

26 November 2015



Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Mr Pierce,

Energex welcomes the opportunity to provide comment on the Australian Energy Market Commission's (AEMC) option paper on retailer-distributor credit support arrangements. As previously outlined Energex's strong view is that the current credit support arrangements are inadequate in effectively managing retailer default risk. Energex believes that enhancing the cost passthrough provisions and strengthening of the credit support arrangements (option 2.3) will better mitigate the risks and promote greater system stability, efficiency and incentives in the long term interests of customers. Energex addresses each of the four options outlined in the AEMC's options paper.

#### *Option 1*

Option 1, which is retaining the status quo, is not feasible in Energex's view. The existing mechanisms available to distributors to manage retailer default risk (that is, the credit support arrangements, insurance, unders and overs, corporate insolvency process and cost passthrough provisions) have shortcomings as discussed below.

The current credit support arrangements do not permit Energex to request any credit support from the 28 authorised retailers operating in its distribution area, including those with the equivalent of speculative grade credit ratings. This is despite being obliged to provide electricity distribution services to all authorised retailers and a current network charges liability of \$410 million. Energex considers that the credit support arrangements developed as part of the National Energy Customer Framework (NECF) promoted the retail competition at the cost of distributors being able to effectively manage retailer default risk.

Energex's ability to insure against retailer default risk is varied given that commercial insurance is not available for all authorised retailers and is costly.

The corporate insolvency process can be lengthy with little certainty around the likelihood of creditors being paid. In the case of former retailer Jackgreen the corporate insolvency process took almost two years and recovered only four percent of foregone revenue.

As recognised by the Commonwealth of Australian Government (COAG) Energy Council, the passthrough provisions are currently ambiguous around the treatment of foregone revenue as a cost passthrough event and apply the materiality threshold which limits the level of protection.

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As such the only mechanism genuinely available to Energex in the event of a retailer default is the unders and overs mechanism under a revenue cap which only addresses revenue risk not liquidity risk. Promontory's report recognised the limitations of the current mechanisms in managing both revenue and liquidity risk.

### *Option 2*

Option 2 considers a strengthening of the existing arrangements with three alternatives assessed. Option 2.1 adopts the COAG Energy Council and Jemena proposals to enhance the retailer insolvency cost passthrough provisions. Energex strongly supports the COAG Energy Council rule change as articulated in its December 2014 and July 2015 submissions. This rule change effectively seeks the correction of an error and would align the National Electricity Rules with the NECF policy intent.

Option 2.2 combines the COAG Energy Council and Jemena enhanced cost passthrough provisions with the AGL rule change proposal which seeks to limit any credit support requirements for retailers with a credit rating of BBB- or better irrespective of the retailer's market share. The application of option 2.2, would in Energex's case, result in a small number of retailers having to provide credit support. While this arguably results in a marginal improvement to Energex's ability to manage retailer default risk, it does little to address the issue of credit concentration.

Energex's preferred option of 2.3 adopts the COAG and Jemena enhanced cost passthrough provisions with strengthened credit support arrangements. The alternative credit support arrangements apply the AGL rule change proposal methodology with a benchmark credit rating of A- (which is consistent with current benchmark underpinning credit allowance). In addition this option involves the realignment of Dun & Bradstreet (D&B) dynamic risk scores and credit ratings to reflect differences in methodology and restricting the use of D&B scores in some instances.

The application of option 2.3, would likely result in the majority of retailers having to provide some level of credit support. This would allow distributors to better manage retailer default risk from a revenue, liquidity and systemic risk perspective. Unlike option 2.2, this would most likely provide liquidity in the event of a very large retailer failure. Such an approach would incentivise retailers to actively manage their credit ratings and D&B scores. Energex appreciates that being able to effectively manage retailer default risk comes at a cost. However, Promontory's modelling suggests relatively negligible increases in costs on average on an ongoing basis and the lowest cost impact in the event of the major retailer default.

### *Options 3 and 4*

Option 3 of a retailer default fund appears to have merit from a distributor perspective as it offers the greatest mitigation of retailer default risk. The option would address revenue, liquidity and systemic risks in the event of a retailer default. However, given this represents a significant change to arrangements, extensive consultation would be required around the design of the fund and its implementation, noting that the fund may be established over a period of ten years. While this approach would promote regulatory stability and market integrity, Energex acknowledges that it would likely be the most costly approach (as identified by Promontory). Similarly option 4 of a liquidity support fund potentially could have some merit however this would require significant scoping, development and consultation before this option could legitimately be considered. In the interests of time and recognising Energex's limited ability to effectively manage current retailer default risk currently, Energex does not consider either of these to be legitimate options at this time. That is, their consideration should

not delay the COAG Energy Council rule change proposal at the very least, which would address some of the current inadequacies.

*Summary*

These options represent a range of trade-offs between risk and cost and meet key regulatory principles to varying degrees. Option 2.3 addresses Energex's immediate concerns regarding the effective management of retailer default risk. This option, on balance, represents a more appropriate allocation of risk and would promote regulatory stability and market integrity which ultimately is in the long term interests of customers.

As a member of the ENA, Energex supports the ENA's submission which similarly promotes option 2.3 as the preferred option. If you have any queries in relation to the information provided, please do not hesitate to contact Nicola Roscoe, Acting Network Regulation Manager on (07) 3664 5891.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Rheaver', written in a cursive style.

Rachel Leaver  
Acting Group Manager, Regulation & Pricing