26 November 2015

Richard Owens
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Australian Energy Market Commission
PO Box A2449
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Dear Richard

Options Paper – Retailer-distributor credit support requirements

Origin Energy (Origin) welcomes this opportunity to respond to the Australian Energy Market Commission (AEMC) Retailer-Distributor Credit Support Options Paper. As Australia's largest energy retailer, Origin has a strong interest in the proposed changes to credit support arrangements and the impact these changes will have upon customers and the retail energy market. As Origin has previously observed the current credit support rules are somewhat arbitrary with some settings determined by a late change in policy, intended to promote retail competition to the detriment of cost reflectivity and market efficiency. Origin therefore welcomes the AEMC's consideration of the proposed rule changes and a number of alternative options and encourages the AEMC to focus on the cost efficiency of credit support arrangements. For a low probability event, high risk premiums should not be incurred by customers.

We believe the risks faced by distributors from a retailer default do not warrant the imposition of onerous and costly credit support arrangements in the electricity and gas markets. Revenue risk for distributors is largely eliminated if the proposed COAG Energy Council and Jemena Rule changes are accepted. Origin believes the market would benefit from such an amendment and supports the changes proposed by the COAG Energy Council and Jemena.

If the COAG Energy Council and Jemena rule changes are accepted then the residual risk for distributors becomes one of liquidity. In Origin's view, distributors are well placed to manage a temporary cash flow shortfall given their existing funding arrangements and ability to secure additional funding if required given their asset base and the cost recovery certainty afforded by the National Electricity and National Gas Rules (Rules). Origin would urge the AEMC to ensure that the final framework does not overstate distributors' exposure to liquidity risk and hence incur costs that will be passed onto consumers.

The AEMC has identified a broad range of potential options to address credit issues, ranging from current arrangements, to strengthening existing retailer obligations, to establishing a retailer default fund or a liquidity support scheme to mitigate distributors' risk of retailer default.

The option to strengthen credit support requirements includes the proposal by AGL (option 2.2) to amend the Rules such that, regardless of market share, a retailer with a Standard and Poor's (S&P) credit rating of BBB- or above (or equivalent) would not be required to provide credit support to a distributor. As set out in our response to the AEMC's Consultation Paper, the AGL proposal is an improvement to current arrangements as it:

- provides a more economically efficient outcome by better aligning costs with the risk of default;

- removes unnecessary costs to businesses that are not considered a credit risk. Under the current arrangements, businesses may be required to provide credit support when the risk of default is low. Credit support (ie bank guarantees) is expensive and results in leakage of value from the energy sector to the financial services sector with an increase in customer costs;

- is consistent with commercial energy market practices whereby credit support is usually not required from BBB- businesses; and

- removes the current practice of requiring support from retailers based on market share. Given the risk of network default is low, even if a large retailer fails, there is not a case for charging a credit risk premium to retailers because they hold a high market share.

The AEMC engaged consultants to provide advice on effective mechanisms to address risks to the market in the event of a retailer default. Promontory, the AEMC's Consultant, assessed a range of options to address credit risk and quantified the pre and post retailer default costs associated with each option.

In light of the work undertaken by Promontory, it is clear that Option 2.1 (removal of the requirement for retailers to provide credit support) is a lower cost and more efficient solution to dealing with credit support arrangements than the current Rules or proposed alternative options. Promontory's work has also shown that this option does not result in an unreasonable impost on customers (assuming costs are recovered over a number of years) should a large retailer default. This option highlights that it is more efficient for distributors to have a deferred cost recovery and manage liquidity risk as part of their debt portfolio arrangements rather than an industry arrangement that requires "up-front" insurance from other parties. It is also worth noting that default of a large retailer is unlikely to occur without warning. Distributors would most likely have time to firm up any additional funding requirements before a failure eventuates.

Origin's preferred option for a retailer-credit support framework is therefore Option 2.1 (removal of the requirement for retailers to provide credit support) as set out in the Options Paper.

Origin does not support the implementation of Options 2.3 (enhanced credit support), 3 (retailer default fund) or 4 (liquidity support instrument) as proposed by the AEMC. Origin considers the high cost, uncertainty and complexity associated with these options would increase the costs of operating in the market with little benefit to consumers and the industry as a whole.

The AEMC has suggested a revised set of principles to guide the development and assessment of the options to manage the risk of retailer default. Generally, Origin supports the proposed principles. However Origin notes that if, as Origin proposes, the COAG Energy Council and Jemena rule changes are accepted then in assessing the remaining options the 'stability' principle becomes largely irrelevant and that the "incentives" principle is of limited practical concern given the strong incentive retailers already face to maintain strong credit ratings. Origin therefore encourages a greater weighting towards 'efficiency' as guiding principle and strong consideration of the low probability of a large, investment grade retailer failing (Standard and Poor's assess default risk for a BBB- rated entity as ~ 0.3% pa).

Origin's responses to the specific issues identified in the Options Paper are outlined below. We welcome further discussion with the AEMC on any matter raised in this response.

Should you wish to discuss the contents of this response, please contact Caroline Brumby (Regulatory Manager) on (07) 3867 0863 in the first instance.

Yours sincerely

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Outlined below are Origin's responses to the specific issues raised in the Options Paper.

1. OPTIONS TO MANAGE THE RISK OF RETAILER DEFAULT

1.1. The option to retain existing arrangements (Option 1)

Q1: (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? (b) How does this option compare to the other options discussed in this options paper to manage the risks associated with retailer default?

As set out in the Options Paper, there are currently a number of mechanisms for the distribution businesses to manage the financial risk of a retailer defaulting. These being through requesting credit support from a retailer, through the regulatory determination process, insolvency process and recovery under the retailer insolvency cost-pass through mechanism. Credit support can be requested by a distributor at any time without reference to credit ratings if a retailer has defaulted on previous payments[1]. This is an additional revenue protection mechanism for distributors.

Origin believes that these requirements provide a generally robust retailer-distributor credit support framework. However a number of incremental changes would better reflect the risks in the market and clarify the intent of the Rules in terms of cost recovery for distributors in the event of a retailer failure.

In particular, we believe that the market would benefit from the COAG Energy Council and Jemena proposed Rule changes which seek to amend the retailer insolvency cost pass through provisions in the Rules to:

- Remove the materiality threshold which applies to cost pass through provisions relevant to a retailer insolvency;
- Specifically clarify that foregone revenue of distributors as a result of a retailer insolvency event can be recovered as part of a cost pass through application and not just additional costs; and
- Ensure approved pass through amounts are reflected in variations to tariffs[2].

The acceptance of these Rule changes will mean foregone revenue becomes irrelevant as distributors are able to recover accrued costs in full. This removes default related revenue risk to distributors.

A further incremental change that is needed to the framework is in relation to retailer credit support requirements. The current requirements have the potential to require large, low risk retailers to provide the large proportion of credit support for the distribution businesses. Origin is of the view that the primary focus of the credit support arrangements should not be on the overall quantum that a distributor has secured in credit support but based on the risk of an event occurring and how this risk can be covered. The risk profile of a distributor is not automatically improved as a result of overall quantum of credit support provided as it depends on which retailer provides it. Distributors can only utilise credit support based on the retailer that defaults. We are of the view that there are significant inefficiencies in distributors holding credit support for an investment grade retailer that is very unlikely to become insolvent.

Origin believes the AGL proposed Rule change (option 2.2) provides a solution to current short falls in the retailer credit support methodology, however this option comes with a higher on-going

[1] NER, 6B.B3.5; NGR, Part 21, section 522
[2] AEMC, *Retailer-Distributor Credit Support Requirements - Options Paper*, October 2015, p3-5.

cost than Origin's preferred option 2.1 (removal of retailer credit support). These options are discussed further in this submission.

1.2. The option to strengthen existing arrangements (Option 2)

Q2: (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? (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? (c) How does this option compare to the other options discussed in this options paper to manage risks associated with retailer default?

Origin notes that Option 2 comprises of a number of options and sub-options that are aimed at strengthening existing retailer-distributor credit support arrangements. The options are as follows:

- *Option 2.1* – Accept COAG Energy Council and Jemena Rule proposals without credit support. The requirement for a retailer to provide credit support to a distributor would be completely removed from the Rules;

- *Option 2.2* – Accept COAG Energy Council and Jemena Rule proposal as well as the Rule change proposal submitted by AGL. Under the AGL proposal, credit allowances are removed and only retailers rated below BBB- are required to provide credit support; and

- *Option 2.3* – Accept COAG Energy Council and Jemena Rule proposal with enhanced credit support. Enhanced credit support includes the re-alignment of Dun and Bradstreet (D&B) and Standard and Poors (S&P) ratings and mandating the use of a S&P rating if a subsidy company has a cross parent guarantee.

Option 2.3 has considerably higher on-going costs than the other options, but the lowest of the post default costs. Post default costs are low as the distributor would access the highest level of credit support under bank guarantees. Credit support costs across the industry could increase substantially under option 2.3 (even if it is assumed larger retailers are BBB- rated) leading to higher prices for customers.

While this option may be theoretically attractive, customers will pay high on-going costs for a facility that may never be utilised. Given the high on-going costs for such a low probability event, Origin does not support this option.

Origin believes options 2.1 and 2.2 provide improvements to the current arrangements as:

- Option 2.1 provides a more economically efficient outcome;

- Option 2.2 better aligns costs with the risk of default;

- option 2.2 is consistent with commercial energy market practices whereby credit support is not required from BBB- businesses. This includes the wholesale electricity market where BBB- is the investment grade trigger for credit support; and

- both options remove unnecessary costs to businesses that are low credit risks. Under the current arrangements, businesses may be required to provide extensive credit support when the risk of default is low. Credit support (ie bank guarantees) is expensive and results in leakage of value from the energy sector to the financial services sector with an increase in customer costs;

- consumers face little to no-going costs with these options with option 2.1 being the lowest cost option of all the options proposed.

Following the detailed analysis of options by Promontory, it has become clear that Option 2.1 (removal of retailer credit support) is a lower and more efficient cost solution for dealing with credit support arrangements in the national energy market. This option highlights that it is more efficient for distributors (with the lowest industry participant cost of capital) to manage the shortfall funding as part of their current debt portfolio arrangements rather than other parties seeking to obtain funding. Origin believes distributors have the capacity to do this given their strong asset base and creditworthiness. Retailer defaults do not usually occur without warning and Origin believes that distributors will have the capacity to firm up additional funding requirements to cover any shortfalls before a failure eventuates.

Further, Origin does not believe that the existence of retailer credit support will incentivise nor significantly change the creditworthiness behaviour of a retailer to warrant retailers to provide credit support. Energy retailers have significant funding requirements and devise their own risk management strategies to maximise value but also avoid payment default. There are strong incentives to prudently manage their respective business consistent with their preferred risk and return objectives. Prudential requirements alone place an obligation on retailers to maintain a certain level of creditworthiness.

Given the above, Origin does not believe the existence of retailer credit support will add value to framework and thus we support Option 2.1.

Re-alignment and use of credit ratings

Origin has concerns with the AEMC's proposed realignment of the Standard and Poor's and Dun and Bradstreet ratings. There is no quantitative analysis presented to explain how the AEMC arrived at these re-alignments nor is there evidence that one credit agency is a better predictor of a company's creditworthiness over another. Origin does not support the realignment and if this option is to be pursued the AEMC should provide a detailed explanation of how the realignment is justified given the substantial cost increase this may impose.

If there is to be a re-alignment of the S&P and D&B ratings, Origin believes that it is appropriate to consider the distress probabilities and default rates of Dun and Bradstreet and Standard and Poors respectively. S&P conducts an annual study of default rates across corporate issuers globally. Similarly, D&B applies dynamic risk score bands to predict the likelihood that a business will seek legal relief from its creditors or cease operations leaving unpaid debts in the next 12 months. These are reputable and high regarded studies that should be taken into consideration when assessing ratings by the relevant agencies.

It is further noted that the AEMC proposes an option to mandate the use of an S&P or equivalent rating if one is available or for a subsidiary entity to use the parent rating where a cross parent guarantee is provided. There are number of flaws and concerns with such a proposal as:

1. Operating subsidiaries can have higher credit standings than the parent company if they are insulated e.g. through a combination of legal structure, asset ring fencing, separation of management, etc; and

2. Parent company ratings may have limited relevance to the subsidiary company if the subsidiary funding is not dependent on the parent.

3. The nature of cross company guarantees will vary with each case.

It is unlikely to be immediately clear to the AEMC whether parent and subsidiary companies should be considered as integrated or insulated entities. The AEMC would need to undertake a complex analysis as to the financial linkages between them and may need to form a subjective judgement. This at the least adds unnecessary complexity and could result in inconsistent treatment of retailers and disputes.

Origin strongly believes that a generic requirement should not be placed in the Rules to enforce the use of a parent credit rating for subsidiaries.

1.3 Other credit support designs

Q3:

(a) What are the possible advantages or disadvantages of the other credit support designs outlined above?

(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 AEMC engaged KPMG Consulting to provide a review on approaches to distributor-retailer credit support regimes in international jurisdictions to better understand regulated approaches in designing an appropriate framework. It is clear from the KPMG analysis that the framework design principles vary amongst international electricity and gas markets but some key common features of credit support arrangements include:

- an assessment of credit worthiness where credit rating of a certain level must be maintained and there is a relationship between the credit allowance and credit rating;
- the level of credit support does not vary in relation to the retailers' market share;
- the size of the security is linked to the estimate of a retailer's liability to the distributor in terms of network charges; and
- retailers are offered a wide range of choices with respect to the acceptable forms of posting security under the credit support approaches.

It is clear that no jurisdictional credit support framework is the same and they have evolved and developed to suit the market and operational conditions of retailers and distributors in the relevant jurisdictions. Origin notes that the current reference to market share in the NER and NGR credit support methodologies appears out of step with other the jurisdictions surveyed.

Origin notes that a limiting factor in the AEMC determining the most efficient and effective credit support framework is that there has been limited or no testing of the operational efficiency of each of different variations. Similarly the KPMG report does not consider how each credit support scheme operates within the context of the overall default framework (e.g. Retailer of Last Resort, market prudential requirements, etc).

1.4 The option to establish a retailer default fund (Option 3)

Q4:

(a) What are the advantages of establishing a retailer default fund in terms of recovering revenue related to managing the risks associated with retailer default?

(b) How does this option compare to the other options discussed in this Options Paper to manage risks associated with retailer default?

(c) Are there any practical considerations of developing and implementing this type of retailer default fund? If so, what are these considerations?

(d) If a retailer default fund were established:

• how should the size of the fund be determined?

• over what period of time should the fund be built?

• how should the contributions into the fund be determined (eg. based on creditworthiness, market share or some other measures)?

• 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 AEMC has proposed the establishment of a fund, available to distributors in the event of a retailer default, which is funded by retailers based on a set formula. Origin does not support this option given the large number of unknown elements and the considerable costs that would be incurred by retailers and thus consumers if this option was enacted.

Origin believes an upfront assessment of costs for a retailer failure has a number of significant faults. A retailer insolvency event in the energy market is unpredictable and has many unknown variables. It would be difficult to accurately estimate the suitable size of the fund, contributions from retailers and there are costs associated with setting up and managing the fund. While these costs can be estimated, the costs will inevitably be under or over recovered. Under recovery means the distributor (or customers post event) would wear the costs and over recovery means that customers have paid a premium to insure against the risk. There is also the likelihood that the fund is not utilised and retailers will forgo capital that could be used by retail businesses to investment in improvements.

Further, while the fund may be useful to distributors after the build up timeframe of say 10 years, it is only a partial solution if a retailer default occurs before this time period. The distributor’s ability to access immediate cash flow will be limited by the amount that has been contributed to the fund.

In terms of costs, Origin notes that it is estimated that this is the most expensive option from an ongoing costs point of view as customers are required to contribute to the fund on a yearly basis to build up the fund to a required level. Although post-default costs are not the highest of the options, they are still considerable as there is a need to recover and replenish the fund once it has been ustilised.

Based on the above, Origin believes that this option is inefficient and for this reason a retailer default fund is not supported.

1.5 *The option to introduce a liquidity support scheme (Option 4)*

Q5:

(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?

(b) How does this option compare to the other options discussed in this Options Paper to manage risks associated with retailer default?

(c) Are there any practical considerations of developing and implementing such a liquidity support scheme? If so, what are these considerations?

(d) If a liquidity support scheme were established:

• how should the size of each distributor's liquidity support instrument be determined?

• how should the costs associated with the establishment fee and annual commitment fees be funded?

• 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?

The AEMC has proposed the option of the introduction of a liquidity support scheme whereby credit support requirements in the Rules is replaced by a requirement for each distributor to obtain and maintain access to a committed liquidity facility. Under this option, the annual costs of holding the facility would be passed onto retailers and ultimately customers.

Origin does not support this option as we believe that it is more efficient for distributors to manage cash flow shortfalls through their respective existing debt portfolios rather than retailers paying a premium for the security. Distributors have significant network assets and regulatory certainty of revenue. It is therefore difficult to understand how a distributor could not obtain additional short term funding if required. Distributors would have a strong incentive to minimise the costs of funding liquidity where they are responsible (option 2.1) and have a lower cost of capital than retailers.

Origin notes that shortfall funding arrangements did not appear to cause distributor distress when both the Jackgreen and Energy One ROLR events occurred in Australia. Distributors often have substantial unexpected costs that are not recovered until subsequent regulatory periods and a retailer insolvency event should be treated no differently.

In addition to the above, Origin believes the costs in funding the liquidity instrument regime will impose additional and disproportionate costs on the market as a whole as there is a desire to cover the distributor's entire cash flow risks. Customers would fund a high annual risk premium for an event that may never eventuate. The post-default costs are also significant and are in the same vicinity as the other options as customers are required to pay the full costs of the facility utilised at the time of a retailer failure. Origin views this option as purely a value transfer of funding from the energy sector to the finance sector with customers required to pay for a revenue security for the distribution businesses.

Further, Origin notes that a number of assumptions have been made in relation to the utilisation of the liquidity instrument:

- Distributors will only use the liquidity facility if their working capital ratio falls below 1.0; and

- The duration of the facility will depend on the amount to be required with ranges of 1.5 to 3.5 years[3].

Based on these assumptions, it is noted that only a small number of distributors would even utilise this facility in the event of a retailer default as it is assumed that distributors will only draw enough liquidity to bring its working capital ratio back to the level of 1.0. Promontory's, AEMC's Consultants, modelling suggests that only 23%[4] of the retailer's foregone revenue is drawn from the various liquidity facilities across the networks that the retailers operate in. Further, if the retailer with the largest market share across electricity and gas networks defaulted (scenario 2), the large majority of the networks would not utilise the facility at all as the working capital ratio under scenario 2 equals 1.0[5].

Origin believes serious consideration needs to be given to the costs and benefits of this option before proceeding to implement it into the electricity and gas market. It appears the costs outweigh the benefits. Origin believes that the allocation of risk is fundamental and we do not believe that any one party should be completely free of risk.

1.6 Relationship between the discussed options to manage the risk or retailer default

Q6:

(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?
(b) How should these different options be combined in a regime to manage the risk of retailer default to ensure an efficient outcome?

Origin believes that there are a number of mechanisms for distribution businesses to manage financial risks of a retailer defaulting. These being through the regulatory determination process, insolvency process and recovery under the retailer insolvency cost-pass through mechanism. In particular, if the COAG and Jemena Rule change is accepted, then the financial risk to the distributor of non-recovery of network charges is minimised. The existence of a retailer of resort scheme also assists in ensuring that networks can commence billing customers and receive revenues as soon as an event occurs. It is Origin's view that the market framework adequately covers distributors in the event of a retailer becoming insolvent. To the extent that distributors demonstrate additional costs in funding liquidity under Option 2.1 then the AER will assess the efficiency of these costs under the network revenue framework.

[3] AEMC, *Retailer-Distributor Credit Support Requirements - Options Paper*, October 2015, p53.
[4] Promontory, *Principles and Options for Managing Retailer Default Risk - Final Report*, October 2015, p75.
[5] Promontory, *Principles and Options for Managing Retailer Default Risk - Final Report*, October 2015, p71