides that:

- the contract relates to the sale of energy (electricity and/or gas) to the small customer at their premises[44];
- the retailer agrees:
  - to sell to the customer, energy at the customer's premises; and
  - meet its obligations under the contract and applicable energy laws.

43 NERL section 20.

44 NERR, Schedule 1, Preamble.

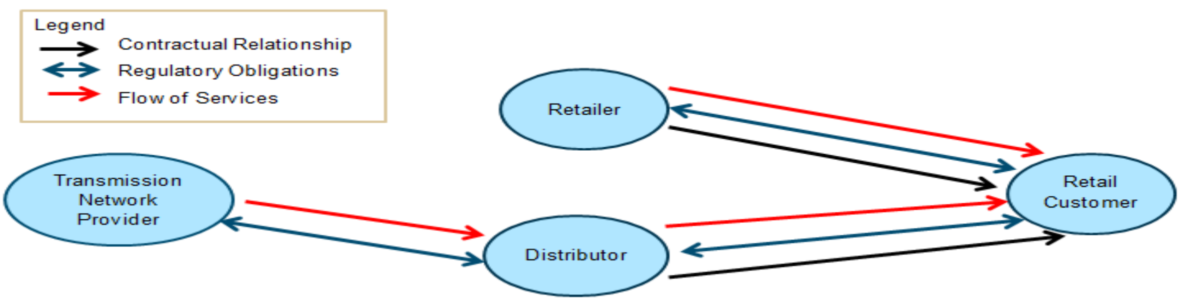
- the customer agrees that in exchange, it is responsible for:
  - charges for energy supplied to the premises until the contract ends;
  - payment of the amounts billed under the contract; and
  - meeting their obligations under the applicable energy laws.[45]
- the contract does not cover the physical connection of the premises to the network or the supply of energy to the premises;[46] and
- the retailer's standing offer prices includes distribution network charges.[47]

A market retail contract is covered by Part 2, Division 2 of the NERR. The NERR sets out the minimum requirements for a market retail contract with the remainder of the terms and conditions to be negotiated between the retailer and the retail customer. The minimum requirements include a requirement for the retailer to set out all the tariffs and charges payable by a small customer under the contract[48] (which would include network charges) and that retail customers are obliged to pay the amount billed under the contract.

The relationship and obligations between the distributor, retailer and retail customers relating to the flow of services are the same for both the electricity and gas markets. However, the relationship between the transmission network provider, distributor and retailer differs between the electricity and gas markets.

In the electricity market, a distributor, as a registered participant, has an opportunity to form a connection and have access to the national electricity grid.[49] This connection is necessary to allow the distributor to provide connection and supply service to retail customers. The relationship and obligations of the transmission network provider and the distributor are regulatory obligations and are governed by the NEL and NER.

Figure B.1 Flow of services: electricity market



45 NERR, Schedule 1, Clause 5.1.

46 NERR, Schedule 1, Clause 5.2.

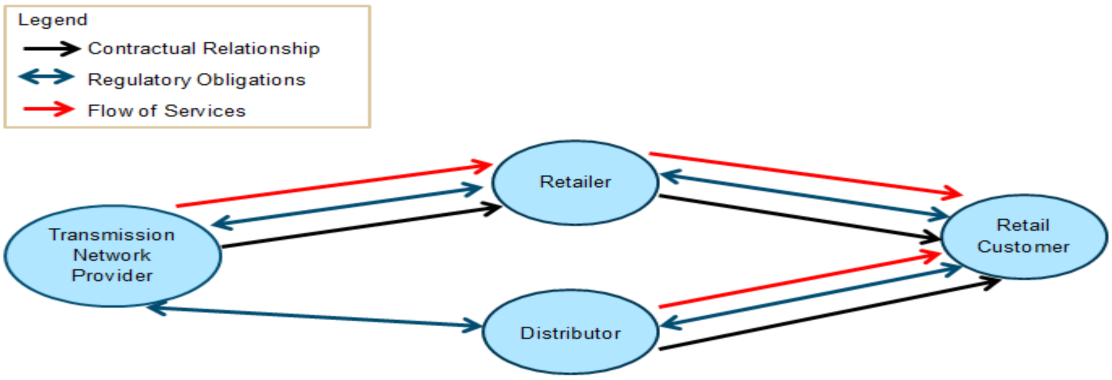
47 NERR, Schedule 1, clause 8.1(a).

48 NERR, Rule 46(2).

49 NER, Chapter 5, Clause 5.1.3.

In the gas markets, a distributor and transmission network provider are still subject to regulatory obligations in relation to the interconnection of the two systems, however, unlike in electricity, the provision of transmission services is between the transmission network provider and the retailer. The relationship and obligations of the transmission network provider and retailer is prescribed through a combination of regulatory requirements and contractual provisions.

Figure B.2 Flow of services: gas market



B.2 Flow of payments

The billing and payment for services relationship between the parties is governed by the concept of a shared customer. A shared customer is defined in the NERL as a "person who is a customer of the retailer and whose premises are connected to the distributor's distribution system."[50]

Although a distributor provides connection and supply services directly to the retail customer (in both the electricity and gas markets), the distributor is prohibited from billing small customers directly and is only permitted to bill large shared customers directly with the customers consent.[51] As a result, the distributor is reliant on the retailer to collect the network charges incurred by their shared customers. The retailer has a regulatory obligation to pay to the distributor the network charges payable in respect of their shared customers.[52]

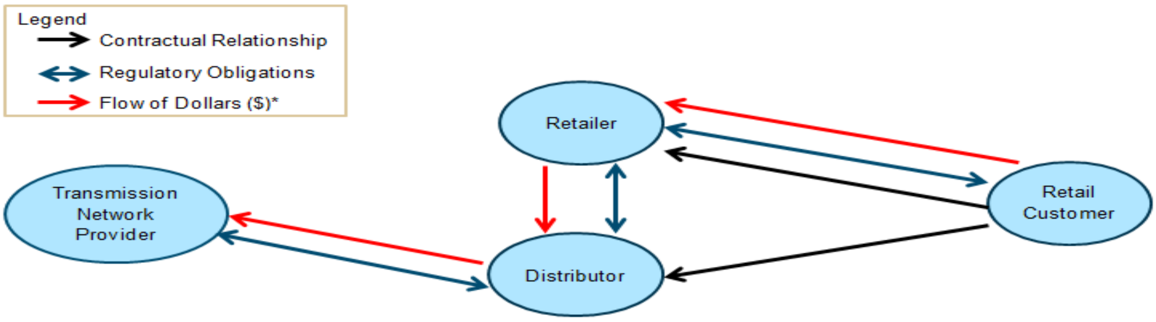
For electricity, the distributor is required to pay the transmission network provider for the use of its network based on its use of the system. The distributor then flows through these charges, as part of its distribution network charges, to the end user of the system, the retail customer. As the transmission network charges form part of the distribution network charges, the retailer is obliged to pay these charges. The retailer will collect the distribution network charges (including the transmission network charges) that the shared retail customer is responsible for pursuant to both the retail customer's connection contract with the distributor and the retail customer's retail contract.

50 NERL, section 2.

51 NERL, section 71(2), NER Section 6B.A2.2; NGR Clause 504.

52 NER 6B.A2.1 and 6B.A2.5; NGR clause 503.

Figure B.3 Flow of payments: electricity market



* Where:

Transmission Charges Billed equals transmission use of system charges for the transmission network

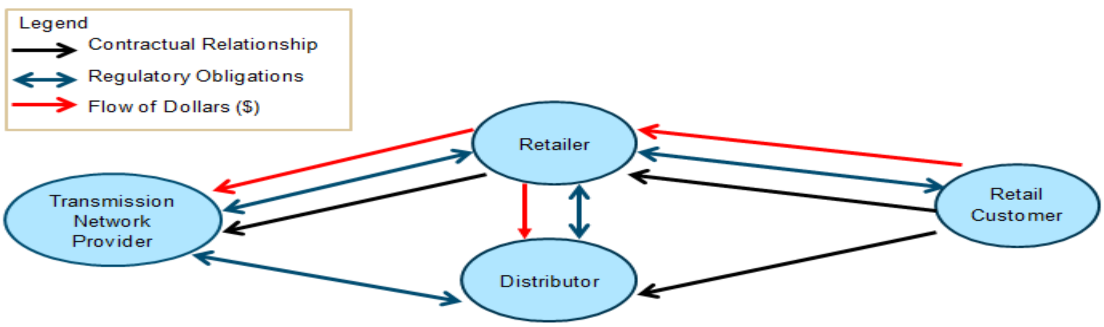
Distribution Charges Billed equals transmission charges plus distribution use of system charges for the distribution network

Retailer Charges Billed equals distribution charges billed plus cost of electricity and other retailer charges

In the gas market, there is a direct relationship between the transmission network provider and the retailer. As a result, the transmission network use of system charges do not flow through the distributor, but rather are billed, pursuant to the contractual relationship between the transmission network service provider and the retailer, directly to the retailer. The retailer then flows through these charges to the retail customer.

The distribution network charges would include only the charges associated with the use of the distribution system for the connection and supply of energy to the retail customer from the distributor. These charges would be billed to the retailer for the shared customers and flowed through to the retail customer. The retailer has the same regulatory obligation in gas as in electricity to pay the distributor for the distribution network charges. The retail customer, under both the retail contract and the connection contract would be obliged to pay the distribution network charges and the transmission network charges to the retailer.

Figure B.4 Flow of payments: gas market



* Where:

Transmission Charges Billed equals transmission use of system charges for the transmission network

Distribution Charges Billed equals distribution use of system charges for the distribution network

Retailer Charges Billed equals transmission charges billed, distribution charges billed plus cost of gas and other retailer charges

C Summary of stakeholder submissions on retailer insolvency cost pass-through rule change request

Stakeholder	Comments
	General comments
Energy & Water Ombudsman (EWO) Queensland	EWO does not favour reallocating risk from distributors to their customers. This reallocation may result in a significant impact on customers, especially those who are vulnerable. Cost pass-through should be a last resort, exercised only where recovery through the regulatory determination process and the credit support arrangements have failed. If a pass-through must be used, the distributor should only recover revenue from the insolvent retailer's customer base, as this is more equitable than charging all of the distributor's customers.
Victorian Distributors, Energex, ENA, esaa, SA Power Networks (SAPN)	These entities support the proposed rule. The Victorian distributors request confirmation that transmission use of system payments are included in the eligible pass-through amount. Energex suggests that credit support arrangements in the NECF should also be reviewed as it provides reduced protection for distributors.
Simply Energy	Simply Energy believes that if the rule is implemented, the equity beta should be reduced for distributors to reflect the shift in risk to customers, otherwise customers will end up paying twice for the risks associated with retailer default. Distributors should have incentives to seek return of lost revenues from an insolvent retailer's administrator; otherwise, lost revenue will end up going to other creditors rather than being returned to customers, who have paid as a result of the cost pass-through mechanism. The cost pass-through mechanism would make the need for credit support redundant. Therefore, there should be a commensurate reduction (if not removal) of the requirement to post credit support with the distributor.
	Allocation of risk
Energex, ENA, SAPN	These entities believe that distributors have limited ability to manage the risk of retailer default, and that it is appropriate to allocate risk to customers. Energex states that the current credit support arrangements are inadequate, and that other measures such as a separate insolvency allowance, self-insurance and external insurance are either unavailable, or costly and do not ensure full recovery. ENA states that in the event of a retailer default, it may be a long time before a cost pass-through amount is approved. As a result, distributors need to carry additional working capital, even though the regulated rate of return is not set having regard to these market conditions. SAPN states there was a clear policy intent to assign the credit risk associated with retailer default to customers, not to distributors, and that this is appropriate since customers benefit from retail competition through lower prices. It also notes that if retailer credit risk was carried by distributors, then distributors would need extra working capital, but the rate of return applied to distributors does not reflect this situation.
Simply Energy	It may be appropriate to reallocate risk to customers if it can be demonstrated that this is in their long term interest.

Stakeholder	Comments
	Recovery of revenue
Energex, ENA, SAPN, Victorian Distributors	These entities believe the cost pass-through mechanism is appropriate to recover revenue forgone as a result of a retailer default. ENA states that the traditional retail business model faces increasing financial risk due to new retail offerings, altered business structures and a significant number of new entrants in the market. SAPN states that its risk levels increased significantly with the implementation of the NECF as it has been unable to request any credit support, since there were no instances where a retailer's network charges liability exceeded its credit allowance.
Simply Energy	It is unclear how the cost pass-through mechanism fits with revenue cap arrangements. Cost pass-through provisions were originally designed for weighted average price caps, aiming to cater for changes in a distributors' costs due to events which were not anticipated at the time the five year price path was set. In recent years, the AER has been moving distributors to revenue cap arrangements. Under a revenue cap, the lost revenue is recovered in subsequent years and no pass-through is required.
	Materiality threshold
Energex, ENA, SAPN	These entities believe it is appropriate to remove the materiality threshold. SAPN points out that there are other examples of pass-through events without a materiality threshold and believes the definition should be amended to make it clear that no threshold applies. Energex states that under current arrangements, it is unable to recoup unpaid charges unless the unpaid charges amount to approximately $18 million.
Simply Energy	Simply Energy believes it is not appropriate to remove the materiality threshold as it reflects the administrative costs of a pass-through event.
	Recovery through credit support
Energex, ENA, SAPN	These entities believe that the current credit support requirements are inadequate. Energex states that as of October 2014, it had 20 retailers individually owing Energex up to $12 million in unpaid network charges. Currently, in the event of any of those retailers becoming insolvent, Energex would not be able to draw on credit support. This is due to the fact that it does not hold any, even though two retailers have below average credit ratings. Further, it would not be able to use the cost pass-through in relation to those retailers as a default event would not meet the materiality threshold. This could create a significant cash flow exposure. Energex is concerned about such exposure since the recent arrival of new retailers in Queensland who represent a higher commercial risk. ENA states that distributors are not able to request credit support in many cases. Months of unpaid invoices can be accumulated before credit support can be used. In addition, some retailers are structured so as to circumvent the credit support arrangements. As all customers benefit from lower prices from retail competition, the cost pass-through to all customers in the event of retailer default is appropriate. The cost pass-through mechanism takes into account credit support held by a distributor and so there is no double recovery.

Stakeholder	Comments
	SAPN states that in practice, it has not been able to seek credit support from any retailer in SA. This is because there have been no instances where a retailer's network charges liability exceed their credit allowance, and because credit support arrangements are being circumvented by retailers operating multiple retailer authorisations under separate entities.
esaa, Simply Energy	These entities believe the credit support arrangements do not need amending. esaa states that the likelihood of retailer collapse is low, and that amending the credit support requirements will impose costs and may create a barrier to entry for small retailers. Simply Energy states that there is no evidence that the current credit support requirements are insufficient, and that the current requirements reflect similar arrangements in Victoria which have operated successfully for a number of years.
	Recovery through regulatory determinations
Energex, Simply Energy, SAPN	These entities do not consider recovery through the regulatory determinations process to be good policy. Energex believes it would be difficult to determine an efficient allowance. Simply Energy believes it is difficult to quantify the risk, and that this would result in customers paying more than is required. SAPN states that from its experience examining insurance options as a substitute for bank guarantees, that customers would pay a higher overall price for electricity under this system.
Energy 7 Water Ombudsman Queensland	EWO considers recovery through the regulatory determination process to be more in line with the National Electricity Objective than the cost pass-through mechanism.
	Recovery through the corporate insolvency process
Energex	Energex believes that the corporate insolvency process does not safeguard distributors against financial risk. There is a high level of uncertainty in using this process. For example, after the Jackgreen insolvency in December 2009 ,Energex received less than four cents on the dollar in September 2011. Processes under the NER should proceed independently of the corporate insolvency process. Energex suggests that to prevent double recovery, two pass-through events should be defined: a positive pass-through for the forgone revenue, and a negative pass-through for amounts recovered through the corporate insolvency process.
ENA, SAPN	These entities believe that the AER can address the issue of double recovery. ENA states that the AER already has sufficient powers to ensure that double recovery in relation to money recouped from a retailer default will not occur. SAPN states that the AER can include a mechanism that allows for the handing back of any amounts recovered from an insolvency process.
esaa	esaa believes a cost pass-through is likely to be faster and more predictable than the corporate insolvency process. A safeguard should be put in place to prevent a distributor from pursuing additional revenue from the insolvency process if they have opted for a cost pass-through.

Stakeholder	Comments
Simply Energy	The AER needs the discretion to ensure that only lost revenues that have not already been recovered from credit support or insolvency processes are passed through. They should be able to apply a 'negative pass-through' so as to return to customers the value of lost revenue that has been passed through but is later recovered by the distributor. In the next revenue determination, they should be able to take into account the conduct of the distributor in seeking to recover the lost revenues - for example, if a distributor fails to seek recovery of lost revenues through the corporate insolvency process, then this could be used to justify a reduction in the distributor's revenue requirement for the next regulatory period.
	Other
ENA, SAPN	The definition of retailer insolvency should be amended to make it clear that the pass-through mechanism can operate before an insolvency administrator is appointed or even if an administrator is not appointed at all.
Simply Energy	Any mechanism that enables distributors to recover lost revenues from customers reduces the incentive to pursue other ways of recovering the lost revenues. The AER must have discretion when dealing with this type of revenue 'true up'.