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26 November 2015

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

ERC0183 - *NATIONAL ELECTRICITY AMENDMENT (RETAILER - DISTRIBUTOR CREDIT SUPPORT REQUIREMENTS) RULE 2015* - OPTIONS PAPER.

Ergon Energy Corporation Limited (Ergon Energy) in its capacity as a Distribution Network Service Provider (DNSP) in Queensland welcomes the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on its *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015* - Options Paper.

Our responses to the questions raised in the Options Paper, are included in the attached submission. Furthermore, as a member of the Energy Networks Association (ENA) Ergon Energy has contributed to and supports the ENA's submission.

Should you require additional information or wish to discuss any aspect of Ergon Energy's submission, please do not hesitate to contact either myself on (07) 3851 6416 or Trudy Fraser on (07) 3851 6787.

Yours sincerely

Jenny Doyle
Group Manager Regulatory Affairs

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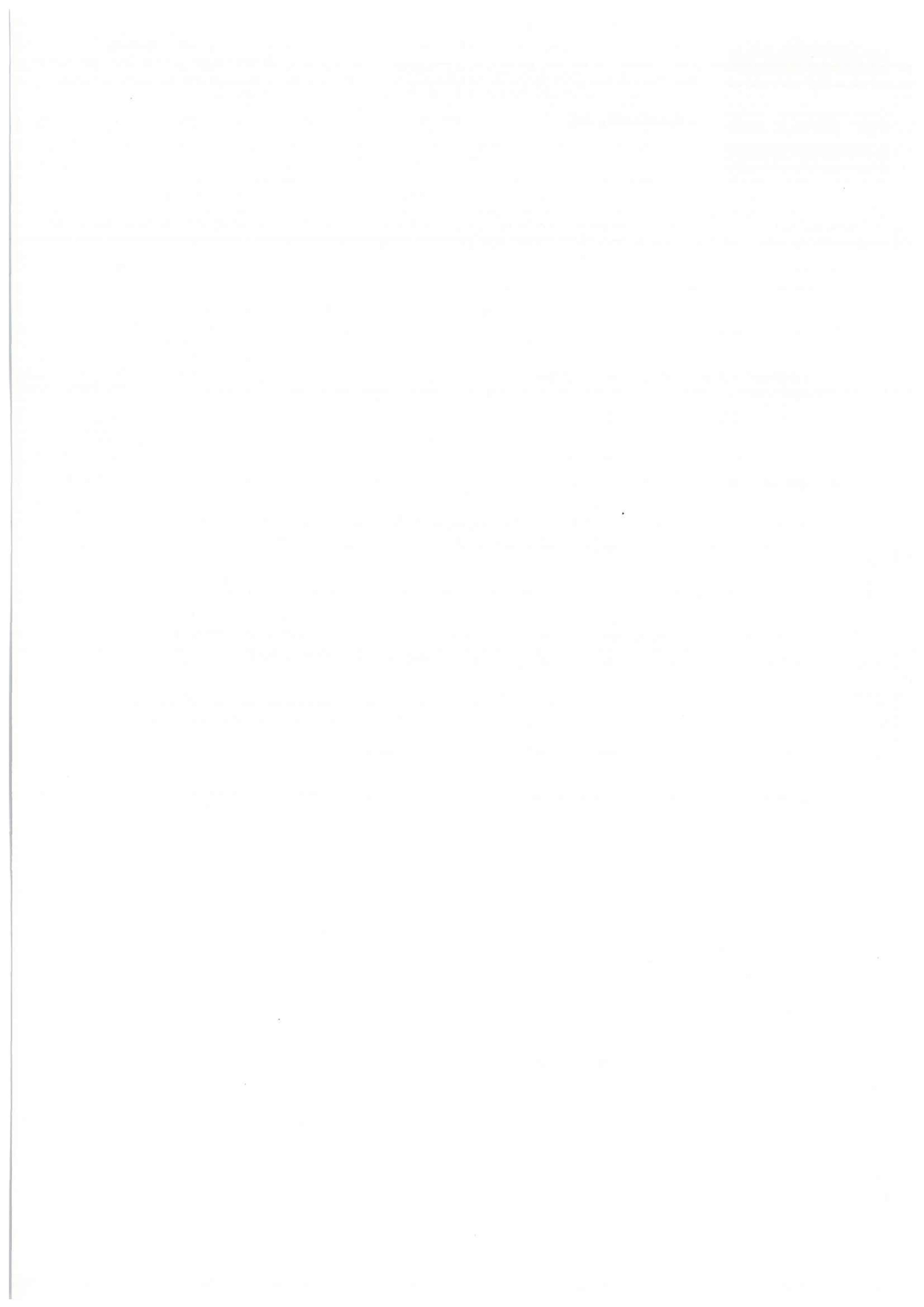
Enc: Ergon Energy's submission



Submission on the *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Options Paper 2015*

26 November 2015

Submission on the *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Options Paper 2015*

Ergon Energy

26 November 2015

This submission, which is available for publication, is made by:

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Introduction

Ergon Energy Corporation Limited (Ergon Energy) in its capacity as a Distribution Network Service Provider (DNSP) in Queensland welcomes the opportunity to provide comment to the Australian Energy Market Commission (AEMC) on its Options Paper - *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015.*

Ergon Energy notes that under the current rules there is minimal credit support provided to DNSPs and inadequate means for distributors to effectively manage or mitigate the risk of retailer default.

As such, Ergon Energy strongly supports the introduction of credit support Option 2.3 as described in the AEMC's Options Paper. This includes the immediate removal of the cost-pass through materiality threshold; and clarification of the rules to stipulate any costs incurred by DNSPs in the event of retailer default can also be recovered.

The reasoning behind these positions is further detailed in response to the AEMC's feedback questions below. As a member of the Energy Networks Association (ENA) Ergon Energy has contributed to and supports the ENA's submission.

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Credit Support Options Paper Feedback Questions	Ergon Energy Comment
Question 1: **The option to retain existing arrangements**	
(a) What are the advantages of retaining the existing arrangements for both the credit support requirements and the cost pass-through provisions in terms of recovering revenue related to managing the risks associated with retailer default?	**Credit Support Arrangements** – Ergon Energy considers there are limited advantages to the existing credit support arrangements under the National Electricity Rules (NER), which leave DNSPs, and in turn customers, highly exposed to the independent business models, risk levels and decisions of retailers. In particular, the existing model is ineffective for mitigating both revenue and liquidity risk associated with retailer default. Specifically, liquidity risk is not mitigated at all and revenue risk is only mitigated to the extent a revenue cap regime applies as the regulatory control mechanism for the overs and unders process. **Cost-pass through provisions** – As in the case of existing credit support arrangements under the NER, Ergon Energy considers there are limited advantages to the current cost pass through arrangements, which may not allow forgone revenue associated with a retailer default to be passed through. On this basis, Ergon Energy strongly supports the implementation of the Council of Australian Governments' Energy Council's (COAG) and Jemena's proposal to remove the materiality threshold from the cost pass-through provisions and to allow foregone revenue (and costs) arising from a retailer default to be passed through. Furthermore, we consider the COAG and Jemena proposal should be implemented as soon as possible.
(b) How does this option compare to the other options discussed in this options paper to manage the risks associated with retailer default?	Ergon Energy is of the strong view that this option is the least effective option for managing the credit risks and liquidity risks faced by DNSPs, compared to the other options being considered. In fact, the existing credit support arrangements are deficient such that: • There is no consideration of industry concentration measures to capture single name retailer concentration risk in the NER and National Gas Rules (NGR); • The existing rules enable unrealistic credit allowances to be set for unrated retailers

	through the use of Dun and Bradstreet (D&B) dynamic scores compared to Standard and Poor's (S&P) and equivalent rating agency's probability of default; and • The existing rules also do not explicitly require credit allowances at the parent entity level to be apportioned between entities / Financially Responsible Market Participants (FRMP) within a retailer group, so that retailers are unable to receive multiple credit allowances. In consideration of these issues, Ergon Energy recommends that the existing arrangements be strengthened to mitigate the risks currently borne by DNSPs.
Question 2: **The option to strengthen existing arrangements**	
(a) What are the advantages of strengthening the existing arrangements for both the credit support requirements and the cost pass-through provisions in terms of recovering revenue related to managing the risks associated with retailer default?	Ergon Energy strongly supports Option 2.3 as outlined in the Options Paper / Promontory report, including the removal of the cost-pass through materiality threshold and clarity that any costs associated with retailer default can be recovered. Option 2.3 will provide additional protection to DNSPs through increased levels of credit support which would work to reduce both the revenue and liquidity risks faced by DNSPs in the event of a retailer default. It would also provide the correct incentives on retailers to manage their credit worthiness and to reduce their risk and probability of default. Ergon Energy considers retailers are best placed to manage their own commercial risks including credit risk profile, risk appetite, cash flow and liquidity risks. Furthermore, any costs incurred in managing these commercial risks, including credit support requirements should be borne by retailers not DNSPs.
(b) Are there other measures that would more effectively strengthen the retailer insolvency cost pass-through provisions and/or the retailer-distributor credit support provisions, which have not been outlined above?	No.
(c) How does this option compare to the other	Option 2.3 is the only option that effectively manages credit risk, revenue risk and liquidity

options discussed in this options paper to manage risks associated with retailer default?	risk associated with retailer default. The enhancements also provide a level of certainty in the recovery of any residual forgone revenue and costs, as those amounts above the level of credit support are passed through. From a post-default analysis perspective, the potential cash flow shortfalls would also be significantly reduced. Ergon Energy does not support AGL's proposal to lower the benchmark credit rating to BBB- as this would result in retailers having an unlimited credit allowance with DNSPs regardless of their market share, and only retailers rated below an investment grade of credit would be required to provide credit support. Under AGL's proposal the three largest retailers would not be required to provide credit support as they currently hold an investment grade credit rating. Ergon Energy also supports the other credit support enhancements outlined within Option 2.3 including: re-alignment of D&B dynamic risk scores and credit ratings to reflect differences in methodology, and restricting the use of D&B dynamic risk scores in instances where a retailer or its parent group has a credit rating. Specifically, the D&B probability of default should be re-aligned to match up with the lower equivalent S & P/Fitch Ratings/ Moody's probability of default as outlined by Promontory in Table 5.7 in Section 5.4 of their report. The current rules should also mandate the use of an S&P (or equivalent agency) credit rating by retailers where one is available. If no such rating is available or the retailer decides not to use the S&P rating, retailers should be treated and assessed as unrated. In relation to multiple retailer authorisations, Ergon Energy considers the NER and NGR should be amended to clarify that a licensed retailer is not allowed to use its parent credit rating unless an explicit guarantee is provided by the parent; and if multiple guarantees are provided by the parent of a retailer group, the credit allowance of the parent must be apportioned out to the individual retailer authorisations or licences being guaranteed. We also consider that the apportionment of the credit allowance should be determined by the DNSP. Furthermore, in order to protect DNSPs from potential contagion risks arising from retailer default, Ergon Energy considers that credit concentration concerns such as single name retailer concentration risk should also be addressed, as outlined in Networks NSW's submission to the AEMC's consultation paper. Ergon Energy also supports DNSPs being allowed the flexibility to request additional credit support to account for a retailer's market share beyond an identified threshold level; based on a formula to be included in the NER

	and NGR.
Question 3: **Other credit support designs**	
(a) What are the possible advantages or disadvantages of the other credit support designs outlined above?	**Advantages:** Ergon Energy considers that New Zealand's approach of providing DNSPs with choice and not the obligation to require a retailer to provide credit support is an example of the potential advantages of the other credit support design models. Another advantage of such arrangements would be the ability to include flexibility to enable a DNSP and retailer to agree on the level of credit support required and where agreement cannot be reached the mechanism outlined in the NER would apply. Both New Zealand and Ireland require retailers to provide credit support of between two to three months of estimated network charges payable by the retailer. This is significant in assisting DNSPs to manage liquidity risk in the event of a retailer default and to minimise potential cash shortfalls. Disadvantages: Ergon Energy notes that some approaches, such as the Alberta approach, obligate the DNSP to request credit support from the retailer. However, we note that this approach is not appropriate for vertically integrated distributors and retailers in the same group. Furthermore, in relation to the provision of a retailer's security deposit, the Alberta approach does not allow the amount of the security deposit to vary with the retailer's market share, and therefore the credit support does not fully reflect the DNSP's exposure to the retailer.
(b) How do these other credit support designs compare to the other options discussed in this options paper in relation to managing the risk of retailer default?	The other credit support designs illustrate that there is no precedent for Option 3; establish a retailer default fund, or Option 4; introduce a liquidity support scheme, in international energy markets for managing the risk of retailer default.
Question 4: **The option to establish a retailer default fund**	
(a) What are the advantages of establishing a retailer default fund in terms of recovering	Once sufficient funds have been contributed over time by retailers, in the event of a retailer default DNSPs could access the fund within a relatively short time frame upon approval by

revenue related to managing the risks associated with retailer default?	the Australian Energy Regulator, thereby mitigating their revenue and liquidity risks.
(b) How does this option compare to the other options discussed in this Options Paper to manage risks associated with retailer default?	This option is the least cost effective of the options outlined. Significant administration, time and resources will be needed to establish the fund and governance structures, including the operation and management of the fund. Additionally, rules would need to be established for how the fund will be replenished in the event a retailer default occurs. The incentives on DNSPs to manage their risks to retail exposures will also need to be considered given the current credit support requirements would be removed under this option. Additionally, as this option is unprecedented in Australian and overseas energy markets further investigation of the option would be required, before it could be adequately considered. This is particularly so in relation to fund size, annual contributions, management costs of the fund, investment returns on contributions and use and replenishment of the fund, which would build upon the research and modelling undertaken by Promontory.
(c) Are there any practical considerations of developing and implementing this type of retailer default fund? If so, what are these considerations?	These are outlined in (b) above.
(d) If a retailer default fund were established: • how should the size of the fund be determined?	Ergon Energy considers the target size of the fund should be set based on the largest retailer in the market, by aggregating the retailer group's network charges liabilities (NCL) outstanding to all DNSPs. It would also be prudent to include a buffer amount of 15-20 per cent as outlined by Promontory to allow for the potential increase in size of the largest retailer and other costs incurred as a result of a retailer default. The fund should be monitored regularly (at least annually), and contributions adjusted to reflect any changes in credit worthiness and market share for the largest retailer.
• over what period of time should the fund be built?	Ten years would be an appropriate time period based on the modelling provided by Promontory. However, the period of time could be further discussed and agreed during the establishment and set up of the fund. The timeframe would need to be continually monitored to ensure the target size of the fund could be achieved over the agreed timeframe, and adjustments made if necessary.

• how should the contributions into the fund be determined (eg. based on creditworthiness, market share or some other measures)?	Contributions should be based both on creditworthiness and market share. Ergon Energy supports the adoption of a risk-weighted approach to account for different levels of credit worthiness when allocating the annual contributions to the fund.
• how should the funds of the retailer default fund be replenished if the fund is called upon in the event of a retailer default?	The fund should be replenished through new contributions from retailers in line with the detailed design set out for the original contributions to the fund. Ergon Energy does not support the alternative approach to replenishment which would effectively require the customers' within the DNSPs' networks to fund the replenishment of the fund. This cost should be borne by retailers and their shared customers not DNSPs.
Question 5: **The option to introduce a liquidity support scheme**	
(a) What are the advantages of introducing a liquidity support scheme in terms of recovering revenue related to managing the risks associated with retailer default?	Provided all DNSPs were able to establish committed facilities from the banking sector, a liquidity support scheme would protect DNSPs from the impact of retailer default on the DNSP's liquidity. The committed facility would provide DNSPs with the ability to recover forgone revenue and provide access to sufficient funds to cover any cashflow shortfalls to restore their working capital ratios to 1.0.
(b) How does this option compare to the other options discussed in this Options Paper to manage risks associated with retailer default?	Ergon Energy considers that this option would require the COAG recommendation to be implemented in combination with the liquidity support scheme to mitigate the risk that the banking sector could refuse to provide or renew a committed facility due to concerns about the credit worthiness of the DNSP. Without the COAG recommendation, there would be greater uncertainty around the recovery of foregone revenue under this option and it is likely there would be an increase in the cost of the liquidity facility. From a credit risk perspective, this option does not manage counterparty credit risk. It does not provide any incentives to retailers to manage their own commercial risks including credit risk profile, risk appetite, cashflow and liquidity risks or exposure to DNSPs (i.e. NCLs). This option essentially involves a DNSP establishing and paying for a line of credit from their

	bank, thereby shifting the risks and costs of credit support from retailers to DNSPs. There may also be ongoing compliance costs for DNSPs in having to meet conditions and reporting obligations levied on the liquidity scheme by their banks. These ongoing compliance costs on DNSPs do not appear to have been considered or quantified in the AEMC options paper or Promontory's report.
(c) Are there any practical considerations of developing and implementing such a liquidity support scheme? If so, what are these considerations?	Key practical considerations are the size of the committed facility and the recovery or allocation of the facility fees, including establishment / set up fees, annual / ongoing commitment fees and utilisation / funding fee in the event of a drawdown.
(d) If a liquidity support scheme were established: • how should the size of each distributor's liquidity support instrument be determined?	Based on the NCL of the largest retailer for that individual DNSP in order to account for concentration risk, and without a cap. Ergon Energy does not support capping the overall size of the facility based on 50 per cent of all retailers' NCLs.
• how should the costs associated with the establishment fee and annual commitment fees be funded?	They should be funded by retailers and their customers and not DNSPs.
• if the establishment fee and annual commitment fees were to be collected from retailers, how should the costs be allocated amongst the retailers of that distributor?	Ergon Energy considers that the costs should be allocated based on the retailer's credit worthiness and NCL as outlined in option 4.2.
Question 6: **Relationship between the discussed options to manage the risk of retailer default**	

(a) How do the various options discussed above, to manage the risk of retailer default, work to complement each other in ensuring that the risk of retailer default is managed in the most efficient manner?	No comment.
(b) How should these different options be combined in a regime to manage the risk of retailer default to ensure an efficient outcome?	No comment.
Question 7: **Options**	
(a) Are there other options for managing the risks and costs associated with retailer default, which stakeholders feel the Commission should consider?	No. Ergon Energy supports the approval and implementation of Option 2.3 as outlined above.