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Via online submission

Australian Energy Market Commission
PO Box A2449
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**ERC0183 & GRC0032: Retailer-Distributor Credit Support Requirements**

Jemena welcomes the opportunity to comment on the Australian Energy Market Commission's (**AEMC's**) consultation paper on the retailer-distributor credit support requirements rule change for gas and electricity (collectively the 'rule change').

Jemena owns and operates the Jemena Gas Network (**JGN**) in NSW and the Jemena Electricity Network (**JEN**) in north-west Melbourne. JGN and JEN deliver gas and electricity to approximately 1,200,000 and 320,000 homes and businesses respectively. Jemena would be directly impacted by the implementation of this rule change and, therefore, we have a strong interest.

**Credit risks should be managed at lowest cost to customers**

Jemena considers that the ideal credit support framework is effective and enforceable, underpins the efficient management of credit risks at lowest cost to customers and supports network businesses performing services under the expectation of being paid at some point in time in the future. The ideal credit support framework is supported by appropriate pass through arrangements that allow networks to recover their lost revenue from retailer insolvency.

**Need to establish customer preferences so policy can meet these**

With pass through arrangements only, customers would ultimately bear the risks of retailer failure given that, if it were to occur, network businesses would be able to recover lost revenue from all customers in its subsequent prices.[1] Alternatively, a comprehensive credit support framework would place the costs to meet these risks with the retailers (and therefore their customers) that give rise to them.

[1] Network businesses would retain some cash-flow risk due to the timing between retailer default and recovery under pass through. There may also be some cost to customers via network businesses required rates of return where this increases the perceived risk of the network business.

The AEMC should, therefore, develop policy and rules to establish the ideal credit support framework based on a thorough consideration of customers' appetite to balance:

- Reliance solely on pass through[2]—where all customers share the risk of any retailer failure, reliance on pass through might be considered appropriate given all customers may benefit from lower prices from the expected increase in competition brought about by lowering the barriers to entry for new entrants—customers might prefer this where they consider the risk of retailer failure is potentially small, would occur infrequently and any costs incurred[3] would likely to be less than the benefits of lower retail tariffs over the long term

- Use of credit support to target the costs associated with the probability and consequence of failure on the retailers (and therefore those particular retailers' customers) via appropriate arrangements that enable network businesses to ask for credit support—customers might prefer this where they are happy for riskier retailers to absorb their relatively higher credit support costs and wish to provide retailers behavioural incentives consistent with the consequences of failure.[4]

### Consequence of retailer failure an important consideration

Jemena assesses risk based on both the likelihood (or probability) and the consequence of an issue occurring.

To appropriately cover the risk of retailer failure, and potential cash-flow implications of large defaults, the credit support framework needs to consider not only the probability of failure (as the rule change is limited to), but also the consequence of failure[5]. The credit rating is principally a measure of the risk of default, not the consequence to network businesses and customers of default. Where the risk of failure is not zero, as is the case with all current retailers, network businesses and our customers are ultimately bearing some risk. The risk of a retailer being in severe financial strife is not always limited to those that are small or lower than investment grade as credit ratings only go to the likelihood of financial difficulties.[6]

The rule change assessment needs to establish whether customers are willing to bear the consequence of significant cost of a large BBB- rated or above retailer failure. We therefore agree that consequence of failure (including potential cascading risk) should be a key element included in the AEMC's principles and assessment framework.[7]

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2 This may not be sufficient to avoid cascading failure resulting from cash-flow shortfalls in the instances of the failure of a large retailer.

3 The costs would materialise via higher rates of return required by the network business, (which is regardless of whether there is a retailer failure event), and when network businesses recover lost revenue (only in the event of a retailer failure) via a price change. This may involve some level of cross subsidisation between customers.

4 Reliance solely on pass through would mean retailers are one-step remote from the consequences of failure, which may have implications for their risk appetite.

5 Sometimes referred to as 'expected loss given default'.

6 For example, On Energy (the retail arm of NGC), New Zealand's largest retailer in 2001 with 405,000 customers (23% of the market), did not sufficiently hedge its wholesale position ahead of a very dry winter, which saw wholesale electricity prices soar. After reporting record losses, NGC exited the market, selling its customers to gentailers Meridian Energy and Genesis Energy.

7 Refer to AEMC questions 2 and 6(a).

**Rule change only impacts low-rated retailers and ignores consequences**

Analysis of the impacts of the rule change is important to guide customers' decisions as to whether the rule change (or a preferred alternative) better meets their long-term interests. Our preliminary analysis for JGN shows that:

- The calculation for credit support under the current rules provides such a high credit allowance for retailers BBB- or above, that we are unlikely to be able to them ask for credit support in most scenarios[8]

- The only impact of the rule change is to increase the credit support that we can ask from low-rated retailers, who are generally smaller (in some cases from $0 currently to relatively large amounts).

Given the Australian Energy Regulator (**AER**) may, in assessing any pass through application, take into account the credit support that network businesses had the opportunity to ask for, a network business' incentive is therefore to ask for the additional credit support allowed under the rule change rather than rely on the pass through arrangements.[9]

The practical effect of the rule change for our NSW gas customers is, therefore, likely to be no change in credit support for retailers BBB- or above and greater credit support provided by retailers below BBB-. This has the potential drawbacks for customers in that it:

- Provides no relationship in the calculation of credit support to the consequence of retailer failure[10]

- Will act as an additional barrier to entry to any small (or low-rated) retailers and might inhibit the benefits of competition that they would bring.[11]

If this is representative of the impact of the rule change in other distributor network areas, then the benefits of the rule change are questionable. In particular, it is not clear whether:

- Higher-rated retailers currently have an inappropriate burden of credit support[12], or indeed, currently provide adequate levels of credit support

- Any additional retailer capital would in fact be freed up in practice.

We consider that further evidence is therefore required to demonstrate whether rule change provides benefits to support the long-term interests of electricity and gas consumers.

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8 By way of example, Jemena Gas Networks total annual retailer charges for 2013-14 was $623M. The maximum credit allowance is therefore $156M and a BBB and a BBB- rated retailer would have a credit allowance of more than $58 and $34M respectively. This calculation results in credit allowances that are more than the network charges liability of any of our BBB- and above retailers.

9 Refer to AEMC questions 4(c) & (d).

10 The current rules also provide only a tenuous relationship to the consequence of failure. This should be addressed as part of the rule change.

11 For example, small retailers might not have a credit rating, or might have a low rating, but can bring downward pressure on prices of all retailers.

12 We note that there is no 'overall' level of burden to be shared between retailers.

**Retailer insolvency event should pass through lost revenues as alternative mechanisms to address risk of retailer default have significant drawbacks**

We agree with the drawbacks—noted by the AEMC in section 6 of its consultation paper—of alternative mechanisms (to pass through and credit support) to manage the risk of retailer default. We do not consider that these alternative mechanisms present viable alternatives to negate the need for effective credit support and revenue pass through arrangements.

To ensure costs do not inefficiently rise in other areas of the regulatory regime (through higher required rates of return or need for regulatory allowances[13]), network businesses pass through arrangements should enable recovery of lost revenue where a retailer fails. In particular, 'cost' pass through arrangements alone are not sufficient to provide for lost revenue resulting from retailer failure.

We therefore support the COAG Energy Council's rule change that the 'retailer insolvency event' in the National Electricity Rules needs to be clear that no materiality threshold applies and that network businesses can recover lost revenues through the pass through arrangements. This should also apply in the National Gas Rules.

In addition to the drawbacks noted in the consultation paper, we consider that we are unlikely to be able to further minimise retailers' network charges liability efficiently because:

- The costs of manually reading meters more frequently are likely to be significant. In particular, for JGN a monthly manual read of 1.2 million analogue meters more often will more than triple these costs

- We already bill retailers on a more frequent basis than monthly with weekly and fortnightly billing options agreed with some retailers.

Revenue caps are also not a valid alternative to pass through given:

- This would reduce the robustness of the Rules as it would not cater for the other valid forms of price control allowable under the Rules and given effect to by the AER (especially in gas) to best meet the long-term interests of customers

- The timing of revenue recovery[14] could cause cash-flow issues for a network business that may impact its ability to meet its investment program developed to meet the long-term interests of customers.

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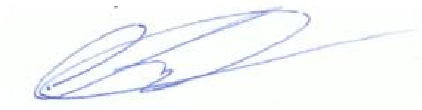
[13] For example, allowances for insurance or to self-insure against retailer default.

[14] Under a revenue cap, network businesses would not be able to start recovering the revenue until the next regulatory year at the earliest. Where the retailer failure occurs too late in the regulatory year to be included in the updated pricing proposal/tariff variation, the network businesses would have to wait a year before it starts to recover the revenue. This is slower than potential intra-year pass through options.

The potential cash-flow exposure of a network business under a revenue cap approach could be as much as 12-15 months from the retailer failure event to begin recovering the revenue, with this recovery not being completed until 24-27 months after the retailer failure event.

If you wish to discuss the submission, please contact Chris Stewart on (02) 9867 7000 or at christopher.stewart@jemena.com.au.

Yours sincerely



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