26 November 2015

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

Dear Mr Pierce

The NSW DNSP's Submission to the AEMC Retailer-Distributor Credit Support Requirements Options Paper

The NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) welcome the opportunity to provide this joint submission in response to the *Retailer-Distributor Credit Support Requirements, Options Paper*.

We believe that an Options Paper is an appropriate consultation stage given the significant industry concern regarding the AGL Energy Limited (AGL) Rule change (AGL Rule change) which proposed to significantly weaken the credit support arrangements in the National Electricity Market (NEM).

In the NSW DNSP's 2 July 2015 submission to the initial Consultation Paper, we did not support the AGL Rule change as it removes the Maximum Credit Allowance (MCA) which results in large Retailers having an unlimited credit allowance with DNSPs regardless of market share. This, coupled with the proposed lowering of the Probability of Default benchmark from A- to BBB-, increases DNSPs' risk tolerance by shifting the risk from Retailers to DNSPs.

The NSW DNSPs, the Energy Networks Association (ENA) members, as well as all smaller Retailers strongly disagreed with the AGL Rule change as it does not achieve the National Electricity Objective (NEO). It represents an inappropriate risk transfer from large Retailers to DNSPs and undermines the traditional roles and responsibilities of these two market participants.

The traditional role of Retailers is to provide a front-end customer service and billing management function, whereas DNSPs provide reliable, secure and safe electricity supply to customers in the long term interests of consumers. DNSPs are subject to a range of regulatory obligations to ensure the efficiency (and prudency) of its capital investments in the long term interests of consumers. Furthermore, DNSPs receive no reward for assuming the risks of Retailers due to the fixed and regulated nature of network billings. Retailers, on the other hand, routinely manage pricing risk and the rapid and often steep swings in wholesale electricity prices.

While not supporting the AGL Rule Change, we are strong advocates of strengthening the existing credit support regime and have raised this in our Consultation Paper submission as well in the NEM Financial Resilience Review. This is because while DNSPs have requested credit support from Retailers in accordance with the Rules, the success of obtaining credit support has varied due to the ambiguity in the current Rules that needs to be addressed.

There are three major issues with the current credit support Rules, namely:

- The three largest Retailers each have a Standard & Poor's corporate credit rating which applies to the consolidated entity, its group financial results and risk structure. Each of these large energy Retailers operates under multiple financially responsible market participants (FRMP) and various legal entities. However, NSW DNSPs' experience is that a Retailer (or Retailers) within the group seeks to rely on the corporate credit rating for the rated FRMP and a Dun & Bradstreet dynamic risk score for the other un-rated FRMP's, thereby availing the Retailer of multiple credit allowances, resulting in the DNSP having no or inadequate credit support.

  In order to address this problem, clause 6B.B3 of the Rules would need to be amended to <u>explicitly</u> state that the applicable credit support allowance can only be obtained for the parent Retailer based on their credit rating and that credit allowance apportioned to the related entities/

FRMPs within a Retailer group, so that Retailers can no longer receive multiple credit allowances for un-rated subsidiaries. That is, where a FRMP(s) or authorised Retailer(s) is a part of a large rated entity, the credit rating assigned by S&P's, Moody's or Fitch applies at the corporate level and the DNSP will determine how the credit allowance will be apportioned amongst the Retailers within the group (based on the methodology prescribed in the Rules).

- While credit ratings incorporate dynamic measures of risk, they do not address the single name concentration risk that DNSPs have to the largest three Retailers that dominate the NEM. We recommend the inclusion of concentration premium 'add on' that should be applied to the current provisions such that the credit support requirement captures single name credit concentration risk as well as the risk of default.

- The current Rules Table in Schedule 6B.1 (Clause 6B.B3.1) misaligns the Probability of Default of Dun & Bradstreet to Standard & Poor's and as a result gives unrated Retailers unrealistic credit allowances. We submit that the Rules should realign the Probability of Default of Dun & Bradstreet to Standard & Poor's/ Fitch/ Moody's PD.

In our Consultation Paper submission we proposed that the Rules should be improved by addressing these issues. We are therefore pleased that the AEMC has incorporated the substance of these proposals in Option 2.3 in the Options paper. We support **Option 2.3** and provide additional detail as to how this Option might be implemented in practice in Attachment A.

The Options Paper also presents three other Options, and further sub-Options for Option 2 which we do not support as they either retain the existing arrangements, give effect to the AGL Rule change or remove the Retailer-distributor credit support Rules. While we prefer Option 3 over Option 4 as it is a more appropriate allocation of risk, we are realistic in thinking that Options 3 & 4 are likely to require significant analysis, consultation and modification in order to contribute to achievement of the NEO, whereas Option 2.3 can be achieved in a timely manner, as part of this consultation process. We provide commentary on each of these Options, and sub-Options in Attachment B.

In relation to the COAG Energy Council Retailer insolvency cost pass through Rule change (and equivalent Jemena Gas Networks Rule Change), we have previously stated that the NSW DNSPs support removing the materiality threshold, where one applies; and clarifying the provisions to ensure that foregone revenue is included in the costs DNSPs are able to recover in the cost pass-through amount.

Next Steps

The most effective way of mitigating the potential credit and cash flow impacts from a Retailer failure is through having effective credit support arrangements that can be enforced. The NSW DNSPs would be pleased to provide any further assistance or detail in order to give effect to the policy intent of Option 2.3. If you would like to discuss our submission further or arrange a meeting with NSW DNSP representatives, please contact Mr Robert Millar at Ausgrid on (02) 9269 3148.

Yours sincerely

Joe Pizzinga
Group Chief Financial Officer
Networks NSW

Attachment A: The NSW DNSP's support for Option 2.3

Option 2.3: COAG Energy Council Retailer insolvency cost pass through Rule change with enhanced credit support.

The NSW DNSPs believe that Option 2.3 meets the objectives of the NEO. We provide commentary on each aspect of the Options Paper 2.3 proposals below.

Enhanced cost pass-through provisions

The NSW DNSPs support both elements of the COAG Energy Council Retailer insolvency cost pass-through rule change (and equivalent Jemena Gas Networks Rule Change). Namely, removing the materiality threshold, where one applies and clarifying the provision to ensure that foregone revenue is included in the costs DNSPs are able recover in the cost pass through amount.

The NSW DNSPs support the cost pass through mechanism to enable cost pass through applications for Retailer insolvency events to be approved by the Australian Energy Regulator (AER) without being subject to the materiality threshold that is usually applied to cost pass through events. We also support amending the distribution cost pass through provisions in the National Electricity Rules (NER or Rules) to allow DNSPs to recoup their unrecovered revenue for direct control services that have been provided, but remain unpaid by Retailers that have become insolvent.

While we support the Retailer cost pass through it is not a replacement for credit support. The most effective way of preventing the potential credit and cash flow impacts from a Retailer failure is through having effective credit support arrangements that can be enforced. While DNSPs can potentially mitigate the recovery of unpaid network charges through a retail insolvency pass through, the remedy may be a slow one due to the likely delays in DNSPs recovering these costs.

Depending on when in the period a Retailer of Last Resort (RoLR) event occurs, a DNSP may have to absorb this cost (and the interest that accrues on having to fund working capital through this debt) for up to 14 months before it can undertake adjustment through its annual pricing proposal to recover the outstanding network charges. This severely constrains its usefulness as a risk mitigation tool in lieu of appropriate credit support arrangements. This may also potentially have an impact on the DNSP's credit rating and overall borrowing costs.

We note that the Options paper briefly mentions another possible enhancement to the cost pass through provisions which would allow the DNSP to start collecting the approved cost pass-through amount immediately after it has been approved, rather than waiting to include it in the next annual pricing proposal. The NSW DNSPs are not sure how this enhancement would work in practice given the recently amended pricing rules and the Tariff Structure Statement process.

Multiple Retailer authorisations

The Options paper goes part of the way in addressing the NSW DNSP's concern that the three largest energy Retailers each have a Standard & Poor's corporate credit rating which applies to the consolidated entity, its group financial results and risk structure and as such, each of these large energy Retailers operates under multiple financially responsible market participants (FRMP) and various legal entities. However, the NSW DNSPs' experience is that a Retailer (or Retailers) within the group seeks to rely on the corporate credit rating for the rated FRMP and a Dun & Bradstreet dynamic risk score for the other un-rated FRMP's, thereby availing the Retailer of multiple credit allowances, resulting in the DNSP having no or inadequate credit support..

In order to address this problem, the Rules amendment (of clause 6B.B3) would need to <u>explicitly</u> state that the applicable credit support allowance can only be obtained for the parent Retailer based on their credit rating and that credit allowance apportioned or applied to the related entities/ FRMPs within a Retailer group, so that Retailers can no longer receive multiple credit allowances for un-rated subsidiaries.

That is, where a FRMP(s) or authorised Retailer(s) is a part of a large rated entity, the credit rating assigned by S&P's, Moody's or Fitch applies at the corporate level and the DNSP will determine how the credit allowance will be apportioned amongst the Retailers within the group (based on the methodology prescribed in the Rules).

Removal of credit allowances

We understand that this AEMC proposal would be to remove the concept of a maximum credit allowances (MCA) but to calculate credit support with reference to a credit rating of A-. Our preference would be to retain the concept of the MCA as it is a practical allowance devised to cover the likely outstanding balance owed to a DNSP (including any balance owed by the largest Retailer). It also ensures that the cost to industry of providing credit support is only increased where material risks exist. Furthermore, to avoid a situation where BBB- rated Retailers and above would receive an unlimited allowance, the A- benchmark credit rating must be maintained in all circumstances.

Limiting the available measures of creditworthiness

The current Rules Table in Schedule 6B.1 (Clause 6B.B3.1) misaligns the Probability of Default (PD) of Dun & Bradstreet to Standard & Poor's and as a result gives unrated Retailers unrealistic credit allowances. In some cases unrated subsidiaries that use Dun and Bradstreet risk scores, and with a rated parent, may be assigned a higher Credit Allowance (CA) % than the parent. The Rules are unclear and we believe that this was not the intent of the credit arrangements in the NEM. The Dun and Bradstreet dynamic risk scores should be realigned with the ratings agencies in Schedule 6B.1 of NER as detailed in the table below.

S&P/Fitch	**Moody's**	**Re-aligned Dun and Bradstreet**
AAA	Aaa	
AA+	Aa1	
AA	Aa2	
AA-	As3	
A+	A1	
A	A2	
A-	A3	
BBB+	Baa1	
BBB	Baa2	
BBB-	Baa3	Minimal
BB+	Ba1	Very Low
BB	Ba2	Low
BB-	Ba3	Average
B+	B1	Moderate
B	B2	High
B-	B3	Very High
CCC	Caa	Severe
CC	Ca	
C	C	

Credit Concentration

The potential for financial contagion exists where a DNSP is exposed to one Retailer in their network area with a very large market share, and additional credit support (concentration premium) would be required to mitigate these risks beyond a threshold level. As such, the NSW DNSPs agree with the sub-Option to take into consideration 'single name' crisis concerns that stem from market concentration.

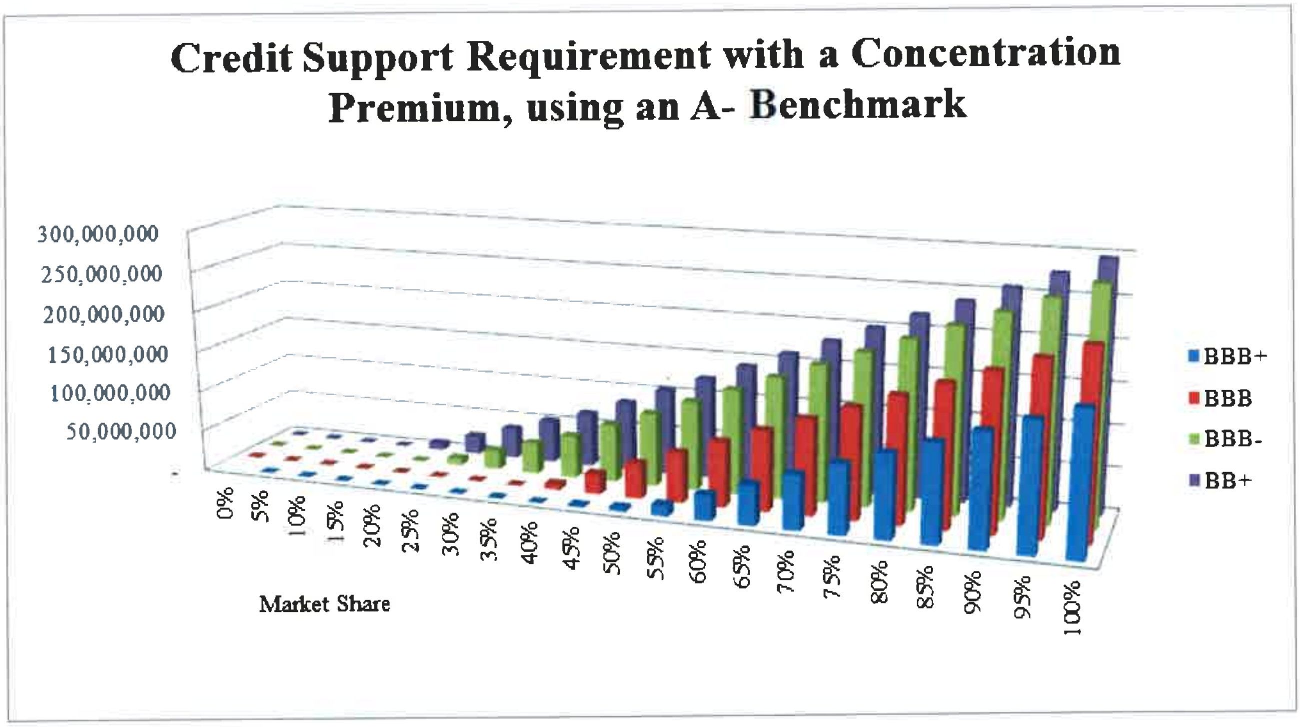
This is because there is nothing in the current NER stopping a single Retailer obtaining a 100 % market share in a DNSP's jurisdiction. The scenarios are considered an extreme 'Name Crisis' event for a DNSP; regardless of Retailer credit rating.

The only mitigant available to a DNSP is the extent of retail competition (i.e. counterparty diversification) within jurisdictions, of which the DNSP has no control over due to its obligation to serve customers. EnergyAustralia, with a BBB- rating accounts for 44.1 per cent market share in Ausgrid's distribution area. Furthermore, each DNSP is unique in terms of capital structure (i.e. leverage), target credit rating, debt covenants, dividend policy and cash-flow / liquidity constraints. As such each DNSP's *risk tolerance* will vary even though each faces contractual and regulatory obligations to serve customers. The cash-flow / liquidity requirement, coupled with the obligation to serve, create the potential for tight asset / liability mismatches over very short time-frames for example, weeks.

As noted in our 2 July 2015 Consultation Paper submission and report we stated that a deeper consideration of the AGL Rule change proposal identifies a lack of *single-name credit concentration limits* within the current provisions. Some DNSPs are heavily exposed to a single Retailer in respect of network charges (NC) billings (i.e. EnergyAustralia in the case of Ausgrid, Origin Energy in the case of Essential Energy and Endeavour Energy and AGL in the case of SA Power Networks). For this reason the Credit Support Requirement (CSR) needs to capture both the credit worthiness of the Retailer *and* the level of exposure (i.e. cash short-fall) over the very short-term asset / liability requirement outlined in the previous section. We introduce a Concentration Premium linked to the contribution of the Retailer's market share to the cash-flow / liquidity risk of the DNSP and we call this the market share threshold.

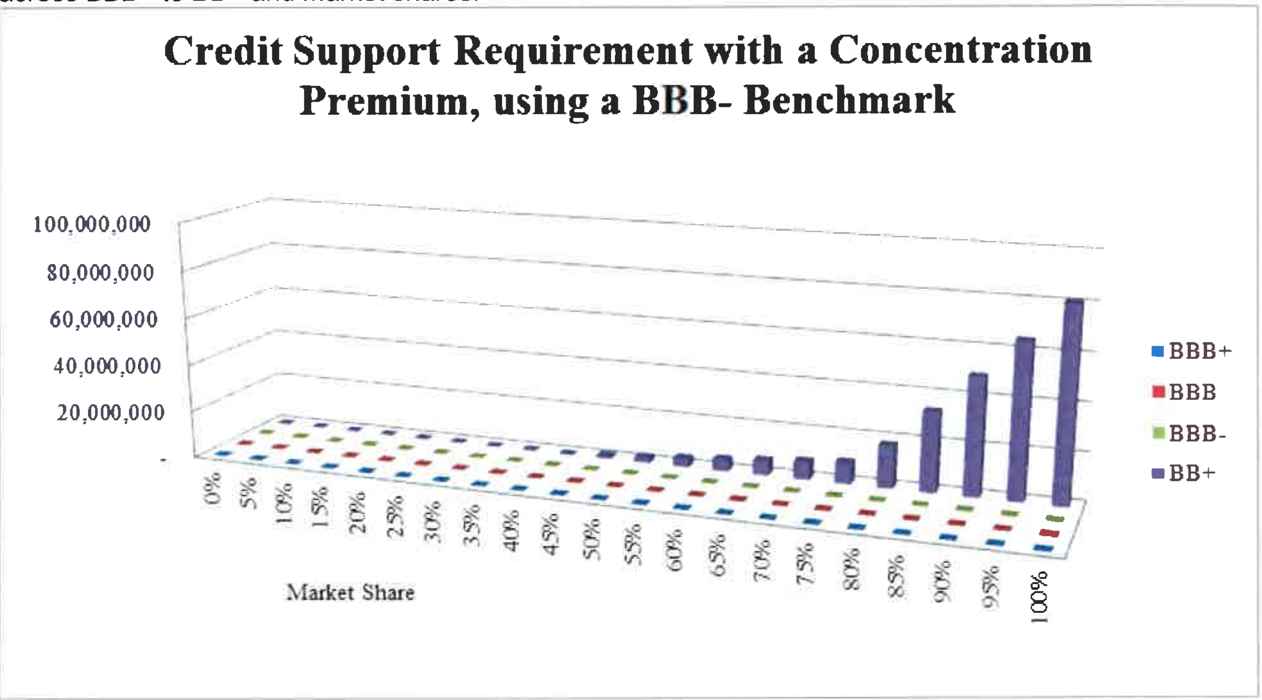
We recommend this concentration premium 'add on' should be applied to the current provisions such that the CSR captures *single name credit concentration risk* as well as the risk of default. Figure 1 illustrates the CSR requirement of the current provisions using an A- credit rating benchmark included a concentration premium:

Figure 1: CSR with a Concentration Premium across BBB+ to BB+ and market shares



By comparison Figure 2 illustrates the CSR pursuant to the proposed shift to a BBB- benchmark credit rating plus the Concentration Premium. The reduction in CSR is significant and this exemplifies the risk transfer:

Figure 2: CSR pursuant to the shift in benchmark credit rating to BBB – plus Concentration Premium across BBB+ to BB+ and market shares:



We submit that any Retailer with a market share greater than the *Threshold Market Share* exposes the DNSP to *single name concentration risk*. As such when a Retailer's market share is greater than the *Threshold Market Share* the total CSR for that Retailer should include an 'add-on' *Concentration Premium* which only applies to the Retailers market share above the *Threshold Market Share*. This is set out below.

Concentration credit support premium = excess market share (%) x cash flow at risk

Where:

Excess market share (%) = retailer's market share (%) – threshold market share (%)

$$\text{Threshold market share (\%)} = 1 - \frac{\text{distributor's committed liabilities}}{\text{distributor's billing revenue}} = \frac{\text{cash flow at risk}}{\text{distributor's billing revenue}}$$

Attachment B- Assessment of other Options in the Options Paper

The NSW DNSPs believe the other Options in the Options paper will not contribute to the achievement of the NEO.

Option 1: retain the existing arrangements.

We submit that the cost of credit support is a necessary and reasonable business expense that a dominant Retailer presenting the greatest risk to the market would be expected to incur. While we do not support the AGL Rule change, our submissions to the Consultation Paper provided evidence that the current credit support arrangements do not provide a sufficient means of managing credit risks faced by DNSPs for both large[1] and small Retailers[2]. The Options Paper represents an opportunity to make a more preferable Rule by re-examining these issues from a first principles and evidence-based review.

There are current deficiencies in the Rules which we highlighted in our Consultation Paper submission.

- The three largest energy Retailers each have a Standard & Poor's corporate credit rating which applies to the consolidated entity, its group financial results and risk structure. Each of these large energy Retailers operates under multiple financially responsible market participants (FRMP) and various legal entities. However, because the Rules are unclear the NSW DNSPs' experience is that a Retailer (or Retailers) within the group seeks to rely on the corporate credit rating for the rated FRMP and a Dun & Bradstreet dynamic risk score for the other un-rated FRMP's, thereby availing the Retailer of multiple credit allowances, resulting in the DNSP having no or inadequate credit support. In order to address this problem, clause 6B.B3 of the Rules would need to be amended to explicitly state that the applicable credit support allowance can only be obtained for the parent Retailer based on their credit rating and that credit allowance apportioned to the related entities/ FRMPs within a Retailer group

- While credit ratings incorporate dynamic measures of risk, they do not address the single name concentration risk that DNSPs have to the largest three Retailers that dominate the NEM.

- The current Rules- Table in Schedule 6B.1 (Clause 6B.B3.1) misaligns the Probability of Default (PD) of Dun & Bradstreet to Standard & Poor's and as a result gives unrated Retailers unrealistic credit allowances. We submit that the Rules should realign the PD of Dun & Bradstreet to Standard & Poor's/ Fitch/ Moody's PD.

We believe that credit support provisions should provide appropriate levels of credit support across the entire portfolio of Retailers, namely high value/ low risk of default and low value/high risk of default. The provisions needs to take into account both the likelihood of default of an individual Retailer (based on their credit rating and payment history) and the level of exposure to an individual Retailer.

Alternative mechanisms in the Rules will not alleviate the potential cash shortfall risks for DNSPs and are not a substitute for an effective credit support regime.

Further, the risk of Retailer default and_cash shortfall risk faced by DNSPs cannot be effectively managed either through statutory mechanisms, including cost pass-through provisions, 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. Only an effective credit support regime provides some risk mitigation for DNSPs. We discuss this below.

[1] When the National Energy Customer Framework (NECF) was introduced in NSW, these arrangements enabled DNSPs to seek credit support in order to mitigate larger exposures to higher rated Retailers, however the exposure level threshold excluded smaller Retailers. While this was appropriate at time, and is still largely the case given smaller Retailers do not substantially add to the risk being carried by the NSW DNSPs as their individual market share is below the material 10 percent, or even 5 percent threshold however we submit that credit support should also be provided by smaller Retailers where appropriate. As such, neither regime provides DNSPs with appropriate levels of credit support across the entire portfolio of Retailers.

[2] NSW DNSPs response to the NEM Financial Market Resilience Review, p 3.

DNSPs manage risk in many ways, for example purchasing insurance; asset design; standards; systems; processes and procedures. The regulatory framework provides allowances to compensate for undertaking these activities to prevent and/or mitigate by risks.

These allowances are provided through three basic mechanisms:

1) Forecast capital expenditure;
2) Forecast operating expenditure (including external insurance); and
3) Rate of return on assets.

However, these regulatory allowances do not provide a return for *all* the risks borne by DNSPs. The regulatory framework recognises this and provides two additional mechanisms for managing risks, cost pass through and self insurance, which are aimed at addressing risks which are not compensated anywhere else in a DNSP's regulatory determination. If a risk is not addressed through: operating expenditure (including external insurance), capex, rate of return, self insurance or pass through, then it is absorbed/retained by the business.

Determining which mechanism is the most appropriate for efficiently managing a risk will depend on the nature of the risk and whether an allowance has been made for the risk through operating expenditure; capital expenditure; or rate of return.

This is because nominated pass throughs and self insurance are limited to risks which

- are not compensated by operating or capital expenditure or the rate of return;
- are exogenous (beyond the DNSP's control) and are asymmetric;
- have a low probability of occurrence or are unpredictable; and
- for which external insurance cannot be obtained or is not 'effective.'[3]

It is important to note that the use of nominated pass throughs is further constrained by the need to establish that the likely financial consequences from the risk eventuating are likely to be catastrophic and also as outlined below, depending on when the pass through event occurs, it can take up to 14 months for DNSPs to recover outstanding network charges. Nevertheless, the above considerations are a distinguishing feature for determining whether a risk should be managed via a self insurance allowance or via a nominated pass through.

In other words, mitigating risks via a nominated pass through should only be used as a last option available to network service providers (NSPs) with respect to risk management relating to the cost recovery of costs associated with the provision of direct control services.[4] The Retailer should be accountable for managing its financial risks and not have these transferred to other parties.

Insurability

Having determined that a risk is not already addressed through the operating expenditure forecast, capital expenditure forecast, or rate of return, it is then necessary to determine whether the risk can be insured. Generally, the main way to mitigate or compensate for risk is through obtaining external insurance. From a regulatory perspective, the insurance premium is usually included as part of the operating allowance and is therefore recovered from customers.

However, not all risks can be externally insured. In some circumstances sufficient insurance may be unavailable due to a lack of capacity in the market[5], while in other cases external insurance may be available but is inefficient/and or inappropriate in light of the costs of the premium.

[3] Even if external insurance is available, it may not be 'effective' as the premium for a low probability high impact insurance policy may be so high as to make it uneconomic to insure for the risk, or the likely impact of the event is likely to be of such a nature that the insurance would be insufficient to cover all of the business' costs.

[4] AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p i. See also AER, Final Decision: ElectraNet Transmission Determination 2013-14 to 2017-18, 30 April 2013, pp 190-191.

[5] A lack of capacity in the market to insure a risk refers to where there is either insufficient people in the market to effectively pool the risk (i.e. insurance cannot be obtained to cover the impact of the risk) or where insurance companies do not want to manage the risk.

Therefore, whether a risk can be effectively insured externally requires examining both the availability of insurance and the affordability of the insurance.

Self Insurance

If it is not possible to obtain effective external insurance for a risk, it may be possible to self insure the risk. Generally, self insurance serves to provide allowances for asymmetric risks which are not incurred in a consistent or predictable manner over time and which have not already been accounted for in the building block proposal. These can be risks which have been historically incurred, or risks that the DNSP expects to face in the future. The timing of these costs is often not known in advance, hence the DNSP 'self insures' for them.

In determining whether it is appropriate to self insure for a risk requires consideration of whether the business can 'effectively' self insured for the risk. That is, does the business have the capacity to effectively pool enough risk to cover the severity of the likely impact should the risk occur.[6] Therefore, the likely magnitude of the risk will be a determining factor as to whether self insurance is an appropriate mechanism for mitigating a particular risk. Other considerations that the business should have regard to in deciding whether to self insure for risks include:

i. Whether the risk is practically quantifiable and does not merely relate to the loss of value;[7]
ii. Whether the risk is negatively asymmetric;[8]
iii. AER information requirements;[9] and
iv. Administrative and reporting requirements.[10]

Nominated pass through considerations and over and under account

The NSW DNSPs understand that this Rule change request is being considered alongside the COAG Energy Council Retailer insolvency events - cost pass through provisions Rule change (and equivalent Jemena Gas Networks Rule Change). Our 11 February 2015 submission supported both elements of the Retailer insolvency Rule change:

- to enable cost pass through applications for Retailer insolvency events to be approved by the Australian Energy Regulator (AER) without being subject to the materiality threshold that is usually applied to cost pass through events; and
- to amend the distribution cost pass through provisions in the National Electricity Rules (NER) to allow DNSPs to recoup their unrecovered revenue for direct control services that have been provided, but remain unpaid by Retailers that have become insolvent.

Notwithstanding our support for the above, we would like to stress in the strongest possible terms that while DNSPs can potentially recover unpaid network charges through a retail insolvency pass through, the remedy may be a slow one due to the likely delays in DNSPs recovering these costs.

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[6] For example, the risk of damages from a significant earthquake that is likely to occur less than 1 in 1,000 years. In theory, this risk can be self insured by saving an annual premium to pay for the earthquake when it occurs. However, if the event occurred prior to 1,000 years (i.e. in year 20) the business would have an insufficient pool of funds to cover the costs of the event.

[7] The probability of the event occurring is relevant for quantifying the likely impact of the event (i.e. loss times probability) as it will determine the self insurance allowance that the AER will likely approve. The AER has stated that the financial impact of the event must be able to be recorded in the building block revenue components (i.e. operating or capital expenditure) hence the mere loss of value from the event occurring would not be allowed as self insurance allowance.

[8] According to the AER, events could have upside and downside risks. Expressed in a different way this refers to whether an event is characterised by symmetrical or asymmetrical risks. Asymmetric risks can be distinguished from symmetric risks, in the sense that if an asymmetric risk occurred it would ONLY increase a DNSPs' costs whereas symmetrical risks are not always characterised by an increase in costs.

[9] The AER requested the very detailed information on 'self insurance' in the regulatory information notice (RIN) it issued to the Victorian DNSPs to substantiate their self insurance claims. Information required by the AER included details of all amounts and values used to calculate the proposed insurance; an explanation of the methodology; Board resolutions to self insure; actuary reports verifying the self insurance premiums; annual accounts recording the cost of self insurance as an operating expense.

[10] Electing to self insure for a risk means that the business must establish formal measures for pooling and managing the risk, and will also need to report the ongoing management of its self insurance via the RIN, which as noted above is onerous.

Depending on when in the period a Retailer of Last Resort (ROLR) event occurs, a DNSP may have to absorb this cost (and the interest that accrues on this debt) for up to 14 months before it can undertake adjustment through its annual pricing proposal to recover the outstanding network charges. This severely constrains its usefulness as a risk mitigation tool in lieu of appropriate credit support arrangements.

Over and unders account.

The overs and unders account relates to a revenue cap control mechanism. It is not mandated in the Rules and can vary from regulatory period to regulatory period as determined by the Australian Energy Regulator (AER); several DNSPs were subject to a price cap in the previous regulatory period.

Under a revenue cap, a regulated business is constrained (i.e. capped) on the overall revenue it can recover in one year. If actual revenue is less than allowed revenue, the DNSP can increase prices in the following years to recoup that under-recovery of revenue. Notwithstanding that any revenue shortfall would likely be recovered in the following year (pending AER approval), it is in no way a substitute for an effective credit support scheme. Linking the decision about a control mechanism and appropriate credit support is wholly inappropriate, it does nothing to mitigate against cash flow risk and the potential for wider market contagion as result of a large Retailer insolvency.

Option 2.1: COAG Energy Council Retailer insolvency cost pass through Rule change <u>without</u> credit support

The NSW DNSPs do support both elements of the COAG Energy Council Retailer insolvency cost pass-through rule change. Namely, removing the materiality threshold, where one applies and clarifying the provision to ensure that foregone revenue is included in the costs DNSPs are able recover in the cost pass through amount. However, we <u>cannot</u> support Option 2.1 as it would remove the Retailer-distributor credit support rules and rely on other regulatory arrangements, which we have highlighted above as not being a substitute for an effective credit support regime.

Option 2.2: COAG Energy Council Retailer insolvency cost pass through Rule change <u>and</u> AGL Rule Change.

The NSW DNSPs do not support the AGL Rule change as it removes the Maximum Credit Allowance (MCA) which means large Retailers have an unlimited credit with DNSPs regardless of market share. This coupled with the proposed lowering of the probability of default (PD) benchmark from A- to BBB increases the DNSP's risk tolerance, shifting the risk from Retailers to DNSPs. The AGL rule change does not strengthen the existing arrangements.

In the AGL Rule change proposal, AGL raises several issues with the current arrangements which are discussed below.

We note that AGL states that the Maximum Credit Allowance (MCA) is arbitrary[11]. The basis for having a MCA is to limit a DNSP's exposure or loss to a Retailer. In the event a Retailer fails it is likely to have credit outstanding to one or more DNSPs. Without an effective and enforceable credit support provision, all customers of the DNSP would bear the cost. Moreover, the MCA is not arbitrary, it is a practical allowance devised to cover the likely outstanding balance at any time, even for the largest Retailer, and to ensure that cost to the industry in providing credit support is only increased where material risks exist.

[11] AGL Rule Change proposal, p 3.

The MCA is based on the DNSP's total annual Retailer charges (TARC), and as Retailers' quarterly read customers pay their bills on average about 3 months in arrears - this is on average 25 percent of a year. DNSPs are therefore not adequately protected for the large exposures from key Retailers and the smaller Retailers who are higher credit risk with as large and significant credit allowances. In addition, we do not agree with AGL that the Rules have misaligned the cost materially given that the cost to the industry of providing credit support is only increased where material risks exist.

Under the current Rules, where a Retailer has a dominant market share (over 45 percent), a network provider may be entitled to request credit support, however this is based on the Retailer's external credit rating and is limited to the amount by which the Retailer's network charges liability exceeds the Retailer's credit allowance.

In previous submissions to the Consultation Paper and NEM Financial Resilience Review, we have argued that this level of credit support is grossly inadequate, and the DNSP would experience cash flow issues and financial distress in the event of a large Retailer failure.

AGL estimates the additional value of credit guarantees to be in the range of $250 to $450 million across both the NEM and the same jurisdictions in the gas market. The NSW DNSPs (Ausgrid) having implemented the provision of the Rules surrounding credit support, does not consider this statement as factually correct. The amount of credit support held by the three NSW electricity distribution network areas ranges between 1/5th to 1/10th ($40 to $50 million) of the amount purported by this paper, and at a two percent direct cost to the Retailer equates to no more than $1 million.

This cost of credit support is a necessary and reasonable business expense that a dominant Retailer presenting the greatest risk to the market would be expected to incur in order to protect the interests of consumers, and effectively caps the level of losses a DNSP will carry, thereby limiting the financial impact to customers more generally were the dominant Retailer to fail.

An inappropriate risk shifting/transfer to the DNSP: Move from A- to BBB- Benchmark

The critical element of the AGL Rule change request is a proposed shift from the current A- benchmark rating to a BBB- benchmark rating. The impact of the proposed change will increase the credit allowance (CA) of all Retailers with a rating below the current A- benchmark, by replacing the A- benchmark rating with a BBB- benchmark rating (as circled in the table below).

This implies BBB- rated Retailers and above would receive an unlimited allowance, as such there would be no credit support requirement for a Retailer unless it is rated a speculative grade of credit (i.e. BB+) or below.

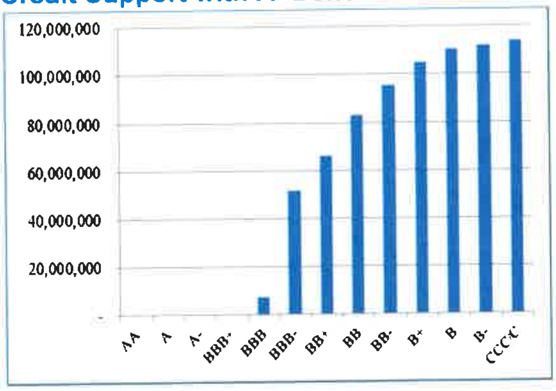
The increase in allowance pursuant to the proposed shift in benchmark credit rating is a significant change to the current settings in Schedule 6B.1. It effectively increases the DNSPs risk tolerance by increasing the risk of a potential shortfall in cash from the Retailer to the DNSP. The sole purpose of the AGL proposed rule change is to lower or shift the benchmark to enable barely investment grade entities to avoid credit support. As the purpose of Chapter 6B Part B of the NER is to mitigate the credit risks of Retailers to DNSPs, then any rule that lowers the benchmark such that a DNSP will never be entitled to credit support until it is too late, leaves the market open to contagion and systemic risk.

Another outcome of the design of a proposal with no credit allowance is that the small unrated Retailers would have to provide some level of credit support, whilst the largest Retailers posing the greatest risk to DNSPs would not provide credit support. The proposal has been made without a full consideration of the financial impacts on DNSPs in light of this risk transfer.

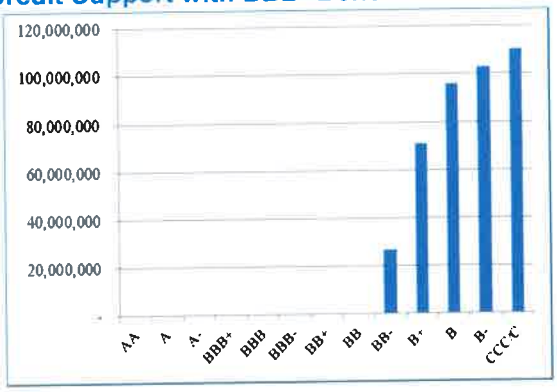
Rating	PD	Current Benchmark CA(%) A-	CA(%) BBB+	CA(%) BBB	AGL - Proposal CA(%) BBB-
AA	0.02	100.00%	100.00%	100.00%	100.00%
A	0.09	100.00%	100.00%	100.00%	100.00%
A-	0.09	100.00%	100.00%	100.00%	100.00%
BBB+	0.17	52.94%	100.00%	100.00%	100.00%
BBB	0.24	37.50%	70.83%	100.00%	100.00%
BBB-	0.41	21.95%	41.46%	58.54%	100.00%
BB+	0.53	16.98%	32.08%	45.28%	77.36%
BB	0.82	10.98%	20.73%	29.27%	50.00%
BB-	1.34	6.72%	12.69%	17.91%	30.60%
B+	2.7	3.33%	6.30%	8.89%	15.19%
B	6.26	1.44%	2.72%	3.83%	6.55%
B-	9.86	0.91%	1.72%	2.43%	4.16%
CCC/C	27.98	0.32%	0.61%	0.86%	1.47%

Graph 1: Impact of the Rule change on Ausgrid's credit support amount on shifting the benchmark from A- to BBB- for a 40% market share Retailer.

Credit Support with A- Benchmark



Credit Support with BBB- Benchmark



The AGL Rule change would effectively remove the sole measure a DNSP presently has to manage its risks to the dominant player in its network area.

Given potential timing lags between a 'name crisis' event and a credit downgrade it is arguably too late to collect credit support following a downgrade to the sub-investment ratings i.e. BB+ or lower.

Moreover, failure of the dominate Retailer would severely constrain our cash flow, compel us to seek emergency funding to fulfil our financial obligations, disrupt the market during the Retailer of Last Resort (ROLR) event and process, and result in the inequity of all customers of the DNSP bearing the costs via an approved pass through event and with consequent delays, not to mention the risk of broader financial contagion.

The AGL Rule Change does not achieve the National Electricity Objective (NEO)

We strongly disagree with the Rule change and do not believe that it achieves the National Electricity Objective (NEO). It represents an inappropriate risk transfer from Retailers to DNSPs and undermines the traditional roles and responsibilities of these two market participants.

The traditional role of Retailers is to provide a front-end customer service and billing management function, whereas DNSPs provide reliable, secure and safe electricity supply to customers in the long term interests of consumers.

DNSPs are subject to a range of regulatory obligations to ensure the efficiency (and prudency) of its capital investments in the long term interests of consumers. Furthermore, DNSPs receive no reward for assuming this increase in risk appetite due to the fixed and regulated nature of network billings.

We do not agree with AGL's argument that this Rule change will free up capital for Retailer investment has any relevance to the NEO and as such the Rule change proposal should be rejected. We strongly disagree with Retailer attempts to shift risk to networks and consider this or any other Rule change that attempts to do so to be self-serving and not in the long term interests of consumers.

Network businesses are under immense pressure to reduce network prices for customers and the NSW DNSPs are undertaking extensive efficiency programs to keep costs down. We do not support this Rule change proposal and consider that shifting costs and risks to network businesses in order to improve the profitability of (particularly large) Retailers is not in the long term interests of consumers. Enabling networks to recovering the costs of a failed Retailer on an *ex post* basis is by far a second best option compared with setting an appropriate *ex ante* credit support regime that sends more timely signals to the market of potential Retailer distress

We would submit that even if there was some societal benefit from transferring risk from Retailers to DNSPs, which we do not consider to be the case, the modelling which underpins the Rule change does not support AGL's argument. For example, AGL estimates the value of credit guarantees to be in the range of $250 to $450 million across both the NEM and the same jurisdictions in the gas market. However, Ausgrid has experience with implementing the current credit support provisions and does not consider this statement as factually correct.

The amount of credit support held by the three NSW DNSPs ranges between 1/5th to 1/10th ($40 million to $50 million) of the amount purported by this paper, and at a two percent direct cost to the Retailer equates to no more than one million dollars.

Furthermore any argument based on Retailer investment objectives seem at odds with AGL and Origin Energy's recently announced divestments including one billion dollars in asset sales[12].

Option 3: Establish a Retailer default fund

The NSW DNSPs prefer Option 3 over Option 4 as DNSPs should not assume the commercial risks of Retailers. This because DNSPs are subject to a range of regulatory obligations to ensure the efficiency (and prudency) of its capital investments in the long term interests of consumers whereas Retailers on the other hand routinely manage pricing risk and the rapid and often steep swings in wholesale electricity prices. Furthermore, DNSPs receive no reward for assuming this increase in risk appetite due to the fixed and regulated nature of network billings.

Retailers are best placed to decide on risk adjusted returns of their investments and DNSP customers should not fund single Retailer investments. As such Retailers are best served to manage their own credit risk and cash-flow liquidity risk (i.e. working capital) in line with their own risk appetite and to align their incentives with their own target credit ratings to ensure efficient investment incentives are maintained. DNSPs should not fund Retailer investments as this is not their purpose given their obligation to serve.

Notwithstanding the above we cannot (at this time) support Option 3 as presented because:

- It would remove the Retailer-distributor credit support Rules, and replacing it with an untested, unquantified funding regime.

[12]http://www.afr.com/business/energy/gas/agl-energy-targets-1b-in-asset-sales-200m-cost-cuts-by-201617-20150526-gh9bge

- There are practical issues in the implementation of this Option as to determining the size of the fund, how it will be managed and the costs associated which we believe will be far greater than has been estimated.
- The proposed fund size of the largest Retailers Network Charges Liability (NCL) across all the DNSP's that the largest Retailer operates is a wasteful allocation of capital, and is a higher cost solution than a bank guarantee.
- Whilst this Option assumes that the fund will be established over approximately 10 years, with price changes and dynamics of this industry, it is foreseeable that the fund would be inadequate by 2025.
- The annual contribution and ongoing costs of this Option will be allocated to Retailers and ultimately paid by the Retailer's customers.
- This Option has too many assumptions, key ones being fund size, annual contributions, management costs of the fund, investment return on the contributions, the fund size remains static for 10 years, and as the contributions are determined by the Retailer's risk and scale, then the customers of a high risk Retailer will be paying proportionately more.
- There would be significant details that would need to be worked before it could be deployed and whether it contributes to or lessens the NEO and NEM Financial Resilience arrangements.

As a result, the NSW DNSPs have a strong preference Option 2.3 which we believe could be achieved with relatively minor adjustments to current Rules.

Option 4: Introduce a liquidity support scheme

Both liquidity support scheme proposals (market-share based allocation of ongoing fees or risk based allocation of ongoing fees) would remove the Retailer-distributor credit support Rules, and replace it with an untested, unqualified liquidity support scheme. We note that the proposed scheme is not referenced in the AEMC's KPMG consultant report which reviews credit support arrangements in international jurisdictions and other sectors in Australia.

Under this proposal, DNSPs would need to obtain and maintain access to a committed facility from their bank (at cost) and would face additional costs should it need to access the facility in the event of Retailer insolvency. In this respect, while some modelling has been undertaken, we note that different assumptions using unpaid billings for NSW DNSPs with highly concentrated large Retailers would mean that the committed facility would potentially be larger than the amounts implied by the modelling. This would be an inefficient allocation of expenditure that could be otherwise used to maintain and/or development the network in the long term interests of consumers.

We note that the consultants used by the AEMC for analysis appear to favour this Option over Option 2.3 but we question Option 4's alignment with the regulatory principles. We briefly address these below.

Stability: to minimise potential financial contagion of a retailer default to its DNSP. Option 4 would not minimise potential for financial contagion of a Retailer default to its DNSP. It does nothing more than demanding that the DNSP pay for a line of credit from their bank, and shifts the risk from Retailers to DNSPs. In other words, it effectively increases the DNSP's risk tolerance by increasing the risk of a potential shortfall in cash from the Retailer to the DNSP.

It is difficult to quantify any positive societal benefits associated with freeing up capital for a Retailer to invest by transferring risk to the DNSP. As noted above, this would be an inefficient allocation of expenditure that could be otherwise used to maintain and/or develop the network in the long term interests of consumers.

Option 4 would not provide network businesses the reasonable opportunity to maintain key financeability metrics in the long term interests of consumers and it leads to higher financing costs over the long-term.

Credit support is an ex-ante mechanism which assists DNSPs to mitigate their loss in the event of a Retailer failure. Credit support lessens the impact on DNSPs cash flow, reduces the magnitude of costs that DNSPs would need to recover from their customers ex-post and the likelihood of customers suffering significant price shocks or price volatility as a consequence of a Retailer failure.

The situation is compounded further when the defaulting Retailer is a large Retailer and is likely to have more far reaching consequences as a result of a DNSP experiencing cash flow issues and having to borrow money to meet its obligations on short notice.

Efficiency and Incentives: to efficiently allocate the risks and costs to the parties and to provide appropriate incentives to minimise the probability and impacts of Retailer default. The traditional role of Retailers is to provide a front-end customer service and billing management function, whereas DNSPs provide reliable, secure and safe electricity supply to customers in the long term interests of consumers. DNSPs are subject to a range of regulatory obligations to ensure the efficiency (and prudency) of its capital investments in the long term interests of consumers. Furthermore, DNSPs receive no reward for assuming this increase in risk appetite due to the fixed and regulated nature of network billings.

Moreover, the transfer of risk to DNSPs from Retailers is not otherwise compensated for through the existing regulatory framework, including the application of existing pass through provisions. As the systematic (i.e. undiversifiable) risks of the businesses increase, there would need to be a thorough assessment of, amongst other things, the impacts on the return on capital as provided for in Chapter 6 of the Rules.

A priori, the Rule change proposal may result in an increase in systematic risks that could require a higher return on capital in future regulatory determinations, thereby increasing the costs of supplying electricity and leading to higher electricity prices for customers. Option 4 would be counter to the efficiency and incentives principles.

We believe that an important ongoing feature of sustainable long-term network investment framework is the regulatory capacity to accommodate financeability adjustments, where required, to ensure the ability of the networks to maintain stable credit metrics and therefore source competitively priced finance.

Revenue and pricing: to take account of any change in network revenue resulting from the application of the scheme's revenue and pricing principles. Under a revenue cap, a regulated business is constrained (i.e. capped) on the overall revenue it can use in one year. If actual revenue is less than allowed revenue, the DNSP can increase prices in the following years to recoup that under-recovery of revenue. Notwithstanding that any revenue shortfall would not be recovered until the following year, it is in no way a substitute for an effective credit support scheme.

Linking the decision about a revenue or pricing control mechanism and appropriate credit support is wholly inappropriate, it does nothing to mitigate against cash flow risk and the potential for wider market contagion as result of a large Retailer insolvency.

Competition: credit support is not a means for encouraging competition; it is a tool to manage credit risk exposure acknowledged to exist between market participants and to do so within set Rules. It should not be considered a regulatory principle in this context. Instead, we consider that a principle should be added which examines credit support in the context of the roles and responsibilities of Retailers and DNSPs.
For example, Retailers were essentially set up to manage risk in that they manage pricing risk and the rapid and often steep swings in wholesale electricity prices. They do this through a range of hedging policies and, in some cases, by being vertically integrated gentailers. They also perform a customer function in terms of a direct customer service interface and packaging up a range of services, billing (collecting meter data) and payment Options. Retailers do not directly supply energy.