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26 November 2015

Shari Boyd
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted electronically

Dear Shari,

Re: National Electricity Amendment (Retailer Credit Support Requirements) Rule 2015: National Gas Amendment (Retailer–Distributor Credit Support Requirements) Rule 2015: Options Paper

A) Background

Red Energy (Red) and Lumo Energy (Lumo) welcome the opportunity to make a submission to the "Options Paper" as part of this consultation.

Red and Lumo are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria and New South Wales and electricity in South Australia and Queensland to approximately 1 million customers.

The current credit support arrangements under the National Electricity Rules (NER) and the National Gas Rules (NGR) permit distributors to request credit support from a retailer when that retailer's network charges liability exceeds its credit allowance.

Under the current arrangements a retailer's credit allowance is a function of its Maximum Credit Limit (MCL). The MCL of a retailer is a function of the distributor's annual network charges and its own credit rating with a higher credit rating equating to a higher credit allowance.

As part of this rule change request AGL has proposed a rule change that would modify the current credit support arrangements. Retailers with a credit rating of between (AAA to BBB-) would not be required to pay for credit support. Those retailers with lower credit ratings (BB+ to CCC) would pay for credit support under a revised methodology.

On the 28th of May 2015 the Australian Energy Market Commission (Commission) released a consultation paper which explored a range of issues relating to the AGL rule change. Lumo and Red responded to the Commission's consultation paper by drafting a submission. In our submission we requested that the Commission give due consideration to a credit support model that we had developed for the market. The model that we had developed was referred to as the "hybrid" model because it adopted parts of the current arrangements and combined them with parts of the AGL proposal.

The Commission did not recommend our proposed "hybrid" model as a potential solution for its consideration as part of its "Options Paper" published on 22 October 2015. Although, we note that Option 2.3 in the Commission's "Options Paper" does have some similar characteristics to our "hybrid model." Nevertheless it does not specifically reflect the model that we had proposed in our submission to the consultation paper.

As the Commission has rejected our "hybrid" proposal, Lumo and Red reserve the right to make a revised submission and effectively chose an option that has been proposed by the Commission in its "Option Paper".

In this submission we chose two options for the Commission to consider as potential solutions to the credit support arrangements. Below we outline our preferred options and the reasons we consider them to be consistent with the National Electricity Objective (NEO) and the National Gas Objective (NGO).

B) Recommendations

Red & Lumo support the following options from Commission's "Options Paper."

Option 1: **retain the existing arrangements**

Retain the current credit support arrangements on the basis that a credible case for removing them has yet to be established.

The current arrangements have worked relatively well to date. So, we would only recommend making a change to the current arrangements if a credible case that proved that the current arrangements were inadequate was established.

We would welcome a cost benefit analysis being undertaken on the current credit support arrangements before any decision to remove them was made.

If the Commission did establish the case that the existing arrangements are substandard and decided to remove them, then we would recommend:

Option 2.1: strengthening the existing arrangements and enhance them with quicker cost past through arrangements

Enhanced Option 2.1 would include:

- the removal of the current credit support arrangements;
- strengthening the retailer insolvency cost pass through provisions by removing the current restriction that only permits distributors to apply for a cost pass through if the pass through amount is greater than 1% of the distributor's regulated revenues;
- allowing a distributor to adjust its tariffs <u>immediately</u> following an approval of a cost pass through by the AER.

More expensive options like Option 2.3, 3 and 4 would be avoided if this option were adopted. Option 2.2, which would effectively move the burden of credit support from larger retailers with stronger credit ratings to smaller players with lower credit ratings, would also be avoided.

C) Option 1 – the case for retaining the current arrangements

Red and Lumo support maintaining the current credit support arrangements and cost pass through arrangements that apply to a retailer insolvency event on the basis that the case for removing them has yet to be established.

Together the combination of the existing mechanisms available (retailer insolvency cost pass through, "overs" and "unders" process under a revenue cap and the corporate insolvency process) can be relied upon to recover the foregone revenue as well as the costs associated with retailer default. These arrangements have worked relatively well to date and there is a lack of evidence to suggest they are inadequate.

The combined market arrangements currently available to distributors in the event of a retailer insolvency include:

1. Credit support arrangements

Under the current arrangements, distributors are able to request credit support from a retailer when the retailer's network charges liability exceeds its credit allowance. A retailer's current credit allowance under the current arrangements is a function of its Maximum Credit Limit (MCL). The credit allowance that it receives reflects the distributor's annual network charges and its credit rating with higher credit rating equating to a higher credit allowance.

Analysis from the "Options Paper" shows that under the current arrangements, whilst the credit support arrangements work well, few retailers end up paying for credit support. This is because their MCL's do not exceed their Network Charges Liability (NCL).

Figure 4.1 of the "Options Paper" shows that from a sample of 11 electricity distributors, retailers breached their MCLs in four distribution networks and were only required to put up some limited credit support.

Similarly, in relation to gas, Figure 4.2 demonstrates that from the sample of 8 gas distribution networks none of the retailers breached their relevant MCLs. As such, they were not required to put up any form of credit support.

Both Figures 4.1 and 4.2 from the Commission's "Options Paper" show that very little credit support is required to be provided by retailers under the current arrangements across the sample of electricity and gas distributors. Nevertheless, the MCL approach to calculating credit support works well. This makes the current arrangements both efficient and cost effective.

2. Revenue Cap

The current approach of regulating distribution networks under a revenue cap guarantees that where a retailer defaults the distributor will recover its foregone revenue in the long term.

However there is a suggestion that the collection of foregone revenue from a retailer default through the "overs" and "under" process under a revenue cap can potentially result in a material impact on customers.

Figure 4.3 of the "Options Paper" modeled the cost increase per distributor customer under a range of three default scenarios of recovering foregone revenues through the "overs" and "unders" process. The analysis shows that the average impact on customer bills would be to increase them between 1% and 11% for electricity. In relation to gas, under all of the three demand scenarios modeled, the average impact on customer bills would be below 10%.

Whilst Red and Lumo are uncomfortable with any increases in costs to customers that result from a retailer default, the price increases in this case are not exorbitant. We consider them to be within acceptable tolerance limits.

3 Insurance

Distributors have the option to pursue self-insurance in order to protect their financial position from a retailer default under the current arrangements. The option to make an application to the AER in order for the expense to be approved as an efficient operational allowance expense is also available to them as part of their rate review application.

The AER would most likely approve these costs in a rate review application, especially if they were prudent.

4 Insolvency cost pass through

The current insolvency cost pass through arrangements provide for distributors to recover their forgone revenue where a retailer insolvency event has occurred.

Unfortunately, distributors argue that the current threshold for allowing pass through provisions in the event of a retailer insolvency event at 1% of the distributor's annual revenues represents a high threshold.

It has also been argued that the insolvency cost pass through arrangements may potentially lead to significant price increases to consumers. Therefore, there is some concern that this is viable option.

Figure 4.4 of the "Options Paper" modeled the cost increase per distributor customer of implementing this solution under two demand scenarios. Under both of these scenarios, the post default costs passed through to customers from a retailer insolvency costs pass through were negligible.

For example, in relation to electricity under both scenario 1 and 2, cost increases to customers as a result of a retailer default cost pass through event showed that on average price increases to customers would be below 2.5%. In gas, under both scenarios 1 and 2, cost increases to customers as a result of a retailer default cost pass through event would result in price increases on average of less than 1.6%. All of these price increases to pay for a retailer default were within what we consider to be acceptable tolerance limits.

In summary the Commission needs to be satisfied that the current credit support arrangements that deal with a retailer insolvency event are inadequate to justify any changes to them. Therefore, change should only occur where a robust case has been made that demonstrates there is a need for alternative credit support arrangements. To date our view is the case that establishes the need for change has yet to be made.

D) Option 2.1 combined with quicker cost past through arrangements

If the Commission determined that the current credit support arrangements that deal with retailer insolvency events were inadequate then it would be required to explore a range of appropriate alternative options.

Red and Lumo have reviewed the options put forward by the Commission in its "Options Paper" for the market to consider. And, following an examination of the options, we have decided to support Option 2.1 with some enhancements.

Below, we provide a brief description of our enhanced Option 2.1 for the Commission's consideration.

Option 2.1 enhanced with quicker pass through arrangements

Red and Lumo's enhanced version of Option 2.1 includes the following key characteristics. This includes:

1. Abolishing the current threshold which only permits the AER to approve a cost pass through for a retailer insolvency event if it is greater than 1% of the distributors' regulated revenues. The effect of this would be to allow the financial impact of **any** retailer default to be recovered through the cost pass through arrangements in both the National Electricity Rules (NER) and the National Gas Rules (NGR).

2. Terminating the current credit support requirements that are currently provided by retailers under the current arrangements in both electricity and gas.

3. Enhancing the current regulatory arrangements to speed up the rate at which a cost pass through application for a retailer default would be dealt with by the AER.

   An enhancement to the rules that would permit a distributor to start collecting the approved cost pass through amount immediately following an approval by the AER would be welcomed. Distributors would avoid having to wait for the next annual price review to lodge their application for a pass though.

   Whilst this proposal has been put forward by us as an enhancement to Option 2.1 the original idea was developed by the Commission in its "Options Paper". That is, the Commission sought feedback on whether it would be appropriate to include an exception in the NER & the NGR that would allow a distributor to start collecting the approved cost through amount immediately after it was approved by the AER, rather than waiting for it to be approved in the next annual pricing proposal. [1]

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[1] AEMC Options paper – National Electricity Amendment (retailer –Distributor Credit Support Requirements) Rule 2015: National Gas Amendment (Retailer –Distributor Credit Support requirements) Rule 2015: p. 27
"Another possible enhancement to the cost pass through provisions relates to the timing associated with when a distributor may be able to start collecting the approved cost pass through amount. A mechanism for consideration is whether it may be appropriate to include an exception in the rules to allow a distributor to start collecting the approved pass through amount immediately after it has been approved, rather than waiting to include it in the next annual pricing proposal."

We have added this enhancement to Option 2.1 to improve its appeal as a potential solution. More timely cost pass through arrangements would address any criticism that Option 2.1 fails to adequately deal with the liquidity problems associated with a retailer default.

The specific changes required to the rules under enhanced Option 2.1 would be:

a) For electricity we would support an adjustment to the retailer insolvency provisions that apply under section 6.6.1 of the NER. In addition to section 6.6.1 (L) & (m) that deal with costs pass through provisions that apply to retailer insolvency events, we would request adding another clause that specifically permitted distributors to increase their tariffs immediately following the AER's decision to approve a positive pass through event for a retailer insolvency event under section 6.6.1 (a1). This immediate adjustment to tariffs would only apply to successful applications for retailer insolvency events approved by the AER.

b) In relation to gas:

- The cost pass through arrangements that apply to retailer insolvency events are dealt with in an appropriate manner in Part 21, Rule 531 of the National Gas Rules (NGR) are appropriate. The NGR is not constrained by the requirement for the costs associated with a retailer insolvency event to exceed one percent of the distributor's annual revenue requirement for a pass through application to succeed;

- Nevertheless the AER access arrangement guideline suggests that a reference tariff variation mechanism for a cost pass through event should establish a "materiality" test. And in some access arrangements the materiality test is set at 1% of smoothed revenues. Because the recovery of the cost pass through amount for a retailer insolvency is applied through a reference tariff variation mechanism, there is a potential for a contradiction with Part 21, Rule 531 of the NGR. To mitigate this issue, we would support an adjustment to the NGR that includes:

    - A materiality threshold would not apply to reference tariff variations for retailer insolvency cost pass through events, and that this provision would prevail with any inconsistent provisions in an access arrangement;

    - Following the successful pass though application by a distributor to the AER for a pass through for a retailer insolvency application, distributors would be permitted to make adjustments to their tariffs immediately.

<u>How Option 2.1 enhanced with quicker pass through arrangements satisfies the NEO and NGO</u>

The Commission is required to make a decision in relation to this rule change in accordance with both the NEO & the NGO.

In its "Options Paper" the Commission sets out principles to guide the development and assessment of an effective rule change for managing the risk of a retailer insolvency event.

The rule change request will be examined by the Commission in light of these underlying principles. The principles will guide the development of a rule that is in the long term interests on consumers.

In the remaining part of this submission, we outline how we consider our enhanced Option 2.1 satisfies the principles that the Commission adopts to assess the rule change. We request that the Commission give serious consideration of our proposal as a preferred rule change.

1. **Allocation of risk to parties that have the incentives to best manage each risk in order to minimize the long term interests to consumers**

   Adjusted Option 2.1 allocates the risks to the parties that are best able to manage them.

   Firstly, our enhanced Option 2.1 removes the perceived current inefficiencies of the current credit support arrangements by removing them altogether. By removing the requirements for credit support, it has the effect of reducing the long terms costs to consumers. The current costs of credit support that the largest three retailers in the National Electricity Market (NEM) are significant and have been well documented in the "Options Paper."

   Secondly, adjusted Option 2.1 has the advantage of providing certainty to distributors about their ability to recover foregone revenue following a retailer default. The current threshold that requires the AER to only approve a cost pass through for a retailer default if it is greater than 1% of a distributors regulated revenues is removed. This adjustment provides more certainty to the distributors that they will recover their financial losses as a result of a retailer default.

   Thirdly, introducing changes to the regulatory regime that would include an exception in the rules to allow a distributor to start collecting the approve cost pass through amount immediately after it has been approved by the AER, rather than waiting for the next annual pricing proposal, would be efficient.

   The introduction of such a policy change would abolish the need for a debt facility to manage the liquidity risks associated with a retailer default (Option 4). This would lead to significant costs savings in commitment fees and potentially utilization fees from a debt facility that might be required to help liquidity in the event of a retailer default under the current rules.

   Fourthly, abolishing the current credit support arrangements and the current rules that restrict a distributor from applying for a cost pass through unless it is greater than 1% of its regulated revenues provides greater revenue certainly for distributors. Given that distributors are regulated monopolies with relatively low risk profiles, this added certainly will definitely allow them to raise debt - if and when it is required through the financial system to mitigate any liquidity issues that arise as a result of a retailer default. Nevertheless, our view is that requiring distributors to arrange for debt facilities prior to an event of a retailer default is premature and creates costs that can be avoided. As we have previously argued, a minor change in the rules that would allow distributors to recover their losses in a quicker way would lead to significant costs savings for consumers in the long run.

Finally, whilst some of the alternative options (like Option 2.3 , 3 & 4) provide more certainty for distributors in the event of a retailer default our view is they represent "gold plated" solutions; as such they are inefficient. For example, as discussed earlier, the need to pay for a liquidity facility under option 4 means consumers will ultimately need to pay for establishment fees, commitment fees and utilization fees (if required) for a debt facility. Furthermore, Option 2.3 would require all parties to pay significant costs for credit support arrangements under a revised methodology that would create a more significant financial burden for all retailers compared to the current credit support arrangements. In the long run these costs would be paid for by consumers. Option 3 would also require retailers to put up significant amounts of capital to provide increased security for the distributors in the event of a retailer default. This would be unnecessary and inefficient. And, Option 2.2 would transfer the burden of providing credit support from larger retailers with stronger credit ratings to the smaller retailers with lower credit ratings, an outcome which is inappropriate.

2. **The rule takes into account the risk of the retailer default and the impact of the default**

Enhanced Option 2.1 takes into account the risk of a retailer default by providing greater certainty to distributors about their ability to recover foregone revenue following a retailer default.

The removal of the current threshold that requires the AER to approve a cost pass through for a retailer default can only be approved by the AER if it is greater than 1% of a distributors regulated revenues. This adjustment provides more certainty to the distributors that they will recover their losses from a retailer insolvency event.

Regarding the impact of a retailer default, introducing changes to the regulatory regime that would include an exception in the rules to allow a distributor to start collecting the approve cost pass through amount immediately following AER approval, rather than waiting for the next annual pricing proposal, would mitigate the impact of such a default in a timely manner.

A decision by the AER to approve a cost pass through under the rules within 40 business days that permitted distributors to alter their tariffs immediately without waiting the need to wait for the next price review deals with the impact of a default immediately.

3. **The rule takes into account the tradeoff between flexibility and regulatory certainty**

Enhanced Option 2.1 provides the right balance between flexibility and regulatory certainty. It does this it two ways.

It provides regulatory certainty:

- By removing the current threshold that requires the AER only approve a cost pass through for a retailer default where it is greater than 1% of a distributors regulated revenues. This adjustment provides more certainty to the distributors they will recover their losses from a retailer default.

- Introducing changes to the regulatory regime that would include an exception in the rules to allow a distributor to start collecting the approved cost pass amount immediately after it has been approved by the AER, rather than waiting for the next annual pricing proposal. This is both efficient and it provides the certainty that distributors require to recover their costs.

- Avoiding Option 2.3 and Option 3 & 4 gives the distributor the flexibility to recover the financial impact of a retailer insolvency event. By avoiding the requirement to put in place more onerous credit support (Option 2.3) , a debt facility (Option 4) or build an expensive retailer fund (Option 3) distributors are free to mitigate the financial impact of a retailer default either by;

    a. Recovering their costs through an amendment to the rules that would allow them to recover their costs immediately following pass through application to the AER;

    b. Raising their own debt facility (if they so desire) from a financial institution to mitigate any potential short term liquidity issues that might arise in the event of a retailer default. Nevertheless, our view is this would not be necessary.

4. **The rule takes into account the potential impact of barriers to entry and competition for retail businesses**

Enhanced Option 2.1 takes into account the potential impact on barriers to entry and competition for retail businesses.

Firstly, our adjusted Option 2.1 removes the current credit support arrangements altogether. By removing the requirements for credit support, it means that no retailer will be burdened by the need to put up credit support to compete in the NEM removing a barrier to entry into the retail market. For example, Option 2.2 (AGL rule change) would have the effect of moving all of the requirements for credit support away from the larger players to the smaller players. At the same time, Option 2.3 would also place large burden on all of the market participants to provide credit support at different levels. Therefore, it would not be beneficial to encouraging retail competition.

Enhanced Option 2.1 would also avoid the requirement to implement Option 4 which burdens retailers by requiring them to pay for establishment fees, commitment fees and utilization fees (if required) for a debt facility. In addition to this, it avoids Option 3 which requires retailers to put up significant amounts of capital to provide increased security for the distributors in the event of a retailer default. This reduces the barriers to entry for all retailers that want to participate in the retail markets.

5. **The rule takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles**

   Enhanced Option 2.1 takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles.

   The revenue and pricing principles are contained in section 7A of the National Electricity Law (NEL) and section 24 of the National Gas Law (NGL). Two of these principles (subsections 2 and 5 of section 7A of the NEL or section 24 of the NGL) are relevant to consideration of a rule for managing the risk of a retailer default.

   a. Networks should have the opportunity to recover the efficient costs of providing their services.

      The implementation of the proposal to enhance the costs pass through arrangements that abolishes the current threshold which only permits the AER to approve a cost pass for retailer insolvency if it is greater than 1% of the distributors regulated revenues provides distributors with the opportunity to recover their regulated revenues in the event of a retailer default

   b. If any risks remain after accounting for efficient operational decisions then the risk could be expected to be considered when estimating the regulated rate of return (WACC).

      We do not envisage that there are any residual risks that remain to distributors as a result of a retailer insolvency event following the implementation of our proposal. Our revised proposal would mitigate both the all of the risks to a distribution from a retailer default and the impact of that default. As such, we consider that any adjustments to the regulated rate of return would be required.

E) Conclusion

The case that establishes that the current credit support arrangements are in adequate has not been made by the Commission.

A strong case that demonstrates that the current credit support arrangements are inadequate needs to be established to justify any changes to the current arrangements. In this regard, we would support a detailed cost benefit analysis being undertaken by the Commission on the existing credit support arrangements before any decision to abolish them is made.

If the Commission is satisfied that that case for change from the current credit support arrangements is warranted then we request that it give serious consideration to our enhanced Option 2.1. It is a highly efficient solution and we urge the Commission to give it the due consideration that is deserves.

Red and Lumo thank the Commission for the opportunity to make a submission in relation to this matter. We look forward to hearing from you and discussing our proposed solution. Should you have any further enquiries regarding this submission, please call Con Noutso, Regulatory Manager on Tel: 03-9976-5701.

Yours sincerely

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