

11 December 2014

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 6, 201 Elizabeth St
Sydney NSW 2000

via AEMC's website, www.aemc.gov.au

Dear Mr Pierce

AEMC Rule change - National Electricity Amendment (Retailer insolvency events – cost pass through provisions)

The ENA welcomes the opportunity to provide a submission to the AEMC in response to the Consultation Paper *National Electricity Amendment (Retailer insolvency events – cost pass through provisions)*.

The Consultation Paper arises from a request by the COAG Energy Council to correct drafting errors in the National Electricity Rules (NER), and to better reflect the original policy intent of the cost pass through provisions in relation to retail insolvency events under the National Energy Customer Framework (NECF).

The ENA is supportive of a retailer insolvency event framework which:

- is not subject to the materiality threshold that is applied to other pass through events: and
- specifically clarifies that revenue forgone to DNSPs as a result of the event is able to be recovered, including TUOS and the additional costs of the retailer insolvency event.

Key message

The ENA supports the proposed Rule change as it provides mechanism to enable distributors to recover debts incurred when retailers become insolvent, and corrects NER drafting which is currently inconsistent with the policy intent of NECF.

The Consultation Paper poses some questions with respect to the fundamentals of the NECF market model behind the NECF policy decisions and the NERL/NER drafting regarding retailer failure impacts on Distributors. ENA considers that the broad market model provides a workable approach to this matter that appropriately addresses the matters raised by the Paper.

Further, the NECF regime was attempting to provide a balanced framework for dealing with DNSP revenue risks. This not only included the insolvency pass through provisions but the retailer credit support regime. To consider changing the balance by revising the insolvency pass through provisions to a different model than intended, would potentially not meet the overall intent of the NECF with respect to DNSP credit risk.

Reallocation of credit risk to customers

The consultation proposes that DNSPs may have a greater capacity to absorb short term losses compared to individual customers and also raises the question as to whether they are in a better position than customers to manage the risk of retailer failure.

The consultation paper notes COAG's statement that the recovery of revenue foregone following a retailer insolvency is appropriate given that:

- under the NER, DNSPs are subject to a mandatory obligation to supply regardless of the risk profile of the party requesting supply; and
- DNSPs are restricted in how they manage that counterparty risk and credit support arrangements are highly prescribed.

DNSPs are limited in their ability to manage the risk in that they cannot choose to limit the bad debt by ceasing to operate and supply services to a failing retailer and their customers.

In contrast a commercial business in less critical markets would have the ability to decide whether to deal with a certain counterparty, have the ability to cease to trade with the counterparty as soon as they believed that they may not be paid or that the counterparty business was failing, and would have no constraints to promptly limit risk.

In a retailer insolvency event, due to the long times to submit and gain approval for a cost pass through, and to implement recovery through revised tariffs, DNSPs will need to top up/carry extra working capital. When DNSPs (and possibly retailers acting in the ROLR capacity) go to the financial market to top up working capital, it is likely that funds will be more expensive due to the risks perceived in the electricity market. The current regulated cost of capital received by DNSPs is not set having regard to these types of market conditions, and should credit risks be materially re-allocated to networks in a manner at variance with past understood approaches, this will clearly impact future risk and rate of return assessments. Further for shareholder-based distributor businesses, shareholder perception drives share prices which in turn drives capability to raise funds. Short lead-time fund raising is not perceived as a desirable feature by investors or prospective investors in distribution business.

The consultation paper recognises that DNSPs and TNSPs should be provided with a reasonable opportunity to recover at least the efficient costs in providing network services and complying with regulatory obligations or making regulatory payments. It will be important to ensure that the balance of risk allocation decided by the policy makers and supported by COAG is recognised and implemented correctly in decisions made under the NER.

Recovery of revenue

ENA is supportive of the retailer insolvency event revenue pass through continuing. The consultation paper notes that this risk predates the NECF arrangements and DNSPs have already had to manage this risk; however all of the jurisdictions had mechanisms to minimise this risk with either a distributor having the ability to seek guarantees from higher credit risk¹ retailers or having access to a similar revenue pass through event.

Further the AEMC Paper makes the point that this is the only pass through provision which specifies "revenue" rather than "cost" recovery and questions whether retailer failure has any special feature which makes this appropriate. However it is unclear what other event other than a retailer failure would lead to a distributor revenue shortfall. A revenue pass through is appropriate in this case as it is the main impact (along with the potential costs of handling the actual failure event).

¹ Higher risk retailers are those with a credit rating below BBB-

The retail market has grown with a significant number of new entrants. New retail offerings and additional products or altered business structures/mergers may mean that the traditional retail business model is more exposed with potential for financial repercussions. In future this can affect energy retail offerings for energy sales, product offerings and leases (eg metering and SPPAs etc). Increased competition in a wide range of products and against an increased number of third parties will result in some business being more successful than others and the potential for some insolvency events. It should be recognised that the approval for an energy retail licence or authorisation by a regulator is a point in time review and does not keep taking into account the ongoing financial viability or risks of the business.

Removal of the materiality threshold

The consultation paper suggests that having a materiality threshold has been and continues to be a fundamental part of the cost pass through mechanism. The arguments are that this avoids DNSPs and TNSPs submitting applications that are trivial in size compared to the distributor's cashflow, and provides an incentive for the DNSPs to self manage the risk.

Where pass through applications are clear cut and able to be supported by unpaid invoices and possibly an independent audit, review by the AER should be able to be progressed in a timely manner. The materiality threshold should not be used to constrain pass throughs where they can be dealt with a prompt, stream lined manner.

As acknowledged in the Paper, the capability for the DNSP to manage the risk is limited and/or involve on going costs passed through in standard control service changes to customers.

Options for recovery

The consultation paper suggests that credit support provisions will limit the financial exposure of a DSNP to the credit risk by capping the amount of debt to be recovered to the amount of the credit allowance. The credit support arrangements operate in a manner that generally does not allow DNSPs to request credit support in many cases and in the event of non payment, months of additional debt are incurred before DNSPs may request credit support thus making the eventual debt to be recovered larger. The many mergers also allow retailers operating multiple retail authorisations, and even more participant IDs, in the NEM to circumvent credit support arrangements.

The credit support arrangements are not a sufficient means of managing credit risk alone, ultimately the cost pass through mechanism (with appropriate credit support business practices) is what provides assurance to the financial institutions willing to invest or fund the electricity assets.

The consultation paper recognises that there is a customer impact with the pass through amounts as some or nearly all customers have paid for the retail services. All customers have benefited from lower prices from retail competition and the customer pass through impacts as a result of an event is a more appropriate option than forecasting an infrequent event so that customers are paying even if the event does not occur. The cost pass through arrangements take into consideration any credit support held by DNSPs and would only provide pass through for the incremental amounts. There is no risk of double recovery.

The impact of any cost pass through event on customer price is able to be managed in terms of the regulated component of customer retail tariffs. In establishing the mechanism for pass through to customers, the regulator will assess the network price impacts and seek to spread the risk in an appropriate manner.

The consultation paper suggests that where a DNSP is able to recover a few cents per dollar of the bad debt that there is a potential that the DNSP can double recover. In the case of Jackgreen Ltd, creditors received 2-3 c per dollar of debt. The regulator can allow a mechanism as part of the cost pass through

to cater for the hand back of this amount in the next annual tariff proposal. The ENA consider that the regulator has sufficient powers to ensure that this does not happen.

Leaving the DNSPs exposed to the risk of retailer failure with limited ability to manage commercial exposure could lead to increased borrowing costs and a re-rating of the industry, ultimately leading to cost increases for customers.

Additional drafting issue for attention of the AEMC

The NER proposed wording in the Rules change request has the following definitions:

retailer insolvency costs

Amounts a *Distribution Network Service Provider* is entitled to be paid (but which are or will be unpaid as a result of a *retailer insolvency event*) for the provision of *direct control services* including the revenue impact a *Distribution Network Service Provider* sustains or will sustain as a result of those unpaid amounts.

retailer insolvency event

The failure of a retailer during a regulatory control period, to pay a Distribution Network Service Provider an amount to which the service provider is entitled for the provision of direct control services, if:

- (a) an insolvency official has been appointed in respect of that retailer; and
- (b) the Distribution Network Service Provider is not entitled to payment of that amount in full under the terms of any credit support provided in respect of that retailer.

Hence the DNSP can recover revenue not paid as a result of the retailer insolvency event, and this event is defined as where a retailer has not paid for provision of direct control services AND an insolvency official has been appointed.

However ENA has a concern that, as this limits the recovery only to situations where an insolvency official has been appointed, where such an official has not been appointed, the DNSP will not be able to rely on this provision to recover unpaid revenue.

The use of the phrase which limits recovery to where an insolvency official has been appointed leaves it unclear whether:

- recovery of unpaid revenue for the period before the insolvency official has been appointed is recoverable, or
- in situations where an insolvency official is never appointed but revenue remains unpaid, the unpaid revenue is still recoverable through the pass through mechanism. For example, a failed retailer's customer base is sold to another retailer but leaves behind unpaid network revenue.

It would appear that if as we understand, the COAG policy was for DNSPs to be able to recover unpaid revenue in the case of retailer insolvency, then the current definition of an retailer insolvency event which requires not only insolvency ie not meeting financial commitments, but specifically the appointment of an insolvency official, appears to potentially limit the application of the policy.

ENA considers that the definition of retailer insolvency event should make it clear that the unpaid revenue pass through arrangements applies for any unpaid revenue left by a failed retailer including for the period before an insolvency official is appointed, or in the event an insolvency official is never appointed.

The ENA welcomes the opportunity to participate in the further development of this rule change, if you have any questions please contact me on 02 6272 1555 or Jim Bain on 02 6272 1516.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'John Bradley', with a stylized, cursive script.

John Bradley

Chief Executive Officer