

2 July 2015

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

via email: AEMC website

Dear Mr Pierce

AEMC Rule change - Retailer-Distributor Credit Support Requirements (ERC0183 and GRC0032)

The ENA welcomes the opportunity to provide a submission to the AEMC in response to the Consultation Paper *Retailer-Distributor Credit Support Requirements (ERC0183 and GRC0031)* published on 28 May.

The Energy Networks Association (ENA) is the national industry association representing the businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia. ENA members own and operate energy network infrastructure assets valued at over \$100 billion.

The ENA appreciates the AEMC's approach to this consultation "to take a broader view of how the risks and costs involved with retailer default should be best managed"¹.

Key messages

- In order to meet the National Electricity Objective (NEO) and the National Gas Objective (NGO) it is necessary to minimise any exposure to financial risk that puts an obligation on regulated network businesses and increases costs to customers. Credit risk should **not** be shifted from retailers to DNSPs.
- The most effective way of mitigating the potential credit and cash flow impacts from a retailer failure is through having credit support arrangements that can be speedily enforced by DNSPs.

¹ AEMC Information Sheet p1

- Under the AGL proposal businesses rated 'BBB-' (Standard & Poor's) or above will not provide any credit support to DNSPs in any circumstances. This change from A- to BBB- ignores the scale and concentration of financial transactions between the counter parties (ie the expected loss given default), which would shift the risk from retailers to DNSPs and raise required rates of return for DNSPs.
- In relation to the COAG Energy Council proposed Rule change to include a 'no materiality' clause for revenue pass-through in the case of a retailer becoming insolvent. The ENA fully supports this Rule change and encourages its implementation as soon as practicable.

AGL proposed Rule change

Issues for distribution businesses

The adequacy of the current credit support regime and the ability for distributors to effectively mitigate the risk of retailer default are important issues in considering whether the rule change request meets the NEO² and NGO³.

Credit support arrangements between distributors and retailers support the integrity of the electricity market in a similar way to the prudential arrangements that the Australian Energy Market Operator manages between generators and retailers.

Under the current Rule there is minimal credit support provided to DNSPs and similarly the AER makes no allowance for DNSPs credit risk in its revenue decisions leaving the credit support issue unresolved and DNSPs exposed to a major retailer default. It would be expected that DNSPs would be entitled to ask for credit support based on a normal commercial basis. Historically retailers are not exempt from default. The wholesale energy trading business is a high risk business and retailers can fall into default very quickly (e.g. Jackgreen).

The electricity industry has a high degree of concentration with three large retailers and thirteen DNSPs operating in the national electricity market. Due to this concentration, the consequences of failure are significantly increased in instances where a single retailer has a large market share of a DNSP's business. The degree of concentration is similar in the gas industry.

Under the AGL proposal businesses rated 'BBB-' (Standard & Poor's) or above will not provide any credit support to DNSPs. The critical element of the rule change request is the proposed shift from the current A- benchmark rating to a BBB- benchmark rating. The impact of the proposed change will increase the credit allowance of all retailers with a rating below the current A- benchmark, by replacing the A- benchmark rating with a BBB- benchmark rating.

² The National Electricity Objective is to promote the efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to – price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.

³ The National Gas Objective 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.

This implies BBB- rated retailers and above would receive an unlimited allowance, and 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 proposal has been made without a full consideration of the financial impacts on DNSPs in light of this risk transfer. We argue that the Probability of Default (PD) benchmark should remain at A- (and not reduce to BBB-) to avoid risk shifting/ transferring risks from retailers to DNSPs.

The AGL proposal ignores the scale and concentration of financial transactions between the counter parties and, therefore, the expected loss given default. This would increase the required rates of return for DNSPs and could only be partially mitigated by appropriate revenue pass through. It would not reflect commercial practice to accept that risk for transaction values at this scale.

ENA notes that DNSPs have limited access to alternative avenues to mitigate the risk of credit default or recover costs associated with a retailer failure. The cost pass-through provisions in the National Electricity Rules (NER) and National Gas Rules (NGR) are one such avenue however these provisions take time to implement and do not assist businesses crucial cash flow requirements resulting from a major retailer default.

Preferred approach to credit support requirements

ENA believes that the AEMC should consider credit support provisions in the NER and NGR that take into account both the likely default of an individual retailer (based on their credit rating) and the distributor's level of exposure to an individual retailer. We believe that neither the AGL rule change nor current credit support provisions address either.

An alternative approach could be to introduce a simple credit support calculation that is based on the credit worthiness of the retailer and the level of exposure to the distributor rather than based on the distributor's annual revenue (which is currently used as the basis for credit support calculations). It is not logical in a competitive environment for a service provider to provide services and a credit allowance to a risky customer based on the revenue of the service provider.

Moreover, the ENA submits that there could be some improvements made to the current Rules in a more preferable Rule. For example, the current Rules facilitate unrealistic credit allowances for unrated retailers through the use of Dun & Bradstreet dynamic (D&B) risk scores. Accordingly we propose that the Rules realign the D&B to Standard & Poor's/ Fitch/ Moody's probability of default⁴. Further, the Rules could be explicit that Credit Allowances must be at parent entity level and must be apportioned between entities/ FRMPs within a retailer group, so that retailers cannot receive multiple credit allowances.

⁴ The current rules refer Table in Schedule 6B.1 (Clause 6B.B3.1) misalign the probability of default of D&B to S&P's and as a result give unrated retailers unrealistic credit allowances. The proposed changes, if implemented, would mean there would be no credit support requirements for retailer's rated BBB- and above. This is a significant change to the current DNSP *risk appetite* settings as they appear in Schedule 6B.1 of the NER.

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 speedily enforced by DNSPs. This gives retailers an incentive to maintain or improve, as far as possible their credit rating, which the current rules do not encourage.

Materiality of credit guarantees

The proponent, in their Rule change proposal (p8), 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. This implies:

- Direct costs well in excess of \$4 million per annum (given that some of the guarantees are provided by lower rated retailers);
- Facility commitment fees well in excess of \$3.1 million per annum;
- A reduction in funds available for re-investment in the electricity and gas markets of between \$250 and \$450 million.

From ENA experience with credit support requirements this claim appears excessive and the ENA would like further evidence of these costs.

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. It is difficult to identify any positive societal benefits associated with freeing up capital for a retailer to invest by transferring risk to DNSPs.

COAG Energy Council rule change request

In relation to the cost pass-through provisions it is important that the proposed 'no materiality' rule change is introduced and processed as soon as practicable. The ENA suggests that the Rule should ensure that revenues are passed through rather than simply allowing for 'cost pass-through', which is likely to be insufficient to avoid increasing the required rate of return for DNSPs.

The rule change is necessary to rectify an inadvertent amendment to the NER that does not align with the original NECF policy but also because a retailer insolvency event does not represent an increase in the costs of providing direct control services.

The ENA looks forward to the opportunity to participate further in the development of this Rule change proposal. If you have any questions please contact me on 02 6272 1555 or Jim Bain on 02 6272 1516.

Yours sincerely



John Bradley
Chief Executive Officer