Australian Energy Market Commission

DRAFT RULE DETERMINATION

National Electricity Amendment (Retailer-distributor credit support requirements) Rule 2016

National Gas Amendment (Retailer-distributor credit support requirements) Rule 2016

Rule Proponent(s)

AGL

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

Summary

The Australian Energy Market Commission (AEMC or Commission) has made draft more preferable rules (draft rules) related to the mechanisms available to distributors to manage the risks they face from retailer default.

In the national electricity and gas retail markets, the distributor provides connection and supply of energy services to the retail customers directly. The retailer provides retail services directly to the retail customers and is responsible to pay the network charges[1] incurred by its retail customers. A time lag exists between when the network services are provided to these shared customers and when the payment for those services is made by the retailer. Due to the combination of a time lag and distributors' not charging customers directly, distributors face the risk of retailer default and the subsequent non-payment of network charges. However, distributors are unable to price this risk into their relationship with retailers. Furthermore, distributors are obliged to deal with any and every retailer, regardless of each retailer's level of default risk.

A distributor's risk from a retailer default consists of revenue risk, liquidity risk and broader systemic risk. Revenue risk relates to the inability of a distributor to recover all of the unpaid network charges, as well as any costs incurred in recovering those charges. Liquidity risk relates to the potential for cash-flow shortfalls for distributors while they await full recovery of unpaid charges as a result of the lengthy process to collect the unpaid network charges. Systemic risk is the risk that a retailer's default could cause its counter-parties, such as distributors, to face financial distress and result in their default. This can then trigger subsequent defaults by that distributor's counter-parties, and so on.

The Commission considers that a regulatory mechanism is necessary to address the revenue risk faced by distributors from retailer default. Given the mandatory requirements placed on distributors to deal with any and every retailer, requirements which are not present in other commercial relationships, a distributor has limited ability to manage revenue risk without a rules-based mechanism. In terms of the liquidity risk faced by distributors from retailer default, the Commission considers that distributors are best-placed to manage this risk. Distributors currently manage liquidity risk arising from a range of sources, including from retailer default.

1 It should be noted that throughout this draft rule determination the reference to network charges includes either distribution charges from electricity distributors or gas distributors, as the case may be.

The draft rules would amend the relevant provisions in the National Electricity Rules (NER) and the National Gas Rules (NGR) to:

- enhance the operation of the retailer insolvency cost pass-through provisions;
- remove the requirement for a retailer to provide credit support to a distributor except in the case of a history of late payment of distributor's invoices by a retailer; and
- retain the existing credit support provisions so that they continue to operate as between any distributor and retailer, where that distributor currently holds credit support from that retailer.

The existing credit support provisions will continue to operate as between any distributor and retailer where a credit support instrument is currently provided given the operation of the savings provisions in the National Electricity Law and National Gas Law. This is because the repeal of the credit support provisions will not affect the accrued statutory and contractual rights associated with the credit support instrument which provides a distributor with a right to receive payment on demand from the financial institution on which the instrument is drawn. This is discussed further in Chapter 6.

The draft rules provide regulatory certainty to retailers, distributors, other market participants and the financial markets regarding the regulatory mechanisms available to distributors to manage the risk they face from retailer default. The enhanced cost pass-through mechanism ensures that distributors are able to collect unpaid network charges and any costs associated with a retailer default, regardless of the size of the retailer default. This provides additional certainty to distributors and the market that a distributor will be able to collect its regulated revenue amount (which includes its regulated rate of return).

The requirement for a retailer to provide credit support where it has a history of late payment provides an incentive on retailers to ensure they continue to pay distributors invoices on time. The amount of credit support that may be provided under these provisions is equal to the amount of the last late or unpaid statement of charges received by the retailer that triggers the requirement for credit support to be provided.

Further, it provides a possible early warning sign to distributors so that they may take operational steps to ensure they minimise any impact that may be caused if the retailer were to default.

The removal of the credit support requirements and reliance solely on the cost pass-through mechanism (with the exception of the late payment provisions) minimises the costs that customers will pay on an on-going basis and will result in higher costs for consumers only where a retailer default actually occurs and then only for a period of time until the unpaid network charges and costs associated with the retailer default have been fully collected.

The rule change requests

In this draft determination, the Commission is considering the following rule change requests:

- retailer-distributor credit support requirements under the NER - submitted by AGL Energy on 19 January 2015;
- retailer-distributor credit support requirements under the NGR - submitted by AGL Energy on 19 January 2015;
- retailer insolvency cost pass-through provisions under the NER - submitted by the Council of Australian Governments' Energy Council (COAG Energy Council) on 20 March 2014; and
- retailer insolvency costs and pass-through arrangements under the NGR - submitted by Jemena Gas Networks on 25 September 2015.

Under the AGL rule change requests, the credit support requirements between distributors and retailers would change so that any retailer with a credit rating below a Standard & Poor's (S&P) rating of BBB- (or equivalent) would provide credit support and those with a rating BBB- or above would not. This is different from the current requirements, which, in practice, generally only require credit support from retailers with credit ratings above BBB- where they also have a significant market share.

Under both the COAG Energy Council and Jemena rule change requests, the retailer insolvency cost pass-through provisions would allow distributors to claim all amounts of unpaid network charges arising from a retailer default as part of its pass-through costs.

Given that all four rule change requests address the issue of the effective management of the risks faced by distributors in the event of retailer default, the rule change requests related to the NER were consolidated, the rule change requests related to the NGR were consolidated, and therefore all four rule change requests are being considered in a single process.

The draft more preferable rules

The issues raised in the rule change request are considered by examining:

- the risks associated with retailer default;
- how the costs associated with managing these risks, including the possible recover of a distributor's foregone revenue; and
- how the risks should be allocated to parties;

in order to best promote the National Electricity Objective (NEO) and the National Gas Objective (NGO).

The Commission's approach has been to develop a set of principles to be taken into consideration in determining effective mechanisms to manage the risk faced by distributors from retailer default. These principles include:

- the rule allocates appropriate risks to the parties that have the information, ability and incentives to best manage each risk in order to minimise the long-term costs to consumers;
- the rule takes into account the risk of retailer default and the impact of default on the distributor;
- the rule takes into account the trade-off between flexibility and regulatory certainty;
- the rule takes into account the potential impact on barriers to entry and competition for retail businesses; and
- the rule takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles.

Any mechanism or mechanisms put in place to manage the risk to distributors from retailer default involves a balancing of these principles. No mechanism, in the Commission's view, is able to fully satisfy all of these principles.

A mechanism that operates on an ex-ante basis would require some or all of the risks to a distributor from retailer default to be managed prior to the risk being realised. Credit support is an example of an ex-ante mechanism. With an ex-ante mechanism, any costs associated with the mechanism are also paid up-front and are incurred whether or not the risk actually eventuates.

Alternatively, the risks faced by distributors could be managed after a default has occurred. An example of such an ex-post mechanism is the retailer insolvency cost pass-through provisions. Any costs associated with this mechanism are only incurred where a retailer default has actually occurred.

In terms of the three risks to a distributor from a retailer default (revenue risk, systemic risk, and liquidity risk), the Commission considers that distributors are best-placed to manage their liquidity risk. A distributor, given its position of receiving a regulated revenue amount (including a regulated rate of return), is, and will be, able to quickly access funds, either from external or internal sources, to manage any cash-flow shortages arising from non-payment of network charges as a result of retailer default. This is especially the case if the regulatory framework provides for the ability for the distributor to collect the unpaid network charges and any costs incurred in collecting those unpaid charges, which mitigates the revenue risk faced by distributors.

Distributors are obliged to deal with any and every retailer, regardless of each retailer's level of default risk. This creates revenue risk for distributors, a risk which is exacerbated by the inability of distributors to price this risk into their relationship with retailers. Consequently, the Commission is of the view that it is not appropriate that revenue risk should be allocated to distributors to manage. Instead, revenue risk is best-managed through existing, regulatory-based, mechanisms, with suitable modifications to these mechanisms (discussed below) needed to fully mitigate distributors' revenue risk.

Any rule addressing revenue risk from retailer default must balance the principles set out by the Commission and determination is required on the level that any mechanism should operate on an ex-ante or ex-post basis. Any rule implemented to manage the risk faced by distributors from retailer default could involve elements of an ex-ante mechanism and ex-post mechanism. The existing risk-management mechanisms to manage retailer default can be either market-based or regulatory-based, and can be either ex-ante or ex-post. An example of the former is default insurance, as well as loan covenants on borrowings from banks and other institutions. An example of a regulatory-based ex-ante mechanism is the set of settlement prudential requirements (known as the prudential standard) imposed on retailers in the National Electricity Market (NEM).

These ex-ante mechanisms place numerous obligations on retailers to manage their default risk. Failure to meet these obligations may impact a retailer's ability to borrow funds, and the cost of borrowing, and to operate its business. The Commission considers that these obligations sufficiently incentivise retailers to minimise their risk of default and remain financially viable.

The cost pass-through and overs-and-unders mechanisms are examples of regulatory-based ex-post mechanisms.

The Commission is of the view that the existing ex-ante and ex-post risk mitigation mechanisms place sufficient risk-mitigation incentives on retailers, and appropriately allocate risk between retailers and distributors. This view is informed by two considerations:

- in the history of the NEM, only three retailers have defaulted. These defaults were all by small retailers, where the associated unpaid network charges and costs would have been fully covered by the Commission's proposed enhancements to the cost pass-through mechanisms (discussed below); and
- distributors are best-placed to deal with any short-term cash-flow issues that may arise as a result of a retailer's default. Distributors currently manage liquidity risks arising from a range of sources, which include retailer default.

Consequently, the Commission considers that there is no need at this time for any further ex-ante mechanism (except in specific instances of late or missed payment by a retailer) to exist in relation to the retailer-distributor relationship.

Therefore, the draft rules contain only a modification of the existing ex-post mechanism, relating to an enhancement of the retailer insolvency cost pass-through mechanism, to manage the revenue risk faced by distributors from retailer default.

This mechanism will:

- ensure distributors are able to collect unpaid network charges and any costs incurred in the event of a retailer default, thereby mitigating a distributor's revenue risk;

- have no impact on barriers to entry or expansion in the retail market, or on retail competition; and

- minimise costs to consumers over the long term, as consumers would only face increased costs in the event of a retailer default, and then only for a set period of time as required to recover the unpaid network charges and costs associated with the retailer default.

Furthermore, by mitigating both liquidity and revenue risk, through the various existing risk-mitigation mechanisms, systemic risk faced by distributors is also mitigated.

The requirement in the draft rules for a retailer to provide credit support where it has a history of late payment provides an additional layer of protection for distributors, and its customers, where a retailer has demonstrated that it is not fulfilling its commercial obligations. These provisions provide an incentive on a retailer to continue to pay its bills on time. Further, it may provide an early warning sign to distributors that a retailer may be facing financial difficulties, allowing the distributor to prepare its affairs in the event a default occurs. This may include arranging for more frequent billing or ensuring it has the required liquidity to ensure its continued operation in the event of non-payment of network charges.

The revised arrangements would likely lead to the efficient management of the risks faced by distributors from retailer default. This would be done through a combination of regulatory mechanisms, risk management practice of retailers and operational and risk management decisions of distributors. The Commission is of the view that this would, or is likely to, contribute to the NEO or NGO by minimising cost impacts of managing the risks which is in the long-term interests of consumers.

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1 Introduction and background

1.1 Risk of retailer default

All businesses, whether regulated or not, face commercial risks and determine if they will manage or mitigate a specific risk and if so, how. Generally, if a business determines that a risk will be managed the business has assessed the costs to the business of mitigating the risk and the exposure it faces from the risk if left unmitigated and determines the appropriate balance between these factors. This balancing, which may be explicit, or implicit, occurs as market conditions and individual business conditions change and lead a business to determine the level of risk it is willing to accept at any particular time.

For distributors, the main commercial risk faced is the failure of a retailer to pay its network charges. The charges relate to network services provided to the shared customers of the distributor and retailer.[2] Retailers are responsible to pay these network charges to the distributor, which are generally included in the amounts collected by retailers from customers. In the case, of electricity, the network charges include both distribution and transmission charges. In the case of gas, network charges only include distribution charges.

Distributors do not generally charge their shared customers directly, but ratherimposes network charges on retailers. The risk to the distributor of retailer default arises due to the time lag between when network services are provided to the shared customers and when payments for those services are made by the retailer.

In both electricity and gas, the distributor provides connection and supply of energy services to retailer customers directly. The retailer provides retail services directly to the shared customers and collects the distribution charges from these customers.[3]

As a result of distributors not charging customers directly but rather imposing network charges on retailers, distributors face two distinct risks arising from non-payment of network charges:

- **revenue risk:** the risk of being unable to recover revenue owing for network services already provided to shared customers;
- **liquidity risk:** the risk of cash-flow shortage due to a shortfall in the recovery of network charges where a distributor will not have access to sufficient cash in the short term to meet its short-term liabilities as they come due; and

2 A shared customer is defined in the National Energy Retail Law (South Australia) Act 2011 (NERL), section 2. Shared customer, in relation to a distributor and retailer, means a person who is a customer of the retailers and whose premises are connected to the distributor's distribution system.

3 The relationships and obligations of the distributor, retailer and retail customer are set out further in E

- **systemic risk:** the risk that a retailer default will have a cascading effect on the financial viability of other market participants thereby causing other market participants, including distributors, to face financial distress or resulting in their default.

As distributors operate in a regulated environment and given their monopoly position, the mechanisms available to manage risk are not the same as for an unregulated business operating in a competitive market. The differences arise as a result of:

- distributors' obligations to provide connection services and supply to customers;[4]

- distributors not charging customers directly but rather imposing network charges on retailers as distributors are prohibited from billing small customers directly and may only bill large shared customers directly with the customer's consent;[5]

- the inability of distributors to refuse to provide services to a customer or to deal with a particular retailer; and

- the inability of distributors to price or factor in the risk of transacting with retailers they perceive to be a credit risk.[6]

A distributor, unlike an unregulated business, has a regulated ability to recover an efficient return on its investment, subject to the overall incentive-based approach to regulation.

Currently, the risks faced by distributors related to retailer default can be managed through statutory mechanisms. These include the retailer insolvency cost pass-through provisions, credit support requirements and the overs and under process under the revenue cap regulatory regime, or through commercial mechanisms, such as third-party insurance or where available, negotiation.[7]

4 NERL, clause 66 provides that a distributor must provide customer connection services for the premises of a customer who requests those services, and whose premises are connected (or requested to be connected) to the distribution network. This obligation is tempered slightly for gas distributors where the distributor may inform the prospective customer that it cannot provide the requested service and the reasons why the requested services cannot be provided pursuant to rule 112 of the NGR.

5 NERL, section 72(b); NER clause 6B.A2.2; NGR clause 504

6 The inability to price discriminate arises as a result of the revenue cap and price cap revenue determination process.

7 Historically, negotiation was available to gas distributors and gas retailers under an access arrangement where the National Energy Customer Framework (NECF) does not apply and may include risk mitigation mechanisms such as more frequent meter reading or billing, or payment in advance rather than arrears.

1.2 The credit support requirements under the NER and NGR

1.2.1 How to determine if credit support is required

The credit support requirements were introduced into the rules as part of the National Energy Customer Framework (NECF) in 2011. The credit support requirements are set out in Chapter 6B of the NER and Part 21, Division 4 of the NGR. The credit support requirements are substantively the same for electricity and gas. As the credit support requirements were adopted as part of the NECF and the NECF does not apply in Victoria, the credit support requirements contained in the NER and NGR do not apply to distributors and retailers in Victoria. Credit support requirements as between distributors and retailers in Victoria will continue to operate as per jurisdictional regulation.

Under the NER and NGR, a distributor may request credit support but is not obliged to do so. If a distributor requests credit support, the credit support must be determined in accordance with the credit support provisions in the rules, must be in a form acceptable to the distributor (usually a bank guarantee), and must be provided by the retailer within 10 days of the request.

Under the current requirements, credit support may be requested by the distributor when the retailer's network charges liability (billed (but unpaid) and unbilled charges over the outstanding period) exceeds its credit allowance. The determination of the retailer's credit allowance is a function of both the retailer's creditworthiness, where the more creditworthy the retailer the higher its credit allowance, and the distributor's total annual retailer charges. For any given credit rating, as a retailer's market share increases, all else being equal, its network charges liability increases, and the amount of credit support that may be required in excess of its credit allowance would increase.

Under the current credit support rules, credit support is calculated as follows:

Credit support = Network charges liability - Retailer's credit allowance

Where

Retailer's credit allowance = credit allowance % x Maximum credit allowance

Maximum credit allowance = 25 % of Distributor's total annual network charges

Each element that is required for the calculation of the credit support required is discussed below.

Maximum credit allowance: Under the current credit support requirements the maximum credit allowance is set at 25 per cent of a distributor's total annual network charges.[8] For example, if a distributor has total annual network charges of $10 million,

8 A distributor's total annual network charges are reported to and published by the Australian Energy Regulator (AER)

the maximum credit allowance for any retailer in that distribution area would be $2.5 million (equals 25 per cent of $10 million).

Retailer's credit allowance: is set as a percentage of the maximum credit allowance in accordance with the retailer's creditworthiness as determined by reference to the retailer's S&P (or equivalent) rating or its Dun & Bradstreet (D&B) dynamic risk score. The more creditworthy the retailer, the higher its individual credit allowance.

For example, for retailers with an S&P credit rating of A- or above, their credit allowance is equal to 100 per cent of the distributor's maximum credit allowance. As a retailer's credit rating moves below A-, the percentage of the maximum credit allowance they are provided goes down. The percentage that applies to a retailer is based on their risk of default compared to the risk of default of an A- rated retailer. The percentages are specifically set out in the NER and NGR and are set out in Table F.1 in Appendix F.

Network charges liability: is the sum of the retailer's average billed (but unpaid) and unbilled network charges for each customer class.[9] For each customer class, this is based on the network charges over the number of days' outstanding taking into account:

- how often the meters are read (eg monthly versus quarterly);
- how often the distributor bills the retailer (ie monthly or as otherwise agreed between the retailer and distributor); and
- the length of time taken to prepare the invoice and the time the retailer has to pay the invoice.[10].

The higher the number of days outstanding, the higher the retailer's network charges liability, and all else being equal, the more credit support that may be required.

Amount of credit support required: the extent that the network charges liability exceeds the retailer's credit allowance determined the amount, if any, of credit support that the retailer may have to provide to the distributor.

An example of how to calculate the credit support required under the current rules is set out Appendix F.

9 A customer class is defined as those shared customers of the distributor and retailer for which the maximum days outstanding is the same.

10 Average outstanding network charges are calculated in accordance with the formula set out in the NER at clause 6B.B2.3 and NGR at Part 21 rule 517

1.2.2 Other credit support regime requirements

Although credit support is generally calculated as set out above, there are certain triggers under the current rules where a distributor may be able to request credit support from a retailer for the retailer's full network charges liability irrespective of the retailer's creditworthiness. These triggers include:

- if within the previous 12 months the retailer has failed to pay in full:
  - charges contained within three statements by the due date;
  - charges contained within two consecutive statements by the due date; or
  - charges contained within one statement within 25 business days of the due date; or.
- if Australian Energy Market Operator (AEMO) makes a claim on its credit support in the wholesale market from the retailer.[11]

The rules also prescribe when a distributor may call on the credit support provided by a retailer and states:

- the distributor must provide notice at least three business days in advance of calling on the credit support held;
- there must be an amount of network charges due and payable which remains outstanding; and
- there is no unresolved dispute relating to the amount that must be paid by the retailer for its network charges.[12]

If these three requirements are satisfied and the distributor holds credit support, it can call on the credit support to satisfy the retailer's outstanding network charges.

1.3 Other mechanisms for the recovery of unpaid network charges

The credit support requirements are one mechanism available to distributors to manage the risk of retailer default. Below is a discussion of the various other ways that a distributor may be able to manage or mitigate the risks that arise as a result of retailer default.

1.3.1 Overs and unders

The overs and unders process is available to distributors whose regulatory revenue determination is based on a revenue cap control mechanism. Under a revenue cap, the

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11 NER, 6B.B3.5; NGR, Part 21, Section 522

12 NER, 6B.B5.3; NGR, Part 21, Section 528

AER sets a maximum amount of revenue that can be recovered each year of the regulatory determination period. Distributors then recover the allowable revenue amount by forecasting demand and setting prices so as to recover the allowable revenue amount. At the end of each year, the distributor accounts for the differences between the amount of revenue actually recovered and the amount of allowable revenue pursuant to its regulatory determination. If the distributor has over-collected, then the amount of allowable revenue for the following year is reduced by the over-collection, and vice versa.

In the event of a retailer default, the distributor would under-recover on its allowable revenue amount for the year in which the retailer default occurred. The distributor may then, with AER approval, add the amount under-recovered to the following year's allowable revenue amount. This increased allowable revenue amount would then be collected from all of the distributor's customers over the following year.

1.3.2 Retailer insolvency cost pass-through

The retailer insolvency cost pass-through mechanism is generally used by distributors who are on a price cap form of regulation. Under price cap regulation the AER, as part of the regulatory determination process, sets the prices that distributors can charge for services. This is in contrast to the revenue cap form of regulation which sets an allowable revenue amount. The retailer insolvency cost pass-through mechanism is one of the revenue adjustment mechanisms set out in the NER and NGR.

Actual revenue for a distributor may deviate from its expected revenue due to the occurrence of exogenous events that are not within the reasonable control of the distributor. The regulatory framework and/or access arrangement makes provision for managing the impact of uncertain exogenous events on revenues through different adjust mechanisms, depending on the nature of the event. These mechanisms include contingent projects, capital expenditure re-openers and cost pass-throughs.

When an exogenous event occurs within the regulatory control period that materially increases a distributor's costs, the distributor may apply to the AER to approve a pass-through of the increased costs under the cost pass-through provisions.

Under the current retailer insolvency cost pass-through provisions, a distributor is able to seek recovery of costs incurred as a result of a retailer default, where the costs exceed the materiality threshold. The materiality threshold is set at one per cent of the relevant distributor's revenue requirement for that year. If the distributor's application for a cost pass-through is approved, the costs incurred as a result of the retailer default are passed through, and recovered from, customers in the form of increased prices.

The cost pass-through mechanism operates to reallocate a risk from distributors to their customers, in circumstances where this is considered to be appropriate. By its nature it is an ex-post mechanism, allowing recovery of actual costs after an event has occurred. This provides transparency regarding the recovery of the costs in comparison to including an allowance in the total regulated revenue.

Once approved, the recovery of cost pass-through amounts is spread across the distributor's customer base, minimising the overall impact on individual customers. All customers, to whom the cost is passed through, would face increases in their charges until the amount is fully collected.

1.3.3 Insurance

One method to manage the exposure to retailer default is by incorporating some consideration for the risk into a distributor's allowed revenues through the regulatory determination process.

Where a distributor elects to purchase commercial insurance against the financial impact of a retailer default, the cost or premium paid for this insurance could be incorporated into the distributor's operating expenditure forecast and the AER, as part of its regulatory determination, would make a decision on whether the expenditure would be an allowance cost.[13]

The effect of commercial insurance would be to transfer the risk from the distributor, as policy holder, to the insurance company which may be better able to manage this risk by pooling it with the risks of other policy holders, and by holding appropriate capital reserves.[14]

However, risks that relate to low probability but potentially high impact events may be difficult to commercially insure. That is, they may be only partially insured, incur high premiums resulting in them being uneconomical, or be uninsurable altogether. In such circumstances, self-insurance may be more appropriate.

Under a self-insurance regime, the risk would remain with distributors, with the intention that the money collected would be ring-fenced until such time as a retailer default occurs, after which it may be drawn down to cover the costs incurred.[15]

The AER's regulatory determination process has historically made allowance for self-insurance as a component of operating expenditure, to the extent that such risks are not:

- able to be effectively covered by commercial insurance;
- already remunerated through other elements of their regulatory regime, such as inclusion in capital expenditure or in the weighted average cost of capital; or

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13 AER, *Victorian electricity distribution network service providers, distribution determination 2011-2015,* Appendices, June 2010, Appendix L, p.315

14 Frontier Economics, Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia, July 2013, p. 45. This report is available at: http://www.aer.gov.au/system/files/Frontier%20Economics%20-%20Assessing%20risk%20when%20determining%20the%20appropriate%20rate%20of%20return%20-%20July%202013%20-%20Draft%20rate%20of%20return%20guideline.pdf.

15 Frontier Economics, Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia, July 2013, p.55

- recovered through the pass-through mechanism.

The AER has also considered it to be necessary for the particular risk to have been historically incurred, in order to be able to use the commonly accepted method of calculating self-insurance premiums.[16]

Inclusion of the cost of commercial or self-insurance premiums into a distributor's forecast capital expenditure over a regulatory period may be possible. However, in practice, such approaches may have a number of drawbacks:

- As an ex-ante allowance, there is potential for the value placed on this risk to be inaccurate. By its nature the risk of retailer default, its potential impact and the possible timing are difficult to estimate. As a result, determining a value to include in operating cost estimates could be problematic.

- Bundled as part of the overall price for network services, there would be less transparency in the amounts recovered and allocated to retailer default.

However, spreading the impact of the risk over time may be desirable to some customers that would prefer not to be impacted from time to time by significant price rises following a retailer default.

1.3.4 Corporate insolvency process

In addition to recovery processes under the NER and NGR, a distributor that is unable to collect unpaid network charges owed to it by an insolvent retailer may join a general corporate insolvency process. The distributor would join this process as an unsecured creditor under the *Corporations Act 2001 (Cth)*.[17]

The recovery of debt that is not secured[18] depends on a number of factors including where there is money available to make any payments at all, or whether there is a specific order of payments that must be followed. Where a distributor's claim sits in the order of creditors will affect its entitlement to payment.

The NER and NGR require that any amount the distributor is likely to receive on the winding up of the insolvency retailer is to be excluded from the eligible cost pass-through amount approved by the AER.[19] Beyond this, there is very little

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16 AER, Victorian electricity distribution network service providers, distribution determination 2011-2015, Appendices, June 2010, Appendix M, p.457

17 The distributor may join a general corporate insolvency procedure as an unsecured creditor under the *Corporations Act 2001 (Cth)* when it is owed money by an insolvent retailer (a retailer is considered to be insolvent when it becomes unable to pay its debt when they fall due for payment). The precise details of the various insolvency procedures under the Corporations Act are outside the scope of this publication.

18 There are two main types of debts: secured and unsecured. A secured debt generally has some form of asset as collateral for the debt. An unsecured debt on the other hand, requires no security for the loan and is based solely on the borrower's creditworthiness and obligation to pay.

19 Clause 6.6.(1) of the NER and Part 21, rule 531 of the NGR.

guidance as to how the timing of, and recoveries under these separate processes are to be reconciled.

The operation of an insolvency process would be uncertain for a distributor in terms of the timing and extent of recovery of money owed. There is no guarantee that it would recover its debt in full or at all. If, for example, the retailer enters into liquidation, payment of the liquidator's fees and costs and payment to priority creditors, employees and secured creditors are prioritised before the remaining monies are distributed to unsecured creditors. Each category of creditor is paid in full before the next category is paid.

The insolvency process is a discrete statutory process that would proceed on a timetable independent of the NER and NGR. It is therefore possible that the lodgement and assessment of a cost pass-through application may be commenced, and completed in accordance with the NER and NGR, independently of any insolvency process.[20]

1.4 Timing of the recovery of unpaid network charges under the various mechanisms

Sections 1.2 and 1.3 outlined the existing mechanisms available to distributors to manage the risk of retailer default. While these mechanisms provide for the recovery of at least part of the unpaid network charges, and therefore mitigate the revenue risk faced by distributors, they differ in terms of when a distributor can begin recovering the unpaid charges. Consequently, the mechanisms differ in terms of their ability to mitigate a distributor's liquidity risk. Liquidity risk is the risk that a retailer's default will result in a cash flow shortage for the distributor due to the time elapsed between non-payment and ultimate recovery of unpaid network charges.

In understanding the differences in timing of the recovery of unpaid network charges, the focus is on the credit support arrangements, and:

- the retailer insolvency cost pass-through mechanism;
- the overs and unders process; or
- the corporate insolvency process.

These mechanisms have been chosen due to their direct relevance to the rule change requests.

To illustrate the differences in timing between credit support and the cost pass-through (or overs and unders) mechanism, a stylised example is used, involving a hypothetical retailer, who defaults, and a hypothetical distributor. In comparing these mechanisms, we assume the amount of unpaid network charges is the same, as is the timing of a

20 See clause 6.6.1 of the NER and Part 21, rule 531 of the NGR.

retailer's default. We also assume, for ease of illustration, that the amount of credit support is sufficient to fully meet the amount of unpaid network charges.[21]

We also assume, consistent with the draft rules, that there is no materiality threshold associated with the cost pass-through provisions, which may otherwise prevent a distributor from recovering the unpaid network charges if the amount was lower than the threshold. A one per cent materiality threshold currently applies under the current arrangements in the NER whereby if the retailer insolvency cost pass-through amount is less than one per cent of the distributor's annual revenue requirement the distributor will not be able to use the cost pass-through mechanism.

1.4.1 Credit support

As discussed in section 1.2, a distributor must provide at least three business days' notice to a retailer when calling on any credit support provided by that retailer. The distributor is able to provide three days' notice any time after the due date has passed on the retailer's invoice for the network charges. Generally, a retailer has ten business days to pay an invoice from its date of issuance. Therefore, a distributor could call on the credit support on the 13th business day after the retailer has been provided the bill for its network charges, if the invoice remains outstanding as at that date.

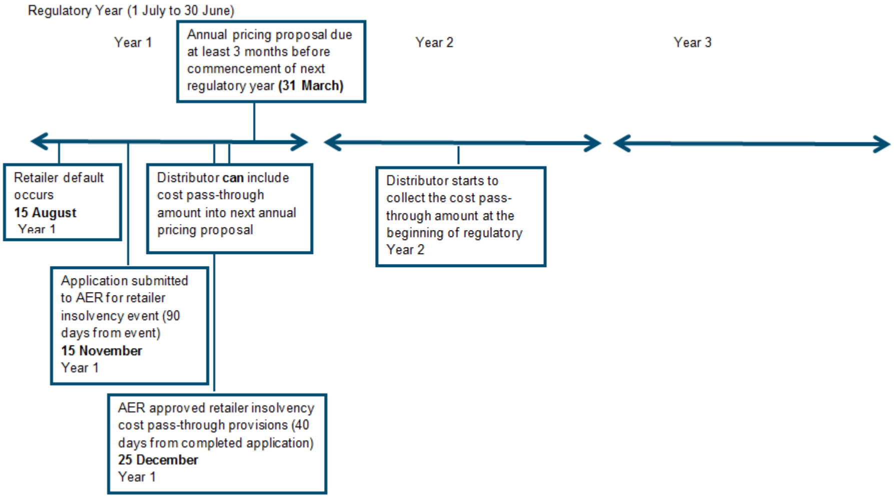
1.4.2 Cost pass-through process

A distributor must apply to the AER within ninety business days of the retailer insolvency event occurring for approval of the cost pass-through. The AER then has forty business days to make a decision on the cost pass-through application including the cost pass-through amount and the length of time that the distributor will have to collect the amount from customers.

Under current practice, if the pass-through application is approved, the distributor incorporates the approved cost pass-through amount from the beginning of the regulatory year to which the pricing proposal applies. This is the case in Figure 1.1 where the timing of retailer default, and the size of the unpaid network charges are such that the unpaid network charges can be fully recovered during the regulatory year following the retailer's default.

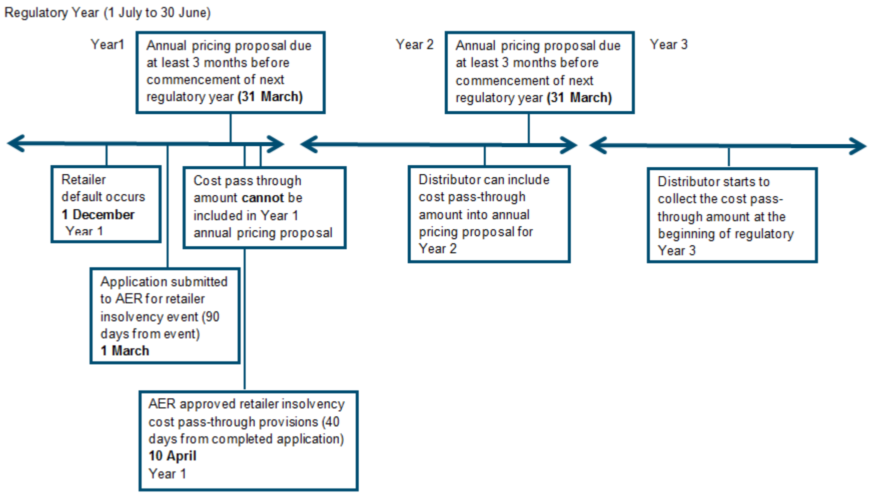
21 In the event that the amount of credit support is insufficient, a distributor would need to rely on either the cost pass-through, or the overs and unders process, to recover the excess unpaid network charges.

Figure 1.1 Collection of cost pass-through amount



In general, the time it takes for a distributor to start recovering the cost pass-through amount will depend on the timing of the retailer insolvency event and when the annual pricing proposal for the next regulatory year is prepared and submitted. For example, Figure 1.2 illustrates the timing of the recovery of unpaid charges when the retailer default occurs later in Year 1 than was in the case in Figure 1.1.

Figure 1.2 Collection of cost pass-through amount: retailer default occurs later in the regulatory year



In the example in Figure 1.2, the distributor has to wait until the start of year 3 to recover the unpaid network charges, a year later than was the case in Figure 1.1. Similar to the example in Figure 1.1., we again assume the size of the unpaid network charges (also referred to as foregone revenue) is sufficiently small such that it can be fully recovered during one regulatory year.

1.4.3 Overs and unders process

As discussed in section 1.3.2, the overs and unders process occurs as part of a distributor's annual pricing proposal process. Under the pricing proposal process a distributor must submit to the AER its pricing proposal three months prior to the next regulatory year in its regulatory control period. The annual pricing proposal would include information on any adjustments to prices arising from the over or under recovery of charges. However, unlike the cost pass-through mechanism, the overs and unders process works on a two-year rolling basis and so where a retailer default occurs in year 1 the distributor would not be able to collect any under-recovery until year 3.

There are other differences between the cost pass-through mechanism and overs and unders process which should be pointed out. First, unlike the cost pass-through mechanism, the under-collection of revenue under the overs-and-unders process will typically occur in the next regulatory year rather than spread out over several regulatory years. This one-year collection period may be tempered in reality where the under-recovery is substantial. Secondly, the overs and unders process offsets any over-collection with an under-collection of revenue for the same period. As such, any under-collection of revenue arising from a retailer default may be offset by the over-collection of revenue associated with other components of the distributor's revenue determination. Lastly, it should be pointed out that the overs and unders process allows adjustments for the under-or over-collection of revenue but does not allow a distributor to collect any costs associated with a retailer default. This is in contrast to the retailer insolvency cost pass-through mechanism that allows the collection of costs associated with retailer insolvency in addition to any foregone revenue.

1.4.4 Corporate insolvency process

The timing associated with the collection of a distributor's foregone revenue under the corporate insolvency process is not prescribed in the rules and is dependent on a number of factors, including:

- when the retailer is placed under administration;
- the number and types of claims; and
- the necessary court applications and decisions to allow the retailer's debts to be paid.

Therefore, any recovery under the corporate insolvency process will generally take a much longer period of time than when decisions are made by the AER under other mechanisms.

1.4.5 Conclusion

These stylised examples provide a useful theoretical illustration of the timing of recovery of unpaid network charges. Determining the timing of recovery in practice is complex and would depend on the timing of a retailer's default and the amount of network charges owed at the time of default. The larger the amount of unpaid network charges, the greater the possibility that:

- the amount of any credit support held may be insufficient, thereby requiring a distributor to also use the cost pass-through or overs and unders process, therefore delaying the recovery of all the unpaid network charges; and/or
- the unpaid network charges may be spread across multiple regulatory years which would delay the ultimate recovery of the unpaid charges.

In either case, a distributor faces greater liquidity risk (which increases the potential for systemic risk faced by the distributor), as the amount of unpaid network charges increases resulting in a delay in recovery of the unpaid network charges.

While credit support is typically the most timely of the various mechanisms, the existing credit support arrangements mean that credit support is provided by some, but not all, retailers to some, but not all, distributors. This significantly limits the ability of the existing credit support arrangements to allow distributors to recover unpaid network charges, and therefore reduces the liquidity risk protection provided under the existing arrangements.

2 The rule change requests

This chapter provides a summary of the rule change requests being considered by the Commission as part of this rule change request process.

2.1 Retailer-distributor credit support requirements

On 19 January 2015, AGL submitted two rule change requests to the AEMC. The rule change requests seek to amend the retailer-distributor credit support requirements in the NER and NGR.

As discussed in section 1.2, credit support may be requested by a distributor when a retailer's network charges liability exceeds its credit allowance. The determination of the credit allowance is a function of both the distributor's total annual retailer charges and the retailer's creditworthiness.

AGL proposed the same changes to the retailer-distributor credit support requirements under both the NER and NGR. Under AGL's proposal, no credit support would be required from retailers with an S&P (or equivalent) credit rating of BBB- or better, no matter the size of the retailer's market share. For a retailer rated below BBB-, credit support would be determined so that the distributor's risk-weighted exposure to the retailer's default, the effective loss faced by the distributor, would be the same as if that retailer was rated BBB-.[22]

Under the proposed rule, credit support levels are based on a percentage of the retailer's network charges liability. AGL proposed to specifically include the percentages in the proposed rules.

The calculation of the retailer's network charges liability would be the same under AGL's proposal and under the current NER and NGR provisions.

2.1.1 Rationale for AGL's rule change requests

In its rule change requests, AGL provides its rationale for the proposed changes to the NER and NGR. AGL's main concern stems from the level of the maximum credit allowance. The maximum credit allowance was changed from 33.33 per cent to 25 per cent between the time of the second exposure draft and the final version of the instruments making up the NECF coming into effect.

AGL is of the view that the change was made to increase the levels of credit support overall in light of the 2007-2009 global financial crisis and greater incidences of peak price events, both of which could increase the risk of retailer default. If this additional amount of credit support was to be provided by the lowest rated retailers, AGL argues, this would discourage market entry and reduce competition from smaller (typically lower rated) retailers, as the cost of credit support tends to be highest for these retailers. Consequently, AGL claims that the current credit support requirements shift

22 An example of the effective loss calculation is provided on p.9 of the AGL rule change requests.

the burden of providing credit support from low-rated retailers to high-rated retailers, and therefore does not properly reflect the risk faced by distributors.[23]

AGL puts forward several arguments for why the current credit support requirements are flawed, including that:

- the concept of a maximum credit allowance is arbitrary and not-well-established;
- credit ratings already incorporate efficient and dynamic measures of risk, and account for the impacts of the global financial crisis and fluctuations in the wholesale electricity prices during that time. Consequently, there is no need to adjust the maximum credit allowance to incorporate these impacts;
- while reducing credit support amounts may reduce barriers to entry and enhance competition, more efficient mechanisms exist (such as independent price comparison websites) to promote competition;
- the revision to the credit allowance, from 33.33 to 25 per cent, was done on the assumption that the quantum of credit support provided overall needed to increase and that this increase should come from larger retailers. However, large and higher-rated retailers cannot cross-subsidise small and lower-rated retailers under a credit support scheme, as credit support can only be drawn-on in relation to the defaulting retailer who provided the credit support. Consequently, a distributor's exposure to the risk of default from lower-rated retailers is not reduced by requiring increased credit support from higher-rated retailers; and
- the relative cost of the misalignment of risks under the existing arrangements is material with the estimated costs of the difference between the existing and proposed arrangements including:
  - direct costs well in excess of $4 million per annum (representing two per cent of the value of the guarantee);
  - facility commitment fees well in excess of $3.1 million per annum (representing roughly one and a half per cent of the value of the guarantee); and
  - a reduction in funds available for re-investment in the electricity and gas markets of between $250 and $450 million.[24]

2.1.2 AGL's assessment of the proposed rule

AGL provides, in terms of both the NEO and NGO that its proposed rule will:

- promote efficient investment in the electricity and gas markets by freeing up capital that is currently inefficiently tied up servicing poorly targeted policy;

23 AGL rule change request, p.5.

24 AGL rule change requests, p.8

- better align a retailer's contribution to credit support with their level of credit risk, encouraging them to make prudent decisions with respect to their payment practices and reducing risk overall, which will promote reliability of supply; and
- reduce costs tor retailers of providing retail services, which will result in lower prices for consumers.[25]

2.2 Retailer insolvency cost pass-through rule change request for the NER

On 20 March 2014, the COAG Energy Council submitted a rule change request to the AEMC to amend the retailer insolvency cost pass-through provisions in the NER. The rule change request seeks to amend the NER to allow a distributor to recover its network charges which are unpaid as a result of a retailer becoming insolvent.

If made, the effect of the proposed rule would be to allow a distributor to recover its charges, following the insolvency of a retailer, from the distributor's entire customer base. To achieve fully recovery by the distributor, the rule change request proposes two key amendments:

- the insertion of a new and separate limb within the current definition of a positive change event to include the occurrence of a retailer insolvency event. This would allow for costs arising from a retailer insolvency event to be passed through to customers without being subject to a materiality threshold; and
- the insertion of a new definition for retailer insolvency costs, which would specifically include a distributor's unpaid network charges as a result of a retailer insolvency event. This would allow distributors to use the cost pass-through mechanism to recover unpaid charges (foregone revenue), and not just the relevant additional costs incurred, following occurrence of such an event.

2.2.1 COAG Energy Council's rationale

The COAG Energy Council has stated that both limbs of its proposed rule are necessary to correct inadvertent omissions made in the previous drafting of amendments to the NER made as part of NECF.

The COAG Energy Council considers that the current provisions of the NER limit the ability of a distributor to manage the commercial risk associated with retailers given that:

- under the NER, the distributors have a mandatory obligation to provide service when they are requested,[26] and therefore are unable to withhold, or otherwise restrict, the supply of these services to retailers that might be perceived as being a commercial risk;

25 AGL rule change requests, p.12 & 13

26 Clause 6.1.3 of the NER

- as the revenue derived from retail services is subject to economic regulation, distributors may not make adjustments to the prices charged for these services to account for any higher risk in dealing with retailers that are perceived to have a higher risk of default; and

- the ability of distributors to manage the risk through the requirement of credit support from retailers is limited by the regulation of these arrangements under the NER.

2.3 Retailer insolvency cost pass-through provisions in the NGR

On 25 September 2015, Jemena Gas Networks (Jemena) submitted a rule change request to the AEMC. The rule change request seeks to amend the retailer insolvency cost pass-through provisions in the NGR to allow a distributor to recover its foregone revenue in the event retailer insolvency. The proposed changes would bring the retailer insolvency cost pass-through provisions in the NGR in line with the changes proposed by the COAG Energy Council related to the retailer insolvency cost pass-through provisions in the NER (discussed above).

In particular, Jemena has proposed amendments to Rule 531 of the NGR to:

- clarify that the pass-through amount includes both foregone revenue and the cost impacts of retailer insolvency; and

- the AER approved pass-through amount is to be reflected in variations to one or more reference tariffs through the reference tariff variation mechanism pursuant to the distributor's access arrangement. This would be the case even when the access arrangement does not contemplate, or is otherwise inconsistent with, the pass-through mechanism prescribed in the NGR.

2.3.1 Jemena's rationale

Jemena has stated that the proposed rule is necessary to correct inadvertent omissions made when the retailer insolvency cost pass-through provisions were originally included in the NGR made as part of NECF.

Jemena indicates that the arrangements for gas distributors and electricity distributors are sufficiently similar for comparable pass-through rules to apply. In particular, as is the case for electricity distributors, gas distributors:

- are required to offer customers connection services; and

- have no ability to make fully independent decisions to manage the risk of counter-party default.

Due to the similarities between electricity and gas distributors, Jemena submitted its rule change request to align any changes made to the NER provisions with the NGR provisions, where appropriate.

2.3.2 Jemena's assessment of the proposed rule

Jemena claims that the key benefit of the proposed rule is to provide clarity to ensure that foregone revenue resulting from retailer insolvency may be recovered. This clarity would result in increased confidence on the part of customers, distributors and associated financial institutions. According to Jemena, this would result in downward pressure on network tariffs.

Further, Jemena indicates that the proposed retailer insolvency cost pass-through provisions are in line with the general regulatory framework, which aims to ensure network revenue covers the efficient cost of providing reference services.

2.4 Consolidation of the rule change requests

The Commission consolidated the COAG Energy Council's retailer insolvency cost pass-through rule change request (ERC0172)[27] with AGL's rule change request related to the amendments to the NER.[28] They are being treated as one rule change request for the purposes of Part 7 of the NEL.

The Commission consolidated the Jemena retailer insolvency cost pass-through rule change request (GRC0035) with AGL's rule change request related to the amendments to the NGR.[29] They are being treated as one rule change request for the purposes of Part 3 of the NGL.

Both consolidated rule change requests are being examined together in a single rule determination process.

2.5 The Commission's rule making process to date

On 28 May 2015, the Commission published a paper identifying specific issues and questions for consultation. At the same time, the Commission decided to extend the period of time to consider the rule change requests under section 107 of the NEL and section 317 of the NGL. The Commission considered the extension necessary due to the complexity of the issues raised by the rule change requests.

Submissions on the consultation paper closed on 2 July 2015. The Commission received 15 submissions, which are available on the AEMC website. A summary of the issues raised in submissions and the Commission's response to each issue is contained in Appendix B.

On 22 October 2015, the Commission published an options paper to facilitate consultation on the rule change requests. The options paper sought stakeholder views on potential options identified to address the rule change requests.

27 The Commission published a consultation paper on the COAG Energy Council rule change request prior to its consolidation. A summary of the stakeholder submissions and the Commission's response is included in Appendix A.

28 The consolidation was approved pursuant to section 93 of the National Electricity Law (NEL) .

29 The consolidation was approved pursuant to section 300 of the National Gas Law (NGL) .

Submissions on the options paper closed on 26 November 2015. The Commission received 17 submissions, which are available on the AEMC website. A summary of the issues raised and the Commission's response to each issue is contained in Appendix C.

On 18 February 2016 and 21 July 2016 the Commission approved an extension of the period of time for making a draft rule determination under section 107 of the NEL and section 307 of the NGL to 27 October 2016.

On 27 and 30 May 2016, the AEMC held workshops with retailers, distributors and other interested parties on the detailed design of a retailer default fund option. The purpose of these workshops was to gather stakeholder feedback on a possible retailer default fund design to allow the Commission to consider the implementation and operation of the retailer default fund when considering the implementation and operation of the other options considered by the Commission. A copy of the staff paper presented at the workshops is attached in Appendix G.

2.6 Consultation on the draft determination

The Commission invites submissions on this draft determination, including the draft rules by 22 December 2016 (8 weeks).

Any person or body may request that the Commission hold a hearing in relation to the draft determination. Any request for a hearing must be made in writing and must be received by the Commission no later than 3 November 2016.[30]

Submissions and requests for a hearing should quote project number "ERC0183" and may be lodged online at www.aemc.gov.au or by mail at:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

30 In accordance with section 101(a) of the NEL and section 310(2) of the NGL. A public hearing is a formal requirement for the Commission to appear before the applicant to enable the applicant to make a presentation to the Commission.

3 Draft rule determination

Following its analysis of the issues raised in the rule change requests, the Commission has decided to make draft more preferable rules to enhance the retailer insolvency cost pass-through provisions and remove credit support requirements as between distributors and retailers, except in the case of late payment, in each of the NER and NGR.

The draft rules are attached to and published with this draft determination. Having regard to the issues raised in the rule change requests and by stakeholders the Commission is satisfied that the draft rules will, or are likely to, better contribute to the achievement of the NEO and NGO than the existing rules or the proposed rules.

This Chapters outlines:

- the Commission's rule making test for changes to the NER and NGR;
- the Commission's assessment framework for considering the rule change request; and
- the Commission's consideration of the draft rules against the National Electricity Objective (NEO) and the National Gas Objective (NGO).

From 1 July 2016, the National Electricity Rules (NER), as amended from time to time, apply in the Northern Territory (NT),[31]subject to derogations set out in Regulations made under the NT legislation adopting the NEL.[32] Under those Regulations, only certain parts of the NER have been adopted in the Northern Territory. As the draft rule relates to a parts of the NER that do not apply in the Northern Territory, the Commission has not assessed the draft rule against the additional elements required by NT legislation.[33]

Further information on the legal requirements for making this draft rule determination is set out in Appendix D.

3.1 Rule making test

The Commission may only make a change to the NER and NGR if it is satisfied that the rules will or are likely to, contribute to the achievement of the NEO and NGO, as applicable.

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31 Details on the parts of the NER adopted by the Northern Territory can be found on the AMEC's website at: http://www.aemc.gov.au/Energy-Rules/National-electricity-rules/Rules-(NT)/National-Electricity-Rules-(NT)-Version-1

32 National Electricity (Northern Territory) (National Uniform Legislation) (Modifications) Regulations.

33 *National Electricity (Northern Territory) (National uniform Legislation) Act 2015*

The NEO is:

> "to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

The NGO 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."

The Commission considers the relevant aspects of the NEO and NGO to the rule change requests are the "efficient operation" of electricity or gas services with respect to price and reliability.[34] Any impact on the retail market is considered in the context of the "long term interests of consumers."

3.2 Assessment approach

The issues raised in the rule change requests are considered by examining:

- the risks associated with retailer default;
- how the costs associated with managing these risks are addressed, including the possible recovery of a distributor's unpaid network charges; and
- how the risks should be allocated to parties;

in order to best promote the NEO and NGO.

The rule change requests alter the mechanisms that help to manage the risk of retailer default. The Commission's approach has been to develop a set of principles to be taken into consideration when designing an effective rule for managing the risk of retailer default. The rule change requests are examined in light of these underlying principles, rather than simply examining the impacts of the specific requests. These principles guide the development of rules that are in the long-term interests of consumers.

34 While there are implications for retailers, there are no changes proposed to the National Electricity Retail Rules (NERR) and therefore the draft rules do not need to be assessed with respect to the National Energy Retailer Objective (NERO).

3.3 Principles for an effective rule to manage the risk of retailer default

The rule change requests have two impacts:

- the direct impact on distributor's revenue and cash flows resulting from a retailer default; and
- the costs incurred by retailers and distributors to manage the risk of retailer default and insolvency.

Any rule to manage the risks faced by distributors from retailer default will affect how and which market participants bear the responsibility and costs of managing the revenue and cash flow risks.

The current arrangements may reduce the exposure of a distributor to revenue and cash flow risk in the event of a retailer default, by allowing a distributor to call on credit support (where it is provided). Some of the remaining exposure to revenue and cash flow risk may eventually rest with the distributor's customer base:

- if the distributor's revenue determination is by way of a revenue cap, then any unpaid network charges resulting from retailer default may be recovered from all customers through the overs and unders process;
- if any additional costs are incurred by the distributor as a result of the retailer default, and the size of these costs are greater than the materiality threshold which applies to electricity distributors, these may be recovered from customers through the cost pass-through provisions.

The costs incurred by the distributor are shared by all customers in that network, while the costs incurred by the retailer are shared only by that retailer's customers. In the absence of rules to mitigate the risk of retailer default, the expected long-term cost to a distributor's customers from retailer default is based on the likelihood of default and the loss in the event of default, which is based on the size of each retailer's outstanding network charges.

In the presence of efficient and effective risk-mitigation rules, the long-term expected costs to a distributor's customers would depend on the costs of implementing and operating rules to manage the risk of retailer default, as well as any residual expected loss given retailer default (in the event that the rule does not eliminate the risk to distributors and their customers from retailer default).

If a distributor is unable to recover unpaid network charges and reasonable costs incurred as a result of a retailer default, then this risk may be reflected in the regulated rate of return. This is because, generally, distributors are unable to price differentiate between retailers on the basis of each retailer's credit risk profile. If a rule to manage the risk of retailer default enables the distributor to recover unpaid network charges and reasonable costs incurred as a result of a retailer default, then the risks faced by the distributor are reduced. The risks faced by distributors should be reflected in the regulated rate of return, as specified in the rate of return objective and the revenue and pricing principles.

The Commission has developed the following principles to guide the development and assessment of an effective rule for managing the risk of retailer default:

- the rule allocates appropriate risks to the parties that have the information, ability and incentives to best manage each risk in order to minimise the long-term costs to consumers;
- the rule takes into account the risk of retailer default and the impact of default on the distributor;
- the rule takes into account the trade-off between flexibility and regulatory certainty;
- the rule takes into account the potential impact on barriers to entry and competition for retail businesses; and
- the rule takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles.

Based on the analysis undertaken to date by the Commission, the following principles were also considered in developing an efficient rule for managing the risks of retailer default:

- **Stability:** the rule should minimise potential financial contagion from a retailer default to its distributor;
- **Efficiency:** the rule should efficiently allocate the risks and costs to parties in order to minimise the long-term costs to consumers;
- **Incentives:** the rule should provide appropriate incentives to minimise the probability and impact of retailer default;
- **Revenue and pricing principles:** the rules should take into account any change in network revenue resulting from the mechanism adopted to manage the risk of retailer default and the application of the revenue and pricing principles; and
- **Competition:** the rule should consider any unintended or unwarranted impacts on barriers to entry for retail businesses.

3.4 The draft more preferable rules

The Commission's draft rules address the key issue raised in the rule change requests - having an efficient and effective framework for managing the risks faced by distributors from retailer default.

The rule change request sought to address this issue by:

- replacing the existing credit support regime with a new regime which would:
  - remove the concept of a maximum credit allowance; and
  - require retailers with an S&P credit rating below BBB- (or equivalent) to provide credit support to the distributor to an amount equivalent to the value at risk that would be faced by a distributor if that retailer were rated BBB-; and
- enhance the retailer insolvency cost pass-through provisions by allowing distributors to recover all unpaid network charges.

The arrangements prescribed in the rule change requests will impose additional costs on consumers as higher levels of credit support will be required under the proposed rules, and does not appropriately balance the various principles set out by the Commission.

The draft rules provide an appropriate framework for managing the risks of retailer default, by balancing the above-mentioned principles for developing an effective rule. This framework ensures that distributors are able to collect any unpaid network charges and costs related to a retailer default with no up-front costs incurred by distributors, retailers and their customers to manage an event that may not eventuate.

The draft rules (both in the NER and NGR) will:

- enhance the operation of the retailer insolvency cost pass-through provisions by:
  - removing the materiality threshold (currently one per cent of a distributor's annual revenue requirement), where applicable;
  - confirming that unpaid network charges may be included as part of a distributor's insolvency costs following a retailer insolvency event; and
  - confirming that the retailer insolvency cost pass-through provisions take precedence over any inconsistent provisions in any distributor's access arrangements, which is applicable only to the NGR.
- remove the requirements for a retailer to provide any form of credit support to a distributor except in the case of a history of late payment of distributor's invoices by a retailer. In the case of late payment, a retailer may be required to provide credit support in an amount equal to the last statement of charges issues to the retailer that triggered the requirement to provide credit support; and
- retain the existing credit support provisions in relation to any credit support that is currently held by a distributor, so that the credit support continues to operate on its terms as a result of the accrued statutory and contractual rights under the existing credit support instrument.

3.5 Summary of reasons

As discussed in section 1.1, there are three potential risks faced by distributors arising from a retailer default:

- revenue risk;
- liquidity risk; and
- systemic risk.

A distributor's risk from a retailer default consists of revenue risk and liquidity risk. Revenue risk relates to the inability of a distributor to recover all of the unpaid network charges, as well as any costs incurred in recovering those charges. As recovery of unpaid network charges can be a drawn-out process, liquidity risk relates to the potential for cash-flow shortfalls for distributors while they await full recovery of unpaid charges.

As with most risks, the actual impact on distributors and other parties from a retailer default depends on several factors. These factors may include, but are not limited to:

- the mechanisms available to the distributor to recover any unpaid network charges;
- the timing of retailer default (that is, when in the billing cycle default occurs);
- the total amount of unpaid charges owed by the defaulting retailer;
- potential implications for counter-parties in spot and derivative wholesale energy markets, whereby counter-parties to wholesale or hedging contracts may be unable to enforce or call on those contracts;
- macroeconomic conditions including the availability and the cost of funding in lending markets; and
- the reason for retailer default, which could be due to either retailer-specific issues (for example, an excessive amount of borrowing), or broader issues, either in the wholesale electricity market or in the macroeconomy (such as an economic downturn).

Retailer-specific issues are unlikely to have systemic risk implications for a distributor. Alternatively, if broader factors such as extremely high electricity prices combined with diminished availability and liquidity of hedging instruments, led to retailer default, this can create systemic risk as more than one retailer may be impacted. Therefore, risk mitigation measures may need to be put in place by distributors to safeguard against potential systemic risk, in additional to any measures put in place to minimise retailer-specific risk.

In terms of the three risks to a distributor from a retailer default, the Commission considers that distributors are best-placed to manage their liquidity risk. All businesses have to manage liquidity, including distributors, as a normal aspect of their business operation. There are various commercial and operational mechanisms that may be used to manage this risk. A distributor, given its position of receiving a regulated revenue amount (including a regulated rate of return), is, and will be, able to quickly access funds, either from external or internal sources, to manage any cash-flow shortages arising from non-payment of network charges as a result of retailer default

A distributor's liquidity risk is increased in situations where a defaulting retailer has a large market share in the distributor's network area. However, the retailers who currently have significant market shares in the NEM all hold investment grade credit ratings (S&P of BBB- or above). While an investment grade credit rating does not mean that a default can never occur, it does imply that the probability of default is fairly low; in the case of a retailer rated BBB-, it is 0.30%.[35]

Therefore, given the relatively low probability that a significant liquidity risk would arise from retailer default, and that distributors already manage liquidity risk as part of their day-to-day operations, a regulatory mechanism to mitigate liquidity risk is not necessary at this time. Consequently, the Commission considers that distributors are best-placed to determine how to manage their liquidity risks, which can arise for a range of sources, including retailer default.

Distributors' ability to mitigate their liquidity risk is enhanced if the regulatory framework provides for the ability for the distributor to collect the unpaid network charges and any costs incurred in collecting those unpaid charges, which mitigates the revenue risk faced by distributors.

Distributors are obliged to deal with any and every retailer, regardless of each retailer's level of default risk. This creates revenue risk for distributors, a risk which is exacerbated by the inability of distributors to price this risk into their relationship with retailers. Consequently, the Commission is of the view that it is not appropriate that revenue risk should be allocated to distributors to manage. Instead, revenue risk is best-managed through existing, regulatory-based, mechanisms, with suitable modifications to these mechanisms (discussed below) needed to fully mitigate distributors' revenue risk.

Any rule addressing revenue risk from retailer default must balance the principles set out by the Commission and a determination is required on the level that any mechanism should operate on an ex-ante or ex-post basis. An ex-ante mechanism requires some or all of the risks to a distributor from retailer default to be managed prior to the risk being realised. Credit support is an example of an ex-ante mechanism. With such a mechanism, any costs associated with the mechanism are also paid-up front and are incurred whether or not the risk actually eventuates.

Alternatively, the risks faced by distributors could be managed after a default has occurred. An example of such an ex-post mechanism is the retailer insolvency cost

35 2014 S&P default probabilities

pass-through provisions. Any costs associated with this mechanism are only incurred where a retailer default has actually occurred.

Any rule implemented to manage the risk faced by distributors from retailer default could involve elements of an ex-ante mechanism and ex-post mechanism. The existing risk-management mechanisms to manage retailer default can be either market-based or regulatory-based, and can be either ex-ante or ex-post. An example of the former is default insurance, as well as loan covenants on borrowings from banks and other institutions. An example of a regulatory-based ex-ante mechanism is the set of settlement prudential requirements (known as the prudential standard) imposed on retailers in the NEM.

These ex-ante mechanisms place numerous obligations on retailers to manage their default risk. Failure to meet these obligations may impact on a retailer's ability to borrow funds, and the cost of borrowing, and to operate its business. The Commission considers that these obligations sufficiently incentivise retailers to minimise their risk of default and remain financially viable.

The cost-pass through and overs-and-unders mechanisms are examples of regulatory-based ex-post mechanisms. Under ex-post mechanisms, costs are only incurred where the event has actually occurred and ensures that distributors are able to collect any unpaid network charges and costs incurred in relation to the event, in this case a retailer default.

The Commission assessed several options as part of the rule change process. These options included:

- **Option 1 - retain the existing arrangements:** the existing arrangements for both the credit support requirements and the cost pass-through provisions would remain as currently set out in the NER and NGR. This is the status quo option by which all other options are assessed against in determining if any option proposed better contributes to the achievement of the NEO and NGO;

- **Option 2 - strengthen the existing arrangements:** variations to the current credit support requirements and cost pass-through provisions, including but not limited to one or more of the, AGL proposal, COAG Energy Council proposal and the Jemena proposal;

- **Option 3 - establish a retailer default fund:** the establishment of a fund, available to distributors in the event of a retailer default, which is funded by retailers based on a retailer's creditworthiness and market share. The Commission examined this option in relation to both a retailer default fund set at a level to cover the unpaid charges if the largest retailer in the NEM were to default and also where the fund size was set at a smaller amount based on the cash-flow requirements of distributors if the largest retailer across the NEM were to default; and

- **Option 4 - introduce a liquidity support scheme:** a liquidity instrument to be held by the distributor to be used to address cash-flow shortages arising from a retailer default. Under this option, the costs associated with the liquidity support scheme could be paid by the distributor or collected from the retailers based on a set formula set out in the rules.

With the exception of option 2, where only the cost pass-through provisions are strengthened, all of the other options involve mechanisms that have both ex-ante and ex-post elements.

The Commission is of the view that the various existing ex-ante and ex-post risk-mitigation mechanisms, outside of the retailer-distributor credit support requirements, place sufficient risk-mitigation incentives on retailers, and appropriately allocate risk between retailers and distributors. This view is informed by two considerations:

- in the history of the NEM, only three retailers have defaulted. Furthermore, these defaults were all by small retailers, where the associated unpaid network charges and costs would have been fully covered by the Commission's proposed enhancements to the cost pass-through mechanisms (discussed below); and
- distributors are best-placed to deal with any short-term cash-flow issues that may arise as a result of a retailer's default. Distributors currently manage liquidity risks arising from a range of sources, which include retailer default.

Consequently, the Commission considers that there is no need at this time for any further ex-ante mechanism, such as retailer-distributor credit support (except in instances of late or missed payment by a retailer), to exist in relation to the retailer-distributor relationship.

The draft rules have two key elements:

- a modification of the existing ex-post mechanism, relating to an enhancement of the retailer insolvency cost pass-through mechanism, to manage the revenue risks faced by distributors from retailer default; and
- removal of the credit support requirements (with the exception of the late or missed payment provisions and the continuing operation of existing credit support instruments).

The draft rules will:

- ensure distributors are able to collect unpaid network charges and any costs incurred in the event of a retailer default, thereby mitigating a distributor's revenue risk;
- have no impact on barriers to entry or expansion in the retailer market, or on retail competition; and

- minimise costs to consumers over the long term, as consumers would only face increased costs in the event of a retailer default, and then only for a set period of time as required to recover the unpaid network charges and costs associated with the retailer default.

Furthermore, by mitigating both liquidity and revenue risk, through the various existing risk-mitigation mechanisms, systemic risk faced by distributors is also mitigated.

The requirement in the draft rules for a retailer to provide credit support where it has a history of late payment in an amount equal to the last statement of charges which triggers the provision, provides an additional layer of protection for distributors, and its customers, where a retailer has demonstrated that it is not fulfilling its commercial obligations. These provisions provide an incentive on retailers to continue to pay their bills on time. Further, it may provide an early warning sign to distributors that a retailer may be facing financial difficulty, allowing the distributor to prepare its affairs in the event a default were to occur. This may include arranging for more frequent billing and/or ensuring it has the required liquidity to deal with any non-payment of network charges, to enable it to continue operating even if that retailer were to default. Further, where a retailer has provided credit support under the late payment provisions, the distributor is provided with some revenue and liquidity protection in the event that the retailer defaults in the future.

The revised arrangements, which will not apply in Victoria given they have not adopted the NECF, would likely lead to the efficient management of the risks faced by distributors from retailer default. This would be done through a combination of: regulatory mechanisms; the existing ex-ante mechanisms in place; the risk management practices of retailers; and operational and risk management decisions of distributors. The Commission is of the view that this would, or is likely to, contribute to the NEO or NGO by minimising cost impacts of managing the risks which is in the long-term interests of consumers.

3.6 Strategic priority

The Commission's draft rule determination relates to the first and third of the AEMC's strategic priorities: enabling consumers to make informed decisions in competitive retail markets (the consumer priority) and market and network arrangements that encourage efficient investment and flexibility (the market and network priority).

In particular, the draft rule determination focuses on the protection aspect of the consumer priority. The draft rule determination is aimed at ensuring that the NER and NGR contain specific provisions that serve to prevent detrimental outcomes that could undermine confidence in retail markets. The Commission's draft rule contributes to the consumer priority by minimising the costs associated with mitigating the risk of retailer default.

The Commission examined impacts on barriers to entry and competition resulting from a rule to manage the risk of retailer default. In line with the Commission's markets and network priority, the draft rules do not impose a barrier to market entry or expansion. This will ensure that the market can continue to evolve and new business models and entrants are able to enter the market and provide consumers choice regarding how they will participant in the market. This is done while still ensuring that distributors' revenue risk is mitigated.

4 Assessment of the options considered

As part of the Commission's assessment of the rule change requests, several options to address the risks of retailer default were developed and considered.

4.1 Modelling of the options

The Commission published an options paper on 22 October 2015 in which the four options were modelled.[36] The modelling framework examined the revenue and cash flow implications of the above options on retailers and/or distributors, as well as the post-retailer default costs that would flow through to customers.

The key model inputs and assumptions included:

- **distributor revenue:** the relevant component of revenue for each distributor (ie a distributor's total annual retailer charges (TARC)) is a key component in all of the options and was used to estimate items such as a retailer's network charges liability (NCL) and a distributor's current assets;

- **shared customers:** shared customer data was used to estimate each retailer's market share within a network which, in turn, allows the allocation of each distributor's TARC to the relevant retailers that operate in the distributor's network. From this, the NCL for each retailer is calculated. A shared customer is a customer of both the retailer and distributor;

- **creditworthiness:** credit ratings and D&B dynamic risk scores for retailers were used to determine the amount of credit support under options 1 and 2 and the allocation of costs under options 3 and 4. The credit ratings of distributors were used to determine the costs associated with option 4, the liquidity support scheme.

The modelling undertaken by Promontory for the AEMC and published with the Commission's options paper modelled the on-going and post-default costs for the various options being considered by the Commission.

4.2 Description of options

A summary of the options considered, as well as the on-going and post-default costs are set out in the table below. Further information regarding the options and the costs is discussed in the following sections.

36 The options paper can be found on the AEMC website at: http://www.aemc.gov.au/getattachment/4bc70d48-cc26-45d4-9914-cce6cc772df8/Options-Paper.aspx

Table 4.1 Options considered

Option	Description	Sub-option	On-going costs[37]	Post-default costs[38]
1	**retain the existing arrangements**: the existing arrangements for both the credit support requirements and cost pass-through provisions would remain as current set out in the NER and NGR. This is the status quo option by which all other options are assessed in determining if any option proposed better contributes to the NEO and NGO;	No sub-options were considered	minimal[39]	Electricity: 0% - 2.5%[40] Gas: 0% to 1.5%
2	**strengthen the existing arrangements**: variations to the current credit support requirements and cost pass-through provisions	**2.1 - COAG Energy Council and Jemena proposals only:** enhanced cost pass-through whereby the materiality threshold is removed and confirmation that unpaid network charges is included in retailer insolvency costs	0	Electricity: 0.65% - 12% Gas: 0.1% - 5%
		2.2 - COAG Energy Council, Jemena and AGL proposals: enhanced cost pass-through as in option 2.1 and AGL's proposal whereby all retailers rated below BBB- provide credit support	Electricity: 0.15% - 0.65% Gas: 0.1% - 0.2%	Electricity: 0.65% - 12% Gas: 0.1% - 5%
		2.3 - COAG Energy Council and Jemena proposals with enhanced credit support provisions: enhanced cost pass-through as in option 2.1 and credit support requirements whereby all retailers rated below A- provide credit support	Electricity: 0.35% - 0.75% Gas: 0.15% - 0.45%	Electricity: 0.2% - 5% Gas: 0.1% - 4%

37 Average on-going costs or ex-ante costs as a percentage of the customer's total annual bill. The on-going costs are generally dependent on the creditworthiness of the retailer.

38 Average post-default costs or ex-post costs as a percentage of the customer's total annual bill. The post-default costs are generally dependent on the market share of the defaulting retailer.

39 Modelling showed very little credit support is required under the existing requirements.

40 It is assumed for the modelling that distributors were not able to collect unpaid network charges as part of the post-default costs under this option.

Option	Description	Sub-option	On-going costs[37]	Post-default costs[38]
3	**establish a retailer default fund**: the establishment of a fund, available to distributors in the event of a retailer default, which is funded by retailers based on a retailer's creditworthiness and market share. In addition, the enhanced retailer insolvency cost pass-through provisions as described in option 2.1 would be implemented.	**3.1 - target fund size set to cover revenue risk of largest retailer default:** under this sub-option the fund size was set at $940 million across the electricity and gas markets	Electricity: 0.15% - 1.2% Gas: 0.1% - 0.8%	0
		3.2 - target fund size set to cover liquidity risk of largest retailer default: under this sub-option the fund size was set at $130 million across the electricity and gas markets	Electricity: 0.08% Gas: 0.02%	Electricity: 4.5%[41] Gas: 4.3%
4	**introduce a liquidity support scheme:** a liquidity instrument to be held by the distributor to be used to address cash-flow shortages arising from a retailer default. In addition, the enhanced retailer insolvency cost pass-through provisions as described in option 2.1 would be implemented.	**4.1 - market-share based allocation:** the on-going costs of the liquidity facility is allocated to retailers in proportion to their annual network charges	Electricity: 0.02% - 0.9% Gas: 0.01% - 0.27%	Electricity: 0.01% - 11% Gas: 0.00% - 9% The post default costs are the same under both sub-options.
		4.2 - risk-based allocation: the on-going costs of the liquidity facility are allocated to retailers by a set formula based on the retailer's annual network charges and its creditworthiness.	Electricity: 0.01% - 0.26% Gas: 0.00% - 0.27%	

41 It should be noted that under sub-option 3.2, the target fund size would be insufficient to cover the entirety of the unpaid network charges for the three largest retailers but would be sufficient to cover 100 per cent of the retailer insolvency costs, including unpaid network charges, associated with a small market-share retailer default.

The Commission's draft rules implements a variation of option 2.1 - strengthening the existing arrangements by implementing the COAG Energy Council and Jemena proposals. However, the Commission's draft rules also remove the existing credit support arrangements as between distributors and retailer with the exception of the late payment provisions. The late payment provisions require a retailer to provide credit support equal to the amount of the last statement of charges issued to the retailer which triggers the requirement to provide credit support. This option and the Commission's reasoning are discussed in Chapter 5.

4.2.1 Existing arrangements

Under this option, the following existing mechanisms would be available to distributors to manage the risk of retailer default:

- credit support requirements;
- insurance (either private or self-insurance);
- overs and unders process (for distributors on a revenue cap form of regulation);
- corporate insolvency process; and
- retailer insolvency cost pass-through provisions.

The current arrangements were discussed at sections 1.2 and 1.3.

Three stakeholder submissions expressed their support for the current arrangements: Alinta Energy, Red Energy and Lumo Energy, and the joint submission from Blue NRG, Pooled Energy, People Energy, M2 Energy, QEnergy and Click Energy. These stakeholders were of the view that the current arrangements were adequate[42] or that a credible case for removing the current provisions has not been established.[43]

In relation to the existing arrangements, the modelling showed that very little credit support is required by either electricity or gas distributors in the NEM.[44] As a result, the modelling focussed on the post-default costs and assumed that distributors were not able to collect unpaid network charges as part of the existing retailer insolvency cost pass-through mechanism. Depending on the size of the retailer default, the modelling indicated that on average the annual cost increase as a percentage of the customer's bill to allow for the recovery of the costs associated with the retailer default would be somewhere between 0 per cent (for small-market share default) to 1.50 per cent for gas customers and 2.50 per cent for electricity customers (for a large-market share retailer default).[45]

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42 Joint submission to the Commission's options paper, p.2

43 Submission of Red Energy and Lumo Energy to the Commission's option paper, p.2

44 See : AEMC 2015, Retailer-distributor Credit Support Requirements, options paper, 22 October 2015, Sydney, p. 24

45 *Ibid*, p.26

4.2.2 Strengthen the existing arrangements

Three variations were considered to strengthen the existing arrangements. Each one of these is discussed in turn.

Enhanced cost pass-through provisions

Under this option, the COAG Energy Council and Jemena proposals would be implemented and the credit support provisions would be removed in their entirety. The retailer insolvency cost pass-through provision enhancements would include:

- removal of the one per cent materiality threshold, where one applies;
- clarifying the provisions to ensure that unpaid network charges are included in the costs distributors are able to recover as part of the cost pass-through process; and
- confirming that the retailer insolvency cost pass-through provisions in the NGR takes precedence over any inconsistent provisions in a gas distributor's access arrangement.

Alinta Energy, Red Energy and Lumo Energy and the joint submission from Blue NRG, Pooled Energy, People Energy, M2 Energy, QEnergy and Click Energy provided that, if the Commission determined that the status quo should not be maintained, this option should be implemented. In addition, Sumo Power, Origin Energy and ERM Power were supportive of this option to strengthen the existing arrangements. The NSW DNSPs indicated that the cost pass-through provisions are not a replacement for credit support.[46]

Under this option there are no on-going costs. The modelling indicates that the post default costs as a percentage of the customer's annual bill is approximately between 0.65 per cent to 12 per cent for electricity customers, depending on the market share of the defaulting retailer. The cost increase as a percentage of the customer's annual bill is approximately between 0.2 per cent and 9 per cent for gas customers.

The Commission's draft rule implements a variation of this option. The Commission's reasoning is set out in Chapter 5.

Enhanced cost pass-through provisions and AGL's credit support proposal

Under this option, the COAG Energy Council, Jemena and AGL proposals would be implemented.

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46 NSW DNSP submission to the Commission's option paper, p.3

This would result in the following:

- enhanced retailer insolvency cost pass-through provisions whereby:
  - the one per cent materiality threshold, where it applies, is removed;
  - the provisions are clarified to ensure that unpaid network charges are included in the costs distributors are able to recover as part of the cost pass-through process;
  - confirmation that the retailer insolvency cost pass-through provisions in the NGR takes precedence over any inconsistent provisions in a gas distributor's access arrangement.
- credit support would be determined on the following basis:
  - removal of the maximum credit allowance;
  - setting the benchmark credit rating to BBB- (or equivalent) from A- (or equivalent); and
  - retailers rated below BBB- (or equivalent) would provide credit support so that the value at risk to the distributor is the same as if the retailer were rated BBB- (or equivalent).

In its submission to the options paper, EnergyAustralia indicated its support for this option.

The modelling for this option reflects costs per shared customer - electricity under this option to be on average between approximately 0.15 to 0.65 per cent of the customer's annual bill depending on the retailer's credit rating. For shared customer - gas, the on-going costs to shared customers as a percentage of their annual bill is on average approximately 0.1 per cent to 0.2 per cent.[47]

In examining the post-default costs, it is assumed that the AER will allow no more than a 10 per cent increase in any one year. The post-default costs, as a percentage of the customer's annual bill for electricity customers is on average approximately 0.65 per cent to 12 per cent, depending on the market share of the defaulting retailer. For gas customers, the costs as a percentage of the customer's annual bill is on average approximately 0.1 per cent to 5 per cent, again depending on the market share of the defaulting retailer.[48]

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47 See : AEMC 2015, Retailer-distributor Credit Support Requirements, options paper, 22 October 2015, Sydney, p.p. 33-34

48 *Ibid*, pp. 36 -37

Enhanced cost pass-through provisions and credit support provisions

This option includes the following components:

- retailer insolvency cost pass-through provisions whereby:
  - the one per cent materiality threshold, where it applies, is removed;
  - the provisions are clarified to ensure that unpaid network charges are included in the costs distributors are able to recover as part of the cost pass-through process; and
  - confirmation that the retailer insolvency cost pass-through provisions in the NGR takes precedence over any inconsistent provisions in a gas distributor's access arrangement.
- credit support is determined on the following basis:
  - removal of the maximum credit allowance;
  - setting the benchmark credit rating to A- (or equivalent); and
  - retailers rated below A- (or equivalent) pay credit support so that the value at risk to the distributor is the same as if the retailer were rated A- (or equivalent).

Several stakeholders expressed their support for this option including the Energy Networks Association, Ergon Energy, Energex, Australian Gas Networks, SA Power Networks and the NSW DNSPs. However, both Ergon Energy and NSW DNSPs were of the view that in addition to the credit support payable under this option, retailers should also have to provide additional credit support to protect from concentration risk[49] faced by distributors from a retailer that has a significant market share in their distribution area.[50] ERM Power indicated that it was not supportive of this option.

The modelling for this option indicates the following cost per shared customer, as a percentage of the customer's annual bill:

- ongoing costs (also referred to as ex-ante costs) to shared electricity customers: average of approximately 0.35 per cent to 0.75 per cent, based on a retailer's creditworthiness;
- ongoing costs to shared gas customers: average of approximately 0.15 per cent to 0.45 per cent, based on a retailer's creditworthiness;

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49 Concentration risk arises when a creditor is heavily exposed to a particular counter-party

50 Ergon Energy submission to Commission's options paper, p.3; NSW DNSPs submission to the Commission's options paper, pp. 4-6

- post-default costs (also referred to as ex-post costs) to electricity customers: average of approximately 0.2 per cent to 5 per cent, based on the defaulting retailer's market share; and
- post-default costs to gas customers: average of approximately 0.1 per cent to 4 per cent, based on the defaulting retailer's market share.[51]

4.2.3 Retailer default fund

The retailer default fund would replace the existing credit support requirements. The purpose of the retailer default fund is to mitigate the revenue, liquidity and systemic risks that distributors may face from retailer default.

A retailer default fund is in effect a form of industry self-insurance where a pool of funds is accumulated over time which could be drawn upon by distributors in the event of a retailer default. The Commission examined broadly a retailer default fund where the target fund size was set to cover the revenue risk associated with a default by the retailer in the NEM with the largest market share. The fund size was set at approximately $940 million for the gas and electricity markets combined. The retailer default fund would operate in conjunction with the enhanced retailer insolvency cost pass-through provisions. This is the option that was modelled in the AEMC options paper.

A detailed design of the retailer default fund was also examined by the Commission where the target fund size was set to cover the liquidity risk faced by distributors if the retailer with the largest market share in the NEM were to default. Under this design, the fund size was set at $130 million for the electricity and gas markets combined.

In response to the Commission's options paper, several distributors and the Energy Networks Association (ENA) indicated that a retailer default fund may be an appropriate solution but that extensive scoping, development and consultation would be required before it could be determined if a retailer default fund would balance the various principles set out for an efficient rule.[52] Sumo Power and the joint submission from Blue NRG, Pooled Energy, People Energy, M2 Energy, QEnergy and Click Energy indicated that they were not in favour of this option.

The Commission's option paper assumed a target fund size of $941.25 million for the electricity and gas markets combined. The modelling indicated that the on-going costs for shared customers - electricity as a percentage of the customer's annual bill would on average be approximately 0.15 per cent to 1.2 per cent, and 0.1 per cent to 0.8 per cent for shared customers - gas, depending on the creditworthiness of the retailer. Where the fund reached its target size there would be no post-default costs as the

51 See : AEMC 2015, Retailer-distributor Credit Support Requirements, options paper, 22 October 2015, Sydney, pp.33-34, 36-37.

52 See Energex submission to the Commission's options paper, p.2

retailer default fund would have sufficient monies available to pay all distributors any unpaid network charges resulting from the retailer default.[53]

Given the relatively low probability of default associated with the largest retailer in the NEM defaulting, the Commission also examined a retailer default fund design where the target fund size was $130 million. The target fund size was based on the liquidity requirements of distributors using assumed working capital requirements where the largest retailer across the NEM defaulted. The modelling for the reduced retailer default fund showed on-going costs as a percentage of the customer's annual bill would be on average approximately 0.08 per cent for electricity customers and 0.02 per cent for gas customers.

When the fund size is reduced, depending on the size defaulting retailer, there may also be post-default costs that will need to be collected through the retailer insolvency cost pass-through mechanism. Where the defaulting retailer has a significant market share (ie one of the three large retailers), and therefore the retailer default fund is insufficient to cover the entirety of the unpaid network charges, it could be expected that on average, the increase in costs as a percentage of the customers annual bills would be would be approximately 4.5 per cent for electricity customers and for gas customers, it would be 4.3 per cent. Where the defaulting retailer has a small market share, it is expected that the post-default costs would be nil as the fund would have sufficient monies available to cover the full amount of the distributor's unpaid network charges.

4.2.4 Liquidity support scheme

Under this option, each distributor would be required to obtain and maintain access to a committed liquidity facility from the banking sector, which would be used to mitigate the cash flow impacts in the event of a retailer default. In the event of a retailer default, the distributor would call on the liquidity instrument to cover its cash flow shortages. The distributor would use the foregone revenue and other costs recovered through the cost-pass provisions, overs and unders process or the corporate insolvency process to repay the funds borrowed through the liquidity instrument.

The costs associated with the liquidity support scheme could either be paid by the distributor or alternatively could be collected from retailers who operate in that distribution area. If it were to be collected from retailers, retailers would pay based on their market share alone or on a combination of market share and creditworthiness. Under the liquidity support scheme option, the enhanced retailer insolvency cost pass-through provisions would also be implemented.

Simply Energy expressed their support for this option if the distributor, and not retailers, were responsible for the costs associated with obtaining and maintaining the liquidity support instrument.[54] Sumo Power and the joint submission from Blue NRG,

53 See : AEMC 2015, Retailer-distributor Credit Support Requirements, options paper, 22 October 2015, Sydney, pp. 45-46

54 Simply Energy submission to the Commission's options paper, p.3

Pooled Energy, People Energy, M2 Energy, QEnergy and Click Energy both indicated that they were not in favour of this option.

The modelling for this option indicates the following cost per shared customer as a percentage of the customer's annual bill:

- on-going costs to shared electricity customers: average of approximately 0.01 per cent to 0.25 per cent, depending on the retailer's creditworthiness;
- on-going costs to shared gas customers: average of approximately 0.05 per cent to 0.27 per cent, depending on the retailer's creditworthiness;
- post-default costs to electricity customers: average of approximately 0.05 per cent to 11 per cent, depending on the market share of the defaulting retailer; and
- post-default costs to gas customers: average of approximately 0.00 per cent to 9 per cent, depending on the market share of the defaulting retailer.

4.3 Assessment of the ex-ante mechanisms

With the exception of the sub-option that removes the credit support requirements and implements the enhanced cost pass-through provisions, all of the other options considered by the Commission contain both ex-ante and ex-post elements. As discussed in Chapter 3, costs associated with an ex-ante mechanism are incurred even when the risk being mitigated does not eventuate. However, this does not imply that ex-ante mechanisms are inefficient, as the cost incurred by the mechanism can reduce the likelihood of the risk eventuating, and therefore deliver a long-term net benefit to consumers. In designing an efficient rule to manage the risks faced by distributors from retailer default it is necessary to examine all of the principles developed by the Commission and balance those principles in the long-term interests of consumers.

Although the ex-ante costs are different under each of the four options, the same question arises in relation to the retailer-distributor relationship: namely, whether, given current market conditions, the regulatory framework, commercial incentives and existing ex-ante mechanisms in place (outside of retailer-distributor credit support requirements), it is in the long-term interests of consumers for the regulatory framework to include an additional ex-ante mechanism. The Commission is of the view that the answer to this question is in the negative; that is, no additional ex-ante mechanism is needed to mitigate the risk faced by distributors from a retailer default.

In terms of the three risks to a distributor from retailer default (revenue risk, liquidity risk and systemic risk), the Commission considers that distributors are best-placed to manage their liquidity risk. All businesses have to manage liquidity, including distributors, as a normal aspect of their business operation. There are various commercial and operational mechanisms that may be used to manage this risk. A distributor, given its position of receiving a regulated revenue amount (including a regulated rate of return) is, and will be, able to quickly access funds, either from external or internal sources, to manage any cash-flow shortages arising from non-payment of network charges as a result of retailer default.

This revenue certainty reduces the overall risk of distributors and will generally result in an increased ability for distributor to seek low-cost financing when needed. This ability to acquire additional liquidity when needed allows distributors to make decisions regarding how it operates its business on a day-to-day basis and the flexibility to organise its financial affairs to meet its organisations goals. For example, the NSW DNSPs all have liquidity ratios below one. However, the Auditor General indicated that in some circumstances liquidity ratios below one may be appropriate:

> "A liquidity ratio of one is generally considered an appropriate level of liquidity to support business operations. However, in circumstances where businesses have access to regulated revenue streams, regulated rates of return and strong cash inflows, businesses can operate at lower levels of liquidity.[55]"

A distributor's liquidity risk is increased in situations where a defaulting retailer has a large market share in the distributor's network area. The Commission recognises that the NEM currently has three retailers with a significant amount of the total market and several other retailers each with a fairly small market share. Therefore, when examining the impact of default it is the default of one of the three largest retailers that creates the concern related to the impact of default.

However, the retailers who currently have significant market shares in the NEM all hold investment grade credit ratings (S&P of BBB- or above). While an investment grade credit rating does not mean that a default can never occur, it does imply that the probability of default is fairly low; in the case of a retailer rated BBB-, it is 0.30%.[56]

It is also expected that, over time, competition in the retailer market will result in new retailers entering the market and new entrants and smaller retailers growing their market share. This should result in a reduction in the overall impact of any single retailer default over time, event in respect of the current large market-share retailers.

Under the existing retailer-distributor credit support requirements, small retailers with a sub-investment grade credit rating do not provide credit support, as a result of the operation of the maximum credit allowance. On the other hand, retailers with an investment grade credit rating and a significant market share, may be required to provide credit support. Therefore, the existing retailer-distributor credit support requirements place large, well-rated retailers at a competitive disadvantage to small, less well-rated retailers.

In addition, the operation of the materiality threshold in the cost pass-through mechanism results in the possibility that distributors will be unable to collect the unpaid network charges associated with small retailer default. This lack of revenue

55 New South Wales Auditor-General's Report, Financial Audit, Volume Thirteen 2015, Electricity, p.27

56 2014 S&P default probabilities

recovery increases the risks posed by small, sub-investment grade retailers, which are typically at a higher risk of default than larger retailer, to distributors.

As a result of the minimal amounts of credit support under the existing framework, the applicable materiality threshold applicable to the retailer insolvency cost pass-through provisions, and the fact that the current design placed increased emphasis on the impact of default over the risk of default, the Commission is of the view that the current framework does not result in an efficient or effective framework for managing the risk of retailer default.

When examining barriers to entry and impact on competition, it is important to differentiate between efficient and inefficient barriers to entry. There may be circumstances where it is appropriate for retailers to face a barrier to entry, such as incurring the costs of mitigating some or all of the risks retailers pose to its counter-parties in the NEM. An inefficient barrier to entry, on the other hand, imposes costs that exceed any improvement in outcomes.

Any ex-ante mechanism which requires a retailer to incur costs mitigating the risk of retailer default may be a barrier to entry. However, where these costs are set at an efficient level, which would occur when the benefits of the reduction in expected losses from default exceed the costs, retail competition may be enhanced in the longer-term, even if these costs detract from competition in the shorter term.

The Commission considers that the existing ex-ante mechanisms, which include both regulatory-and market-based mechanisms, impose efficient barriers to entry into the retail market. The main regulatory ex-ante mechanisms are:

- The need for retailers to obtain a retailer authorisation from the AER, prior to entering the electricity or gas markets. This application process involves an assessment of the financial position of the retailers, its business model and key executives expertise in the market. This process serves a gate-keeping function in order to protect consumers and the overall market from potential market participants that may not be in a financial position or have the operational and industry experience to participate in the market; and

- The NEM settlement prudential requirements - retailers are required to provide credit support to AEMO as part of their participation in the NEM, which imposes obligations on retailers to prudentially manage their risk of default.

These two mechanisms are in addition to market incentives and general commercial practices which encourage retailers to operate their business in a commercially responsible manner.

Therefore, the Commission is of the view that the existing regulatory and commercial incentives on retailers place sufficient incentives on retailers to limit their risk of default. Any additional ex-ante mechanism, such as retailer-distributor credit support, is therefore likely to create an inefficient barrier to entry. There is no need at this time for any further ex-ante mechanism (except in specific instances of late or missed payment by a retailer) to exist in relation to the retailer-distributor relationship.

4.3.1 The retailer default fund

As part of the AEMC's options paper, a retailer default fund with a target fund size of $941 million was put forward as one possible option. The retailer default fund at the size prescribed in the option paper would result in relatively high ex-ante costs but minimal to no ex-post costs.

As few other details on the design and operation of the retailer default fund were provided in the options paper, the Commission decided that it was necessary to develop a detailed design of a retailer default fund in order to fully assess the fund's potential viability. As part of the detailed design, all elements of the design and operation of the retailer default fund were considered, such as:

- the fund size - the fund size was revised down to $130 million , $90 million for the electricity market and $40 million for the gas market;
- fund's manager: AEMO would be responsible for managing the retailer default fund as a rule fund;
- fund contributions - this would be based on a retailers creditworthiness and market share. Where an individual retailers creditworthiness changes, its contribution would change, but all else equal, no other retailers contribution would be impacted;
- frequency of fund contributions - to be paid by retailers to AEMO on an annual basis;
- fund's accumulation period - target accumulation period of 10 years, which would change depending on the investment returns of the fund and/or changes in retailer's creditworthiness over time; and
- the claims process - this would involve distributors submitting claims to the AER including the amount of unpaid charges (including estimates) and then AEMO paying out claims based on the AER decisions based on a proportionality formula (if the fund size was inadequate to cover the full amounts of all claims).

The detailed design of the retailer default fund attempted to balance the up-front costs of retailer contributions into the fund, with minimising the costs to consumers where a default occurs. The AEMC conducted stakeholder workshops with retailers, distributors and other interested parties on the detailed design. A copy of the staff paper provided at the stakeholder workshops is attached as Appendix G. Although the detailed design did not address all the concerns raised by stakeholders, it did allow the Commission to fully understand how a retailer default fund may be implemented and how it would operate, including costs associated with administrating the retailer default fund.

The Commission is of the view that a retailer default fund with design elements similar to those set out in the AEMC's detailed design may have merit where it is determined that some form of ex-ante mechanism is required. However, as previously indicated, at this time given current market conditions, the regulatory framework related to both retailers and distributors, and the market incentives on retailers, any ex-ante costs borne by retailers and therefore its customers are not justified when revenue risk may be mitigated through an ex-post mechanism and liquidity risk (and therefore distributors' systemic risk) can be managed best by distributors.

5 The draft more preferable rules

This chapter sets out the rationale for the draft rules and sets out the Commission's assessment against the principles set out in section 3.3.

5.1 Summary of the draft rules

In considering the rule change requests, the AEMC assessed the effectiveness of various mechanisms at managing the risks faced by distributors from retailer default. The current arrangements, including the current credit support requirements and retailer insolvency cost pass-through provisions are inefficient. This is due to:

- the design of the credit support requirements, including the use of a maximum credit allowance: the design results in minimal amounts of credit support being provided and does little to provide any level of revenue, liquidity or systemic risk protection; and
- the retailer insolvency cost pass-through does not allow the collection of all unpaid network charges in the event of default: the inclusion of a materiality threshold and the lack of certainty related to the specific inclusion of unpaid network charges in the retailer insolvency cost amount results in the possibility that upon a retailer default, a distributor may under-recover on its regulated revenue amount.

Therefore, the Commission is of the view that the current framework inefficiently manages the risk faced by distributors, and its customers, from retailer default. Distributors receive a regulated revenue amount, including a regulated rate of return, and have strong cash inflows. However, where a retailer defaults, a distributor, without some type of regulatory mechanism would be unable to receive its regulated revenue amount in full. As such, a regulatory mechanism is necessary to ensure that distributors are able to obtain the amount of revenue it is authorised, through the regulatory determination process.

For the same underlying reasons distributors should have access to a regulatory mechanism for revenue protection is why a regulatory mechanism is not necessary to mitigate a distributor's liquidity (and associated systemic) risks. The distributor is best placed to determine how these risks should be managed, and where it does so efficiently, it will be able to apply to have these costs included either in its revenue determination (where they are on-going costs) or as part of the retailer insolvency cost pass-through application (where the costs were incurred as a result of the retailer default).

Therefore, the Commission's draft rules focus on implementing a regulatory mechanism to mitigate the revenue risk faced by a distributor from retailer default. This is accomplished through enhanced retailer insolvency cost pass-through provisions.

The enhanced retailer insolvency cost pass-through provisions provide:

- no materiality threshold is applicable to the retailer insolvency costs that may be claimed through the retailer insolvency cost pass-through process;
- unpaid network charges are clearly to be included in distributors' retailer insolvency costs following a retailer insolvency event; and
- in the NGR, the retailer insolvency cost pass-through provisions take precedence over any inconsistent provisions in a distributor's access arrangement.

The Commission acknowledges that counter-parties have mechanisms available to them to ensure that retailers continue to pay their debts to them in a timely manner. These mechanisms may include reporting late payment to trade credit agencies, requiring retailers to pay a deposit or up-front or terminating the counter-party relationship, among others. Distributors, given their regulatory obligations to serve all shared customers regardless of the retailer, do not necessarily have access to all of these mechanisms. As such, the draft rules contain provisions to ensure that retailers continue to pay the distributor's statement of charges on time. In particular, the draft rules provide:

- a distributor may request credit support from a retailer where the retailer, in the previous 12 months, has failed to pay in full:
  - the charges contained in three statements of charges by the due date for payment;
  - the charges contained in two consecutive statements of charges by the due date for payment; and
  - the charges contained in one statement of charges within 25 business days of the due date for payment.
- the amount of credit support the distributor may request is equal to amount of the last statement of charges that triggered the request for credit support; and
- the distributor must return or cancel the credit support held where:
  - the retailer and distributor no longer have any shared customers; or
  - if within the 12 months since the credit support was provided, the retailer has paid in full the charges contained in each statement of charges for that 12 month period by the due date for payment.

The enhanced retailer insolvency cost pass-through provisions, together with the ability to obtain credit support where there is a history of late payment provide distributors with mechanisms to manage the revenue risk associated with retailer default and provide incentives on retailers to ensure timely payment of network charges where limited commercial incentive may exist.

5.2 Assessment against principles

This section sets out the Commission's assessment of the draft rules against the principles set out in section 3.3.

5.2.1 Allocation of risk between retailers and distributors

The risks examined in these rule change requests are risks faced by distributors. However, these risks generally arise as a result of operational decisions made by retailers.

Retailers have increased information, relative to distributors, relating to their financial position and whether they pose a risk to a distributor or other counter-parties. Distributors may not have the same level of information related to a retailer's operations, but do have information relative to its financial position, the impact a particular retailer default may have on its financial positions and other decisions made by the business which may impact is ability, positively or negatively, to manage the risks related to retailer default. Therefore, both retailers and distributors have access to information that the other does not which may impact on their ability to manage the risks faced by distributors from retailer default.

Retailers have incentives to minimise the risk of default - these incentives are market based (the same incentives for all businesses to continue to operate in a financially viable manner) and regulatory based (the retailer authorisation process and NEM settlement prudential requirements). Distributors, although regulated monopolies, still should respond to market-based incentives relative to its operational and risk-management decisions. Further, distributors should be incentivised to ensure that it is taking all steps necessary to minimise the risk and impact of any retailer default.

The draft rules allow distributors to request credit support where there is a history of late payment. This mechanism is not automatic, but rather the distributor may request credit support where particular conditions have been triggered. It would be assumed that the distributor's risk-management practices would involve asking for credit support where possible. A distributor, however, is not limited to this mechanism as its only risk mitigation measure. Distributors have other risk mitigation measures available to it that it uses to mitigate other commercial risks faced by its business, including liquidity risk posed by other commercial transactions. It is important that distributors assess, and where appropriate, implement similar risk mitigation measures relative to the risk of retailer default.

Distributors are also best, given the revenue certainty provided by the enhanced retailer insolvency cost pass-through provisions, able to manage the risks associated with retailer default. Any regulatory mechanism implemented that requires retailers to contribute to the mitigation of the risk of retailer default would involve up-front costs to the retailer and its customers. This retailer may never default.

On the other hand, a distributor may manage the risks faced by it of retailer default through a combination of the cost pass-through mechanism and short-term measures.

These mechanisms and measures would only be implemented when and if a retailer default occurs. Therefore, the distributor, and its customers, will only face increased costs where a retailer has actually defaulted.

It is recognised that where a distributor manages the risk of retailer default, either through the cost pass-through mechanism or through risk-mitigation or short-term measures, all of the distributor's customers will be responsible for those costs. This is in contrast to where a retailer is responsible for the costs associated with any regulatory mechanism to mitigate the risk of retailer default. In this case, only the retailer's customers pay.

Given the probability of defaults associated with the various credit ratings held by retailers in the NEM and the low historic occurrence of defaults in the NEM and the overall costs of an ex-ante mechanism, in the long-term it would appear that all customers would face increased costs whether their retailer defaulted or not. Further, given customers' ability to switch retailers, the overall benefits of a competitive retail market, and the low likelihood that customers assess the creditworthiness of their retailer (with the possible exception of commercial and industrial customers), the imposition of costs on the customers of the distributor is not inappropriate and is likely to lead to lower overall costs for consumers in the long-term.

5.2.2 Risk of retailer default and impact of retailer default

The retailer insolvency cost pass-through provisions will operate to manage revenue risk for a distributor no matter the risk of retailer default or the impact of default. Where the defaulting retailer has a large market share, and therefore has a more significant dollar impact on the distributor, the time required to collect the full amount of the unpaid network charges may be longer than if the dollar amount were smaller. However, given the regulatory framework, distributors are rewarded, through the regulated rate of return, for this time value of money.

Further, given that distributors will generally have easy access to liquidity facilities given their revenue certainty, any impact from retailer default that actually arises can be dealt with by the distributor and the costs recovered through the retailer insolvency cost pass-through provisions.

5.2.3 Trade-off between flexibility and regulatory certainty

Both the COAG Energy Council and Jemena rule change requests related to the retailer insolvency cost pass-through provisions considered that the current rules contained a degree of regulatory uncertainty. This uncertainty arose as a result of the question of whether unpaid network charges were eligible to be included in a distributor's retailer insolvency costs. The draft rules provide regulatory certainty to distributors, the AER and the market that retailer insolvency costs include unpaid network charges.

The implementation of a regime which contains an ex-post mechanism provides distributors with the flexibility to determine how, if at all, it will manage commercial risks it may face including the risk of retailer default. Distributors are best placed to make the operational decisions to manage the risks that may arise (liquidity, systemic or other risks) and already exercise this flexibility in managing its day-to-day operations.

5.2.4 Barriers to entry and impacts on competition

The draft rules impose no barriers to entry or expansion or impacts on competition. Where a retailer has a history of late payment to a distributor and is required to provide credit support, it may face a competitive disadvantage in comparison to other retailers who are not providing credit support. However, the retailer is in control of this potential disadvantage as it flows directly from its business decisions. Therefore, it cannot be said that this is an inefficient competitive disadvantage or create any barriers to entry.

5.2.5 Impact from the revenue and pricing principles

Generally, as part of the regulatory determination process the AER determines the efficient regulated rate of return that the distributor is able to collect as part of its regulated revenue amount. This regulated rate of return, in a broad sense, takes into account the risks that a distributor faces in operating its business. The method used by the AER to determine the regulated rate of return and the actual rate of return awarded to distributors in their last revenue determinations or in future revenue determinations or access arrangements are outside the scope of the Commission's assessment in these rule change requests.

However, the Commission is of the view that there would be minimal to no impact on customers from changes in network revenue as a result of the draft rule taking account of the revenue and pricing principles. The draft rules ensure that a distributor has a regulatory mechanism available to collect unpaid network charges and any efficient costs incurred by the distributor as a result of the retailer default, regardless of the size of the claim. Therefore, the risks it faces in operating its business, versus the current arrangements, do not appear to have increased. Unlike the current arrangements, the draft rules ensure there is no gap in relation to a distributor's ability to recover unpaid network charges and costs associated with retailer defaults of small market-share retailers.

5.2.6 Conclusion

The Commission considers, at this time, only an ex-post mechanism is required; namely, the enhanced retailer insolvency cost pass-through provisions.

This, together with the late payment provisions, will:

- ensure distributors are able to collect unpaid network charges and any costs incurred in the event of a retailer default, thereby mitigating a distributor's revenue risk;
- have no impact on barriers to entry or expansion in the retailer market, or on retail competition;
- minimise costs to consumers over the long term, as consumers would only face increased costs in the event of a retailer default, and then only for a set period of time required to recover the unpaid network charges and costs associated with the retailer default; and
- provide an incentive on retailers to continue to pay distributor's statement of charges on time.

The revised arrangements would likely lead to the efficient and effective management of the risks faced by distributors from retailer default. This would be done through a combination of regulatory mechanisms, the risk management practices of retailers and the operational and risk management decisions of distributors. The Commission is of the view that this would, or is likely to, contribute to the NEO or NGO (whichever is applicable) by minimising consumer cost impacts of managing the risks which is in the long-term interests of consumers.

6 Transitional arrangements

Under the draft rules, the credit support provisions will be removed with the exception of the late payment provisions and enhanced retailer insolvency cost pass-through provisions. From the commencement of the final rule, no new credit support will be able to be requested by distributors or provided by the retailer (apart from the operation of the late payment provisions).

Stakeholders are invited to comment on the following transitional arrangements, which assume a final rule is made in February 2017:

- the new provisions in the NER and NGR would commence on 2 February 2017; and
- given the current NER and NGR already contain similar late payment provisions as in the draft rule, the 12-month period as referenced in the draft rule will commence 12 months immediately preceding the effective date of the final rule.

The transitional arrangements also provide the following:

> "The credit support rules in old Chapter 6B [of the NER or Part 21, Division 4 of the NGR] continue to apply to any credit support held by a Distribution Network Service Provider immediately before the effective date [of any final rule]."

This would operate so that any distributor who currently holds credit support under the existing rules would be entitled to maintain that credit support instrument up until either:

- the distributor and retailer no longer have any shared customers;
- the retailer's required credit support amount (under the calculation in the existing rules) falls to zero; or
- the credit support instrument held by the distributor expires or terminates on its terms.

The Commission is of the view that the savings provision in section 33(1) of Schedule 2 to the NEL and section 43 Part 9 of Schedule 2 of the NGL may operate to preserve the existing rights to the credit support held even where a new rule is made specifically providing that those rights are void or unenforceable. This possible 'accrued right' arises as once a retailer provides credit support, in a form acceptable to the distributor, the distributor has certain contractual rights under that instrument in addition to the statutory rights under the rules. The contractual rights provide a distributor with a right to receive payment on demand from the financial institution on which the instrument is drawn.

This contractual right of the distributor is not unlimited but rather can only be exercised in line with the contractual terms in the instrument and in accordance with provisions of the NER or NGR, whichever is applicable. The distributor's right to demand payment is a function of the instrument itself rather than the potential to ask for credit support under the rules. The Commission understands that these instruments are for an indefinite term, and therefore this right of demand would also be indefinite. This of course is limited to situations where the retailer, under the current provisions of the rules, is required to provide credit support.

Given the operation of these contractual rights of distributors under existing credit support instruments currently held, and to limit regulatory uncertainty relating to the interaction between these existing rights and the draft rules, the transitional provisions 'grandfather' the current rules in relation to these arrangements. The 'grandfathering' of the current credit support provisions will only apply to those distributors and retailers where the distributor holds an existing credit support instrument from that retailer and will be frozen in time as at the commencement date of any final rule. The Commission welcomes stakeholder comments on this aspect of the transitional provisions.

Abbreviations

AEMC or Commission	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
COAG Energy Council	Council of Australian Governments' Energy Council
D&B	Dun & Bradstreet
MCE	Ministerial Council on Energy
NCL	Network charges liability
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Electricity Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
S&P	Standard & Poor's
TARC	Total annual retailer charges

A Summary of issues raised in submissions to the consultation paper on the COAG Energy Council consultation paper

Stakeholder	Issue	AEMC Response
General Comments		
Energy & Water Ombudsman (EWO) Queensland	EWO does not favour reallocating risk from distributors to their customers. This reallocation may result in a significant impact on customers, especially those who are vulnerable. Cost pass-through should be a last resort, exercised only where recovery through the regulatory determination process and the credit support arrangements have failed. If a pass-through must be used, the distributor should only recover revenue from the insolvency retailer's customer base, as this is more equitable than charging all of the distributor's customers.	The cost pass-through mechanism works to ensure that a distributor is able to collect its unpaid network charges. Unlike other mechanisms such as credit support, the cost pass-through mechanism works on an ex-post basis thereby ensuring that customer costs only increase in the event of an actual default. Although a defaulted retailer may not have paid its network charges to a distributor, this does not necessarily mean that the retailer's customers did not pay the retailer. In this case, imposing the unpaid network charges solely on the defaulted retailer's customers would be inequitable. Further, there would be significant complexity involved in charging defaulting retailers customers via the cost pass-through mechanism, and is further complicated by the fact that those customers will become customers of other retailers.
Victorian Distributors, Energex, ENA, esaa, SA Power Networks (SAPN)	These entities support the proposed retailer insolvency cost-pass through rule change. The Victorian distributors request confirmation that transmission use of system payments are included in the eligible cost pass-through amount. Energex suggests that credit support arrangements in the NECF should also be reviewed as it provides reduced protection for distributors.	The draft more preferable rule provides that unpaid network charges (which would include transmission and distribution use of system charges) are eligible to be included in the cost pass-through amount. The credit support requirements in the NER and NGR were examined as part of the consolidated rule change requests.
Simply Energy	Simply Energy believes that if the retailer insolvency cost pass-through rule is implemented, the distributor's equity beta should be reduced to reflect the allocation of revenue risk from distributors to customers; otherwise, customers will	The issue of the appropriate equity beta is determined by the AER and is not within the scope of this rule change request. The Commission is of the view that distributor should pursue their rights under the corporate insolvency process and that the cost pass-through

Stakeholder	Issue	AEMC Response
	end up paying twice for the risks associated with retailer default. Distributors should have incentives to seek return of lost revenue from an insolvent retailer's administrator otherwise lost revenue will end up going to other creditors rather than being returned to customers, who have paid as a result of the cost pass-through mechanism.	amount approved should take into account any monies the distributor is able to collect through the various other mechanisms available to it.
Allocation of Risk		
Energex, ENA, SAPN	These stakeholders believe that distributors have limited ability to manage the risk of retailer default, and that it is appropriate to allocate risk to customers.	These rule change requests have examined the allocation of risk of retailer default between the distributor, retailer and the customer and is discussed in chapter 4 and 5 this draft determination.
Simply Energy	It may be appropriate to reallocate risk to customers if it can be demonstrated that this is in their long term interest.	These rule change requests have examined the allocation of risk of retailer default between the distributor, retailer and the customers and is discussed in chapters 4 and 5 of this draft determination.
Recovery of revenue		
Energex, ENA, SAPN, Victorian Distributors	The cost pass-through mechanism is appropriate to unpaid network charges as a result of a retailer default. ENA is of the view that the traditional retail business model faces increasing financial risk due to new retail offerings, altered business structures and a significant number of new entrants in the market.	The draft more preferable rule includes the ability of a distributor to collect unpaid network charges as part of its retailer insolvency costs. The Commission approached the consolidated rule change requests by examining the principles for an efficient rule to manage retailer default recognising that the market has changed since the NECF was first introduced and that the market will continue to change and evolve as new entrants, business models and technologies enter the market.
Simply Energy	It is unclear how the cost pass-through mechanism fits with revenue cap arrangements.	Where a distributor is on a revenue cap, the distributor is able to collect its unpaid network charges through the overs-and-unders process. However, given that it cannot collect insolvency costs through the overs-and-unders process, it is likely that a distributor, even one on a revenue cap, will use the cost pass-through mechanism.

Stakeholder	Issue	AEMC Response
Materiality Threshold		
Energex, ENA, SAPN	It is appropriate to remove the materiality threshold.	Under the Commission's draft more preferable rule, no materiality threshold is applicable to retailer insolvency cost pass-through events.
Simply Energy	It is not appropriate to remove the materiality threshold as it reflects the administrative costs of a pass-through event.	As discussed in chapter 5, the Commission is of the view that no materiality threshold should be applicable to the retailer insolvency cost pass-through mechanism.
Recovery through regulatory determinations		
Energex, Simply Energy, SAPN	These stakeholders do not consider recovery through the regulatory determinations process to be good policy. Energex believes it would be difficult to determine an efficient allowance. Simply Energy believes it is difficult to quantify the risk, and that this would result in customers paying more than is required. SAPN states that from its experience examining insurance options as a substitute for bank guarantees, that customers would pay a higher overall price for electricity under this system.	The Commission is of the view that the regulatory determination process is not the appropriate mechanism to manage the liquidity risk faced by distributors from retailer default. Rather, the Commission considers that distributors have the ability to manage the cash-flow impacts from retailer default. To mitigate revenue risk, distributors can use the retailer insolvency cost pass-through or overs-and-unders mechanisms to recover unpaid network charges and any costs incurred resulting from retailer default. The costs and unpaid network charges amounts will be known and therefore it is not necessary to determine an efficient allowance.
Energy & Water Ombudsman Queensland	EWO considers recovery of third-party insurance costs through the regulatory determination process, to be more in line with the National Electricity Objective than the cost pass-through mechanism.	The Commission is of the view that the ability of a distributor to obtain third-party insurance to manage the risk of retailer default is difficult, not only due to the expense of such insurance where it can be obtained but also because it is often difficult to obtain. Further, given the test applied for allowances relating to these types of insurance, the AER may not always approve such an expense in the approved revenue amount for a distributor.
Recovery through the corporate insolvency process		
Energex	The corporate insolvency process does not safeguard distributors against financial risk. There is a high level of uncertainty in using this process.	The Commission recognises the uncertainty in the corporate insolvency process, and the draft more preferable rules provide mechanisms that will work with the corporate insolvency process to allow distributors to collect unpaid network charges while ensuring that distributors continue to

Stakeholder	Issue	AEMC Response
		pursue their claim through the corporate insolvency process. This will limit the total amount passed-through to customers.
ENA, SAPN, esaa, Simply Energy	The AER can address the issue of double recovery through the corporate insolvency process and the cost pass-through provisions.	The draft more preferable rule provides that the distributor is to deduct from the amount of the cost pass-through amount, any amount that is expected to be recovered through the corporate insolvency process.
Other		
ENA, SAPN	The definition of retailer insolvency should be amended to make it clear that the pass-through mechanism can operate before an insolvency administrator is appointed or event if an administrator is not appointed at all.	The trigger for a retailer insolvency balances ensuring an insolvency event is called as soon as practicable limiting the liabilities incurred by the defaulting retailer and ensuring the retailer has an opportunity to restructure or sell its business to obtain value for its shareholders and creditors.
Simply Energy	Any mechanism that enables distributors to recover lost revenues from customers reduces the incentive to pursue other ways of recovering the lost revenues. The AER must have discretion when dealing with this type of revenue 'true up'.	The draft more preferable rule still requires the distributor to provide an estimate of the amount that it forecasts it will be able to collect from the corporate insolvency process and retains the AER's discretion in evaluating the approving the retailer insolvency cost amount.

B Summary of issues raised in submissions on consultation paper

Stakeholder	Issue	AEMC Response
General Comments		
United Energy (UE) and Multinet Gas (MG) pp.1 and 3	UE and MG are Victorian businesses which have responded in view of the changes proposed to the NER and NGR and the relevance of the NECF starting point being the Victorian electricity arrangements. They are not supportive of AGL's proposed rules and do not agree that AGL's proposed rules reflects the actual risks faced by distributors from retailer default.	The Commission's draft more preferable rules will not apply in Victoria given that Victoria has not adopted NECF.
Energy Networks Association (ENA) p.4 NSW DNSPs p.2	ENA does not agree with the estimated values provided by AGL in its rule change requests. ENA and the NSW DNSPs indicates that they do not agree with AGL's argument that this rule change will free up capital for investment has relevance in assessing the rule against the NEO. ENA submits that it is difficult to identify any positive societal benefits associated with freeing up capital for a retailer to invest by transferring risk to distribution businesses.	The Commission determined it would examine the rule change requests by examining the principles for an effective rule to manage the risk of retailer default. The solution implemented in the Commission's draft more preferable rules were assessed against these principles to determine if the draft rules would contribute to the achievement of the NEO and NGO. The Commission's principles are discussed in Chapter 3.
NSW DNSPs, p.8	The rule change proposal may result in an increase in distributors' systemic risk that could require a higher return on capital in future regulatory determinations, thereby increasing the costs of supplying electricity and leading to higher electricity prices for consumers.	As part of its assessment of the rule change requests, the Commission has considered revenue risk, liquidity risk and systemic risk where it may arise. The issue of an efficient return on capital is an issue decided by the AER and is not within the scope of this rule change except to the extent that any rule made by the Commission takes into account the impact on customers from changes in network revenue as a result of the revenue and pricing principles.

Stakeholder	Issue	AEMC Response
Principles for an efficient rule		
UE and MG, p.4	UE and MG submit that the principles need to ensure that large retailers in the market have an incentive to spread retail competition and not seek to remain stapled to one network. They indicate that the principles need to include a proportionate approach that recognises that even large seemingly staple businesses could make poor decisions or have poor risk management and fail.	The Commission's principles examine an efficient rule to manage the risk of retailer default both in terms of an individual retailer's creditworthiness but also the impact that retailer could have on distributors and the market as a whole. This recognises that even large retailers may face financial difficulties for a variety of reasons.
EnergyAustralia (EA), p.4	EA is of the view that in order to minimise risk to the distributor, credit support arrangements which require new entrant retailers to demonstrate financial viability would be more appropriate than a regime which effectively absolves them of such responsibility. EA submits that the rule should ensure that credit support is calculated on the basis of each retailer's actual value at risk and consequently ensures that only the real cost of mitigating the risk to distributors of retailer default is ultimately borne by customers.	The Commission is of the view that no additional ex-ante mechanism is required, balancing the various principles developed to assess the rule change request.
SA Power Networks (SAPN), p.4	SAPN indicates that it generally supports the principles set out by the Commission in its consultation paper, with the exception of minor amendments to the first two and the addition of a third; namely, (1) the rule allocates appropriate risk to the parties that have the information, ability (provided that the party is provided the tools and not constrained by the rules) and incentives to best manage each risk in order to minimise the long term costs to consumers; (2) the rule takes into account and allocates the risk to the beneficiaries	The Commission's draft rules attempt to balance the various principles that were considered. As part of this, the Commission has attempted to ensure that the draft rules appropriately allocate risk between retailers, distributors and consumers. The draft rule also recognises that customers are the beneficiary of increased retailer competition.

Stakeholder	Issue	AEMC Response
	of increased retailer competition. Noting that the beneficiaries of increased retail competition is customers; and (3) the rule takes into account the risk of retailer default and the impact of default. In addition, the regime treats retailers in an equitable manner.	
Origin Energy, p.3	There are a number of other important factors that should be considered when developing and assessing an efficient rule for managing the risk of retailer default of a distribution business: • the rule should provide certainty, stability, and predictability of obligations and requirements. The greater the ambiguity in the interpretation of the rules, the greater the uncertainty and potential for dispute in the market; • the rule should support and recognise the true financial exposure of the networks from a retailer default. The incidence of retailer default to date has been low and the potential magnitude of the under recovery of network charges as a result of an event is low (in comparison to the their total network charges); • the rule should not hinder or mandate alternative means by which networks can manage their risks. The rule should support alternative solutions such as early billing or payments. Options should be available for business to enter into their own commercial agreements to manage their respective risks; and • the rule should incentivise distributors to seek out the lowest cost solution for covering its credit risk and obtaining cost recovery in the event of a retailer failure including through the insolvency process and revenue cost pass-through mechanism.	Although the Commission's principles do not specifically set out the factors outlined in Origin's submission, the assessment of the rule change request, and the principles outlined in Chapter 3, inherently contain these elements. The Commissions draft rule provides an ex-post mechanism for managing risks of retailer default and does not limit the range of other mechanisms that distributors may pursue in mitigating any of the risks it faces in running its business.

Stakeholder	Issue	AEMC Response
NSW DNSPs, p.7 EA, p.2	NSW DNSPs do not agree with the principles set out in the consultation paper in relation to the following: • the rule takes into account the trade-off between flexibility and regulatory certainty; and • the rule takes into account the impact on barriers to entry for retail businesses. These are regulatory and competition policy objectives which are best achieved through other instruments, not credit risk objectives. EA does not believe that credit support should be used to stimulate competition.	The Commission views both of these principles as important in developing an efficient rule to manage the risk of retailer default. However, the Commission is of the view that a regime to manage the risk of retailer default should not be used to promote competition but rather that, to the extent possible, the regime should not impose inefficient barriers to entry and competition. Further, it is important that the rules are clear and can be easily followed by both retailers and distributors, while providing flexibility for these market participants to negotiate mutually-beneficial commercial arrangements within the confines of the requirements and restrictions present in the NER and NGR.
QEnergy, p.4	Under the current rules, small retailers are able to manage their growth in each distributor area such that they do not exceed the maximum credit allowance. This means that customers are able to access the benefit of competitive pricing, and the impact on distributors is quarantined in the unlikely event of a retailer default. It also minimises credit support costs for small retailers.	The existing credit support requirements allow retailers with small market shares to operate in several distribution areas without being required to provide credit support. However, the Commission is of the view that a range of ex-ante risk mitigation measures, outside of retailer-distributor credit support, exist and place sufficient incentives on retailers to limit their default risk.
Ergon Energy, p. 5	For many unrated retailers or retailers rated below BBB-, the cost of credit support may be significant. However, new entrants into the market or those seeking to expand should be able to access the capital required to break ground without exposing customers to unsuitable levels of risks.	The Commission is of the view that various ex-ante risk mitigation measures, outside of the retailer-distributor credit support requirements, exist and place sufficient incentives on retailers to limit their default risk.

Stakeholder	Issue	AEMC Response
Retail authorisations		
EA, pp. 1-2	EA identified a source of potential confusion with the current arrangements relating to how obligations apply with respect to different business structures; namely, where a single corporate entity holds multiple retail authorisations it is unclear whether any credit support payable should be calculated for each participant ID separately or in aggregate.	As the Commission's draft rules remove the need for retailers to provide credit support to distributors (except in the case of a history of late payment by the retailer), the issue of multiple retailer authorisations does not need to be addressed.
ENA, p.3 NSW DNSPs, p. 15	The rules should be explicitly that credit allowances must be at the parent entity level and must be apportioned between entities within a retailer group, so that retailers cannot receive multiple credit allowances.	The retailer insolvency cost pass-through provisions will result in a distributor being able to collect its unpaid network charges irrespective of the corporate structure of the defaulting retailer.
Enforcement of credit support provisions		
UE and MG, p. 2	A better protection for distributors and customers would be to reduce the late payment periods before credit support can be requested in order to reduce the impact of financial failure.	The draft rules retain the ability for a distributor to request credit support where a retailer has a history of late payment. The late payment provisions provide either that a retailer's payment has to be late by 25 days or more or alternatively, where a retailer has been late with their payment by a day more than three times in 12 months or by a day or more with two consecutive invoices. This provides an additional layer of protection for distributors, and its customers, where a retailer has demonstrated that it is not fulfilling its commercial obligations. These provisions provide an incentive on retailer to continue to pay its bills on time.
SAPN, p. 3	The current credit support rules contain a design flaw; namely, by the time a distributor can call for credit support, the retailer in question is already exhibiting signs of potential financial instability and the time period may extend up to 140 days. This would create a severe financial stress on distributors which may result in its failure.	The late payment provisions of the draft rule provide an incentive to ensure retailers continue to pay their bills on time. It also provides some indication to distributors that it may be required to take steps to manage the financial instability of the retailer in the short term. These mechanisms are not meant to manage the revenue risk from a retailer default, which will be managed through the retailer insolvency cost pass-through mechanisms.

Stakeholder	Issue	AEMC Response
ENA, p.4 Ergon Energy, p.2	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 distributors.	Although credit support may provide some ex-ante protection for distributors in the event of a retailer default, credit support is an expensive mechanism whose cost is generally borne by the retailer's customers. These costs insure against an event which may never occur. In the event of a retailer default, a distributor will still be able to recover its unpaid network charges through the retailer insolvency cost pass-through mechanism.
Origin Energy, p.2	The current rules have been drafted in a way that is open to multiple interpretations, particularly in terms of how (and how frequently) credit requirements are to be calculated and so the calculations should be clarified to reduce the risk of dispute.	The current credit support requirements will only apply to a distributor and a retailer where credit support is currently outstanding. The retailer insolvency cost pass-through provisions have been drafted to clarify the interpretation and operation to ensure regulatory certainty to distributors.
NSW DNSPs, p. 19	The remedies available to DNSPs to enforce requirements for credit support through conduct provisions are likely to be frustrated due to the time required for court proceedings to resolve such issues. Further, the AEMC should review the effectiveness of current enforcement options and in particular, whether the conduct provisions and the Retailer of Last Resort provisions are properly integrated.	The effectiveness of enforcement options, including any enforcement options related to credit support is outside the scope of these rule change requests.
Other Issues		
UE and MG, p.6 Ergon Energy, p. 5	Frequent changes in the amount of credit support required under the rules can increase the costs to administer the scheme.	Under the draft rules, credit support would only be provided where there is a history of late payments and then would only be held for 12 months after the last time the retailer is late in paying its invoice. Therefore, there would not be frequent changes in the amount.
QEnergy, p.2 Joint retailer submission, p.3	The proposed changes are a shift away from the current regulatory framework which is the framework upon which investment decisions including customer acquisition have been based. Imposing such a change which has a significant risk on existing incumbent small retailers is a	The draft rules balance the risks faced by distributors from retailer default and the implications of any mechanism on barriers to entry and competition. The draft rules, which remove credit support requirements generally, would not increase the regulatory risk posed to retailer and would not unfairly create burdens on new retailers or existing retailers.

Stakeholder	Issue	AEMC Response
	regulatory risk which would both unfairly create burdens for existing retailers and create uncertainty for new retailers.	
QEnergy, p.5	Although distributors face retailer failure risk, which is large, they have very low trade credit risk which retailers assume on their behalf every day and for which retailers receive no allowance. One possible area of improvement would be to provide network cost relief to retailers for the implementation of hardship programs.	The operation of hardship programs is outside the scope of these rule change requests.
NSW DNSPs, p. 20	The current operation of clause 6B.A3.3 Disputed statements of charges has created some practical issues. Some retailers consistently dispute charges and don't adhere to the rules requiring minimum payment when disputing charges and this can delay timely payment and in conjunction with this rule change may place increased pressure on a distributor's cash flow.	The operation of clause 6B.A3.3 is outside of the scope of these rule change requests. The Commission is of the view distributors are best placed to manage liquidity risk and that they often have instruments in place already to manage liquidity risk that arises from other aspects of their business.
Alinta Energy, p.2	An additional aspect of credit support that needs to be considered is the form in which retailers provide credit support.	The Commission's draft rules remove the requirement for credit support, except in the case of late payment. The form of credit support currently prescribed in the rules contains the necessary specificity and certainty to ensure that retailers are aware what needs to be sought, and distributors know what they can expect, when credit support is required.
Other proposals		
Red Energy and Lumo Energy, pp.1-2	An alternative option is for a hybrid model which involves credit support requirements being calculated under the current model for retailers rated BBB- and better and using AGL's proposed model for retailer rated below BBB-.	The Commission is of the view that any regime adopted to manage the risk of retailer default should apply the same method to all retailers. This ensures a principled regime rather than a regime which is being used to pick an outcome.
ENA, p. 3	An alternative approach could be to introduce a simple credit support calculation that is based on	One of the issues with the current credit support requirements is the large credit allowance provided, which is a result of the maximum credit

Stakeholder	Issue	AEMC Response
NSW DNSPs, pp. 3-4	the creditworthiness of the retailer and the level of exposure to the distributor rather than based on the distributor's annual revenue.	allowance being based on the distributor's annual revenue. Many of the credit support options considered in the Commission's options paper removed the concept of the maximum credit allowance for this reason. However, given the Commission's view that existing ex-ante mechanisms, outside of retailer-distributor credit support requirements, place sufficient incentives on retailers to limit their default risk, it is not necessary to design a new credit support regime.
Ergon Energy, p. 8	To further reduce the distributors' exposure to retailer default, retailers should not be able to unreasonably withhold consent to increase the frequency of network payments to distributors if requested, if it assists to reduce the network charges outstanding.	The Commission is of the view that more timely billing of network charges would reduce the amount of outstanding charges and that retailers and distributor may agree to more frequent billing. However, the Commission does not consider it appropriate for distributors to be able to require retailers to accept more frequent billing, especially in cases where retailers are not able to bill its shared customers more frequently.

C Summary of issues raised in submissions on options paper

Stakeholder	Issue	AEMC Comment
NSW DNSPs, pp. 1, 7 ENA, pp, 2, 4 Ergon Energy, p.3	Clause 6B.B of the rules should be amended to explicitly state that the applicable credit support allowance can only be obtained for a parent retailer based on their credit rating, and that credit allowances are apportioned to the related entities/FRMPs within a retailer group.	As the Commission's draft rules remove the need for retailers to provide credit support to distributors (except in the case of a history of late payment by the retailer), the issue of multiple retailer authorisations does not need to be addressed.
Simply Energy, p.11	Providing distributors with an ex ante allowance is not in the interests of consumers. This is because the risk of a large retailer default has not occurred historically and is therefore difficult for insurers to provide, and is also unable to be priced for self-insurance purposes. This means that any ex ante allowance is likely to significantly exceed the expected value of any losses, based on retailer credit ratings and the levels of unpaid charges, given the unknowns that any insurer is faced with.	The Commission recognises that ex-ante mechanisms, such as third-party and self-insurance, need to be supplemented by ex-post mechanisms, and has adopted draft rules that strengthen the existing (ex-post) retailer insolvency cost-pass through mechanism.
Joint retailer submission, p.2 ERM Power, p.2 Sumo Power, p.1	When making a determination as to the costs and benefits of the different options, a much greater weight should be given to the ongoing costs than post-default costs. This is as ongoing costs are certain, whereas post-default costs only arise when a retailer default, the likelihood of which is remote.	The Commission is of the view that various ex-ante risk mitigation mechanisms, outside of retailer-distributor credit support, exist and place sufficient incentives on retailers to limit their default risk. Furthermore, ex-post mechanisms exist which further limit the risk to distributors from retailer default.
SACOSS< p.1	Two additional principles should be included in the Commission's analysis, as they ensure that risk is placed at the feet of the parties who have a duty to manage that risk, and ensure that customers are not unfairly impacted by the management of	The Commission's draft more preferable rules take into account the impact on consumers from the operation of the draft rules both in terms of on-going and post-default costs. The application of the principles to the draft more preferable rule is set out in Chapters 3 and 5.

Stakeholder	Issue	AEMC Comment
	foreseeable risks: • the rule takes into account which parties bear the risk and gives consideration to allocation of risk on that basis; • the rule minimises significant price impacts on customers in both the ongoing and post default scenarios.	
Citipower/Powercor, p.3	Since NECF has not been adopted in Victoria, the prescribed retailer insolvency event provisions under the rules do not apply in Victoria. Accordingly, the AEMC is urged to review the drafting of the legal instrument to assess whether the revised rule could be written such that it applies in Victoria.	At this time, the draft more preferable rules do not apply in Victoria. The Commission examined the issue and determined that application of the provisions should only apply in those jurisdictions that have adopted the NECF.
Sumo Power p.2	If a new credit support arrangement is implemented, it should include as a design feature a retailer credit allowance to minimise any barriers to entry in the retail market, and to reflect the negligible impact that a small retailer default would have on a distributor's revenue and cash flow.	The Commission is of the view that various ex-ante risk mitigation mechanisms, outside of retailer-distributor credit support requirements, exist and place sufficient incentives on retailers to limit their default risk. Therefore, it is expected that there would be no impacts on barriers to entry or expansion in the retail market.
NSW DNSP, pp 4-5 Ergon Energy pp 1, 3 ENA, p. 2	Distributors should have the ability to seek higher amounts of credit support to account for single name concentration risk.	The Commission recognises that some retailers have a large market share in a single distributor. However, these large market share retailers are all investment grade rated, for which the probability of default is relatively low. More importantly, the Commission is of the view that various ex-ante risk mitigation mechanisms, outside of retailer-distributor credit support requirements, exist and place sufficient incentives on retailers of all sizes to limit their default risk. It is expected that competition will continue to operate so as to decrease incumbent retailer's market share over time.

Stakeholder	Issue	AEMC Comment
		Furthermore, ex-post mechanisms exist, such as the overs-and-unders and retailer insolvency cost pass-through mechanisms, which further limit the risk to distributors from retailer default.
Ergon Energy, p.4	New Zealand's approach of providing distributors with choice and not the obligation to require a retailer to provide credit support is an example of the potential advantages of the other credit support design models. Another advantage of such arrangements would be the ability to include flexibility to enable a distributor and retailer to agree on the level of credit support required and where agreement cannot be reached the mechanism outlined in the rules would apply. Some approaches, such as the Alberta approach, obligate the distributor to request credit support from the retailer. However, this approach is not appropriate for vertically integrated distributors and retailers in the same group. Furthermore, in relation to the provision of a retailer's security deposit, the Alberta approach does not allow the amount of the security deposit to vary with the retailer's market share, and therefore the credit support does not fully reflect the distributor's exposure to the retailer.	Credit support mechanisms, like other ex-ante risk mitigation mechanisms can be designed in alternative ways, with each design having both advantages and disadvantages. The Commission is of the view that various ex-ante risk mitigation mechanisms, outside of retailer-distributor credit support requirements, exist and, at this time, place sufficient incentives on retailers to limit their default risk. Consequently, any additional ex-ante mechanism to limit distributors' risk to retailer default would impose costs on retailers, which may be passed through to its customers.
Simply Energy, p.6	With the exception of the AEMO requirements, the other designs considered are similar to the current credit support arrangements modified for the AGL proposal. As such, they would be expected to provide similar results to the current arrangements with the AGL changes.	AEMO's NEM settlement prudential framework, collectively the prudential standard and prudential settings, address the risk of non-payment in the NEM. Therefore, this framework does not directly relate to the retailer-distributor arrangement (except to the extent that the prudential framework incentivises retailers to limit their default risk). As the Commission considers that existing ex-ante risk mitigation mechanisms, outside the retailer-distributor credit support requirements, place sufficient

Stakeholder	Issue	AEMC Comment
	The AEMO NEM settlement prudential requirements are addressing a more significant risk than risks to distributors, because there is no 'unders-and-overs' or pass through mechanism available to retailers' counter-parties (ie generators) in the NEM.	incentives on retailers to limit their default risk, applying the NEM's prudential framework to the retailer-distributor relationship was considered to not contribute to the NEO. It is recognised that any credit support regime will require the balancing of various principles - similar to the exercise undertaken by the Commission in assessing this rule change request. The Commission's discussion about credit support, its benefits and limitations is set out in Chapter 4.
Energex, p.1 Simply Energy , p.11	The ability to insure against retailer default under the current system is varied given that commercial insurance is not available for all authorised retailers and is costly. It is unclear that providing a distributor with a self-insurance allowance for retailer default will effectively protect customers from price shocks in the highly unlikely event of a large retailer failure.	The Commission is of the view that third-party insurance is not an appropriate mechanism for distributors to use to manage the risk of retailer default given the inherent difficulties with its interaction with the regulatory determination process.
NSW DNSP, p.3	Given the recently amended pricing rules and the Tariff Structure Statement process, it is unclear how the retailer insolvency cost pass-through timing enhancement in the Commission's option paper would operate.	Given the complications involved in the timing enhancement given the operation of the regulatory framework around pricing, the Commission is of the view that the timing enhancement should not be implemented. Further, given the draft rules provide both an ex-ante (in the case of late payment) and ex-post risk mitigation mechanism, the timing enhancement is not necessary.

D Legal requirements under the NEL and NGL

This appendix sets out the relevant legal requirements under the NEL and NGL for the AEMC to make this draft rule determination.

D.1 Draft rule determination

In accordance with section 99 of the NEL and section 308 of the NGL the Commission has made this draft rule determination and accompanying draft rules in relation to the rules proposed by AGL, the COAG Energy Council and Jemena Gas Networks.

The Commission's reasons for making this draft rule determination are set out in section 3.5, and chapters 4 and 5.

A copy of the draft more preferable rules are attached to and published with this draft rule determination. Their key features are described in chapter 5.

D.2 Power to make the rules

The Commission is satisfied that the draft rules falls within the subject matter about with the Commission may make rules. The draft rules fall within section 34 of the NEL and section 74 of the NGL as they relate to regulating the activities of person (including Registered participants) participating in the national electricity market or regulated gas market or involved in the operation of the national electricity system[57] and facilitating and supporting the provision of services to retail customers.[58]

D.3 Power to make the more preferable rules

Under section 91A of the NEL and section 296 of the NGL, the Commission may make a rule that is different (including materially different) from a market initiated proposed rule if the Commission is satisfied, having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates), the more preferable will, or is more likely to, better contribute to the achievement of the NEO or NGO, as the case may be.

As discussed in Chapter 3, the Commission has determined to make draft rules, which are more preferable rules.

57 NEL, s. 34(1)(a)(iii) and NGL, s.74(1)(a)(vi)

58 NEL, s.34(1)(aa) and NGL s.74(1)(aa).

D.4 Commission's considerations

In assessing the rule change request the Commission considered:

- the Commission's powers under the NEL and NGL to make the rule;
- the rule change request;
- the fact that there is no relevant Ministerial Council on Energy (MCE) Statement of Policy Principles;[59]
- submissions received on the consultation paper and options paper;
- modelling undertaken by the Commission; and
- the Commission's analysis as to the ways in which the proposed rules will or are likely to, contribute to the NEO or NGO, as the case may be.

The Commission may only make a rule that has effect with respect to an adoptive jurisdiction if satisfied that the proposed rule is compatible with the proper performance of AEMO's declared system functions.[60] The draft rules are compatible with AEMO's declared system functions as the draft rules only impact on the relationship between distributors and retailers and do not affect AEMO's declared system functions.

D.5 Civil penalties

The Commission's draft rules amend Part 6B.B of the NER and Part 21, Division 4 NGR. These provisions are not currently classified as civil penalty provisions under Schedule 1 of the National Electricity (South Australia) Regulations or Schedule 3 of the National Gas (South Australia) Regulations.

The Commission does not consider any provisions of the draft rules should be classified as civil penalty provisions.

D.6 Conduct provisions

The Commission's draft rules amend Part 6B.B of the NER and Part 21, Division 4 of NGR. These provisions are currently classified as conduct provisions under Schedule 1A.A of the National Electricity (South Australia) Regulations and Schedule 4 of the National Gas (South Australia) Regulations.

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59 Under section 33 of the NEL and 225 of the NGL the AEMC must have regard to any relevant MCE statement of policy principles in making a rule. The MCE is referenced in the AEMC's governing legislation and is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011 the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated Council is now called the COAG Energy Council.

60 See section 91(8) of the NEL and 295(4) of the NGL].

The Commission may recommend to the COAG Energy Council that Part 6B.B of the NER and Part 21, Division 4 NGR be retained as conduct provisions or be deleted as a conduct provisions. The Commission considers that Part 6B.B of the NER and Part 21, Division 4 of NGR should continue to be classified as conduct provisions so as to retain a distributors rights to pursue action against a retailer who fails to comply with the requirements of Part 6B.B of the NER or Part 21, Division 4 of the NGR, as the case may be.

E Source of obligations between distributors, retailers and retail customers

In assessing the efficient allocation of costs to manage or mitigate the risks associated with retailer default, it is important to examine the responsibilities and obligations of the various parties to one another in the retail relationship.

E.1 Flow of services

The responsibilities and obligations of the distributor, retailer and retail customer are created through a combination of contractual arrangements and regulatory requirements. The starting place in examining these relationships is the NERL and NERR.

Under the NERR, a distributor (whether electricity or gas) provides connection and supply services to a customer under a customer connection agreement. Supply services include the distributor's network use of system services which is a service for the conveyance of electricity or gas. The customer connection agreement is in the form of a deemed standard connection agreement, an AER approved deemed standard connection agreement, or a negotiated connection agreement.

The model terms and conditions for deemed standard connection agreements are provided for in Schedule 2 of the NERR and apply to both electricity and gas. The model terms and conditions contained within the deemed standard connection agreement create a contractual relationship between the distributor and the retail customer. Under the model terms and conditions, the retail customer agrees that the distribution charges incurred will be billed under the retail contract the customer has with the retailer.

A retailer is only permitted to provide customer retail services to a small customer under either a standard retail contract, or a market contract.[61] Schedule 1 of the NERR provides the model terms and conditions for standard retail contracts. These model terms and conditions, amongst other things, provide that:

- the contract relates to the sale of energy (electricity and/or gas) to the small customer at their premises[62];
- the retailer agrees:
  - to sell to the customer, energy at the customer's premises; and
  - meet its obligations under the contract and applicable energy laws.

61 NERL section 20.

62 NERR, Schedule 1, Preamble.

- the customer agrees that in exchange, it is responsible for:
  - charges for energy supplied to the premises until the contract ends;
  - payment of the amounts billed under the contract; and
  - meeting their obligations under the applicable energy laws.[63]
- the contract does not cover the physical connection of the premises to the network or the supply of energy to the premises;[64] and
- the retailer's standing offer prices includes distribution network charges.[65]

A market retail contract is covered by Part 2, Division 2 of the NERR. The NERR sets out the minimum requirements for a market retail contract with the remainder of the terms and conditions to be negotiated between the retailer and the retail customer. The minimum requirements include a requirement for the retailer to set out all the tariffs and charges payable by a small customer under the contract[66] (which would include network charges) and that retail customers are obliged to pay the amount billed under the contract.

The relationship and obligations between the distributor, retailer and retail customers relating to the flow of services are the same for both the electricity and gas markets. However, the relationship between the transmission network provider, distributor and retailer differs between the electricity and gas markets.

In the electricity market, a distributor, as a registered participant, has an opportunity to form a connection and have access to the national electricity grid.[67] This connection is necessary to allow the distributor to provide connection and supply service to retail customers. The relationship and obligations of the transmission network provider and the distributor are regulatory obligations and are governed by the NEL and NER.

63 NERR, Schedule 1, Clause 5.1.

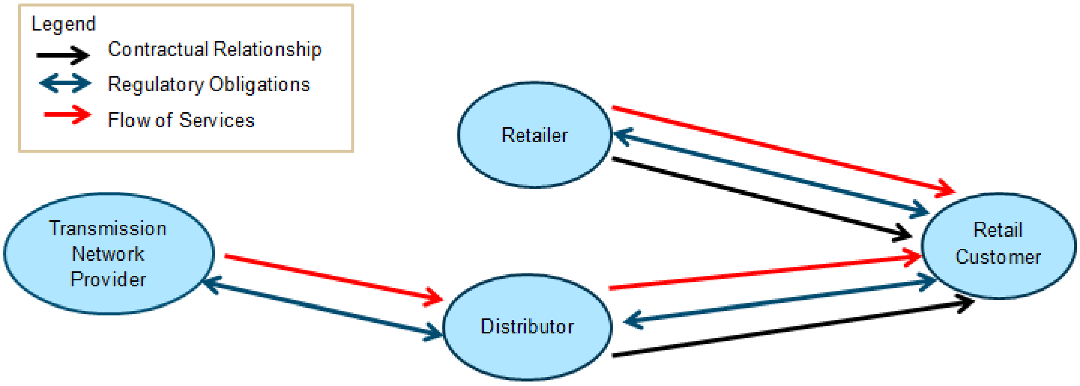
64 NERR, Schedule 1, Clause 5.2.

65 NERR, Schedule 1, clause 8.1(a).

66 NERR, Rule 46(2).

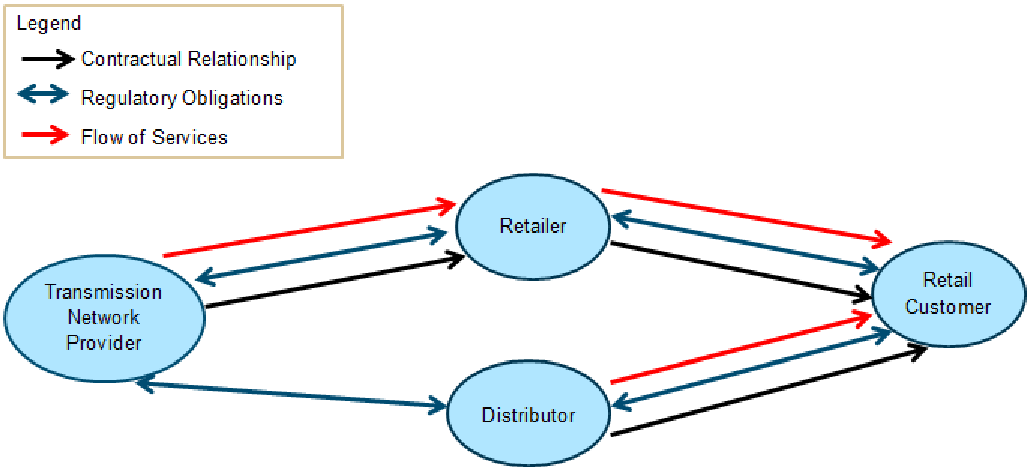
67 NER, Chapter 5, Clause 5.1.3.

Figure E.1 Flow of services: electricity market



In the gas markets, a distributor and transmission network provider are still subject to regulatory obligations in relation to the interconnection of the two systems, however, unlike in electricity, the provision of transmission services is between the transmission network provider and the retailer. The relationship and obligations of the transmission network provider and retailer is prescribed through a combination of regulatory requirements and contractual provisions.

Figure E.2 Flow of services: gas market



E.2 Flow of payments

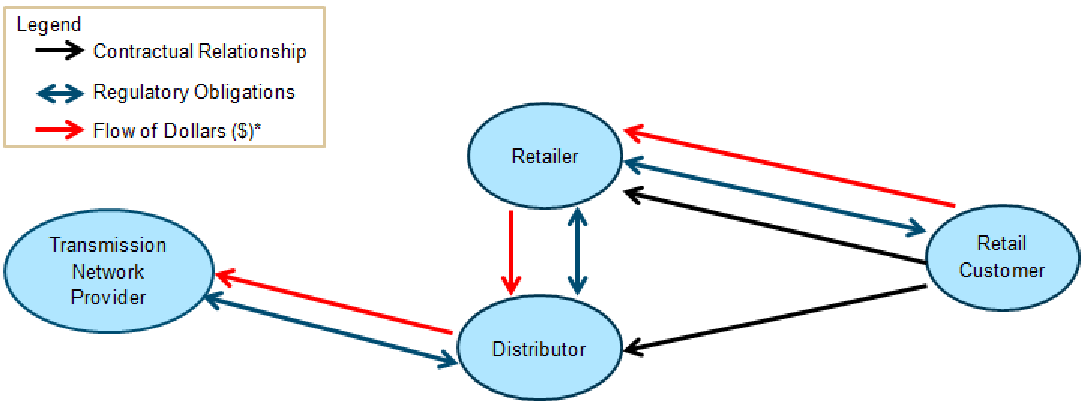
The billing and payment for services relationship between the parties is governed by the concept of a shared customer. A shared customer is defined in the NERL as a "person who is a customer of the retailer and whose premises are connected to the distributor's distribution system."[68]

68 NERL, section 2.

Although a distributor provides connection and supply services directly to the retail customer (in both the electricity and gas markets), the distributor is prohibited from billing small customers directly and is only permitted to bill large shared customers directly with the customers consent.[69] As a result, the distributor's network charges are levied on the retailer in respect of their shared customers. The retailer has a regulatory obligation to pay to the distributor the network charges payable in respect of their shared customers.[70]

For electricity, the distributor is required to pay the transmission network provider for the use of its network based on its use of the system. The distributor then flows through these charges, as part of its distribution network charges, which it levies on the retailer. As the transmission network charges form part of the distribution network charges, the retailer is obliged to pay these charges. The retailer will collect the distribution network charges (including the transmission network charges) that the shared retail customer is responsible for pursuant to both the retail customer's connection contract with the distributor and the retail customer's retail contract.

Figure E.3 Flow of payments: electricity market



* Where:

Transmission Charges Billed equals transmission use of system charges for the transmission network

Distribution Charges Billed equals transmission charges plus distribution use of system charges for the distribution network

Retailer Charges Billed equals distribution charges billed plus cost of electricity and other retailer charges

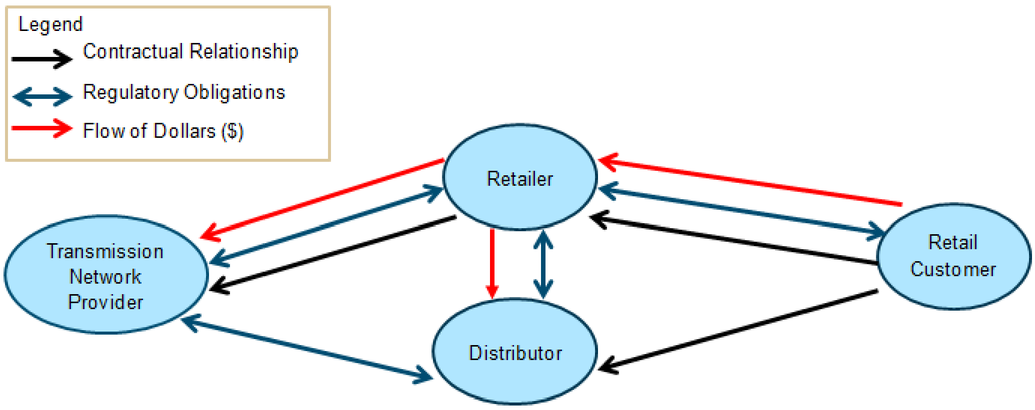
In the gas market, there is a direct relationship between the transmission network provider and the retailer. As a result, the transmission network use of system charges do not flow through the distributor, but rather are billed, pursuant to the contractual relationship between the transmission network service provider and the retailer, directly to the retailer. The retailer then flows through these charges to the retail customer.

69 NERL, section 71(2), NER Section 6B.A2.2; NGR Clause 504.

70 NER 6B.A2.1 and 6B.A2.5; NGR clause 503.

The distribution network charges would include only the charges associated with the use of the distribution system for the connection and supply of energy to the retail customer from the distributor. These charges would be billed to the retailer for the shared customers and flowed through to the retail customer. The retailer has the same regulatory obligation in gas as in electricity to pay the distributor for the distribution network charges. The retail customer, under both the retail contract and the connection contract would be obliged to pay the distribution network charges and the transmission network charges to the retailer.

Figure E.4 Flow of payments: gas market



* Where:

Transmission Charges Billed equals transmission use of system charges for the transmission network

Distribution Charges Billed equals distribution use of system charges for the distribution network

Retailer Charges Billed equals transmission charges billed, distribution charges billed plus cost of gas and other retailer charges

F How to determine if credit support is required

Under the current credit support rules, credit support is calculated as follows:

Credit Support = Network Charges Liability – Retailer's Credit Allowance

Where:

Retailer's Credit Allowance = Credit Allowance % x Maximum Credit Allowance

Maximum Credit Allowance = 25 % of the Distributor's Total Annual Network Charges

Each element that is required for the calculation of the amount of credit support required, is described below.

F.1 Determining the maximum credit allowance

The choice of a credit support design, including the use and level of a maximum credit allowance is a policy decision. Under the current credit support regime it was determined that the maximum credit allowance should be set at 25 per cent of a distributor's total annual network charges.[71]

For example, if a distributor has total annual network charges of $1000, their maximum credit allowance would be $250 (equals 25 per cent of the $1000).

F.2 Determining a retailer's credit allowance

A retailer's credit allowance is set as a percentage of the distributor's maximum credit allowance in accordance with the retailer's credit rating. The higher the retailer's credit rating, the higher the credit allowance of the individual retailer.

For example, for retailers with an S&P credit rating of A- or above, their credit allowance is equal to 100 per cent of the distributor's maximum credit allowance or 25 per cent of the distributor's total annual network charges. As a retailer's credit rating goes down from A-, so does the percentage of the maximum credit allowance they receive. The percentage that applies to that retailer is based on their risk of default compared to the risk of default of an A- rated retailer.

71 A distributor's total annual network charges are reported to and published by the AER.

The percentages are specifically provided for in both the NER and NGR and are as follows:

Table F.1 Credit support allowance percentages under the NER and NGR

Standard and Poor's/ Fitch credit rating	Moody's credit rating	Dun and Bradstreet dynamic risk score	Credit allowance (% of maximum credit allowance)
AAA	Aaa		100%
AA+, AA, AA-	Aa1, Aa2,Aa3	Minimal	100%
A+, A, A-	A1, A2, A3	Very Low	100%
BBB+	Baa1	Low	52.9%
BBB	Baa2	Average	37.5%
BBB-	Baa3		22.0%
BB+	Ba1		17.0%
BB	Ba2	Moderate	11.0%
BB-	Ba3	High	6.7%
B+	B1	Very High	3.3%
B	B2		1.4%
B-	B3	Severe	0.9%
CCC/CC	Caa, Ca, C		0.3%

Based on our example where the maximum credit allowance is $250, a retailer's credit allowance would be calculated by applying the percentage associated with its credit rating to the maximum credit allowance, as follows:

Table F.2 Example of retailer credit allowance calculation

S&P credit rating	Credit allowance %	Retailer credit allowance (maximum credit allowance x credit allowance %)
AAA	100%	$250 x 100% =$250.00
AA+, AA, AA	100%	$250 x 100% =$250.00
A+, A, A	100%	$250 x 100% =$250.00
BBB+	52.9%	$250 x 52.9% =$132.25
BBB	37.5%	$250 x 37.5% =$93.75
BBB-	22.0%	$250 x 22.0% =$55.00
BB+	17.0%	$250 x 17.0% =$42.50
BB	11.0%	$250 x 11.0% =$27.50
BB-	6.7%	$250 x 6.7% =$16.75
B+	3.3%	$250 x 3.3% =$8.25
B	1.4%	$250 x 1.4% =$3.50
B-	0.9%	$250 x 0.9% =$2.25
CCC/CC	0.3%	$250 x 0.3% =$0.75

F.3 Determining a retailer's network charges liability

A retailer's network charges liability is the sum of the retailer's average billed (but unpaid) and unbilled network charges for each customer class.[72] For each customer class, this is based on the average network charges over the number of days outstanding for that class taking into account:

- how often the meters are read (e.g. monthly versus quarterly);
- how often the distributor bills the retailer (i.e. monthly or as otherwise agreed between the retailer and distributor); and
- the length of time taken to prepare the invoice and the time the retailer has to pay the invoice.

The higher the number of days outstanding, the higher the retailer's network charges liability, and all else being equal, the more credit support that may be required.

We can continue our example for two retailers, one with a 30 per cent market share and one with a five per cent market share, both with 90 days' average outstanding network charges:

Table F.3 Example calculation of network charges liability

	30 % market share retailer	**5 % market share retailer**
Annual network charges	$1000 x 30 % = $300.00	$1000 x 5 % = $50.00
Average daily billed and unbilled network charges	$300/365 = $0.822	$50/365 = $0.137
Network charges liability (daily network charges over the outstanding period)	$0.822 x 90 days = **$73.97**	$0.137 x 90 days = **$12.33**

F.4 Determining the amount of credit support required

The extent that the network charges liability exceeds the retailer's credit allowance determines the amount, if any, of credit support that the retailer is required to provide.

Carrying our previous example forward, we can calculate, the amount of credit support required.

72 Average outstanding network charges are calculated in accordance with the formula set out in the NER at 6B.B2.3 and the NGR at Part 21 Section 517.

Table F.4 Example calculation of credit support required

S&P credit rating	Credit allowance %	Retailer credit allowance	Credit support required from 30 % market share retailer	Credit support required from 5% market share retailer
AAA	100%	$250.00	None	None
AA+, AA, AA-	100%	$250.00	None	None
A+, A, A-	100%	$250.00	None	None
BBB+	52.9%	$132.25	None	None
BBB	37.5%	$93.75	None	None
BBB-	22.0%	$55.00	$73.97 - $55.00 = $18.97	None
BB+	17.0%	$42.50	$73.97 - $42.50 = $31.47	None
BB	11.0%	$27.50	$73.97 - $27.50 =$46.47	None
BB-	6.7%	$16.75	$73.97 - $16.75 = $57.22	None
B+	3.3%	$8.25	$73.97 - $8.25 = $65.72	$12.33 - $8.25 = $4.08
B	1.4%	$3.50	$73.97 - $3.50 = $70.47	$12.33 - $3.50 = $8.83
B-	0.9%	$2.25	$73.97 - $2.25 = $71.72	$12.33 - $2.25 = $10.08
CCC/CC	0.3%	$0.75	$73.97 - $0.75 = $73.22	$12.33 - $0.75 = $11.58

F.5 Determining the amount of credit support required under AGL's proposal

So carrying out previous example forward ($1000 total annual network charges, network charges liability of $73.97 for a retailer with a 30 per cent market share and network charges liability of $12.33 for a retailer with a five per cent market share) under AGL's proposed rules we find the following levels of credit support would be required:

Table F.5 Credit support requirements under AGL's proposed rules

S& P Credit Rating	Credit support required as a % of network charges liability	Credit support required with a 30 % market share	Credit support required with a 5 % market share
AAA	0%	None	None
AA+, AA, AA-	0%	None	None
A+, A, A-	0%	None	None
BBB+	0%	None	None
BBB	0%	None	None
BBB-	0%	None	None
BB+	25.58%	$73.97 x 25.58% = $18.92	$12.33 x 25.58% = $3.15
BB	52.94%	$73.97 x 52.94% = $39.16	$12.33 x 52.94% = $6.53
BB-	71.68%	$73.97 x 71.68% = $53.02	$12.33 x 71.68% = $8.84
B+	86.15%	$73.97 x 86.15% = $63.73	$12.33 x 86.15% = $10.62
B	93.23%	$73.97 x 93.23% = $68.96	$12.33 x 93.23% = $11.50
B-	95.96%	$73.97 x 95.96% = $70.98	$12.33 x 95.96% = $11.83
CCC/CC	98.81%	$73.97 x 98.91% = $73.16	$12.33 x 98.91% = $12.20

G Staff paper: detailed design of the retailer default fund

Following is a copy of the staff paper presented and discussed at the stakeholders workshops held on 27 May 2016 and 30 May 2016 in relation to the detailed design elements for a retailer default fund.

Staff paper

Retailer-distributor credit support requirements
Retailer Workshop: 27 May 2016, Melbourne
Distributor Workshop: 30 May 2016: Sydney

1. Introduction

For distributors, the main commercial risk they face is the non-payment of network charges by retailers, related to services provided to their shared customers, resulting from that retailer's default. The risk of non-payment results in the distributor facing the following two risks:

- **Revenue risk:** the risk of being unable to recover revenue owing for the services already provided; and

- **Liquidity risk:** the risk of a cash flow shortage resulting from not being able to collect unpaid charges when they come due and during the period where the unpaid charges are collected through the insolvency process or other mechanism.

As distributors operate in a regulated environment and given their monopoly position, the mechanisms available to them to manage risk are not the same as an unregulated business operating in a competitive market. The differences arise as a result of a distributor's:

- obligation to provide connection services and supply to customers;
- reliance on the retailer to collect the network charges incurred by their shared customers. Distributors are prohibited from billing small customers directly, and can only bill large shared customers directly with the customer's consent;
- inability to refuse to service a customer or to deal with a particular retailer;
- inability to price or factor in risk in transacting with retailers with differing credit risk.

2. Options paper

On 22 October 2015, the Commission released a paper outlining a range of options that have the potential to contribute to the achievement of the National Electricity Objective or National Gas Objective. In order for the Commission to have a more informed view of the efficacy of the options, the Commission needs to understand how such options would work, as well as the cost implications of each option on retailers and end-customers. Detailed design work on one of these options – the retailer default fund – is currently being completed to inform the Commission's analysis.

This AEMC staff paper aims to outline a detailed design of the retailer default fund and facilitate the discussion during the workshop regarding the various design elements.

The content of this paper represents the views of the AEMC staff, and not those of the Commission.

3. Summary of Design Elements

This following are the design elements of a retailer default fund:

<table>
<tr><th>Fund element</th><th>Design</th></tr>
<tr><td colspan="2">Governance of the retailer default fund</td></tr>
<tr><td>Governance of the fund</td><td>The retailer default fund will be constituted as a rule fund under the NER and NGR. As a rule fund, the following will apply:
• AEMO will be the legal owner of the monies in the rule fund;
• AEMO or a director of AEMO is not a trustee of the rule fund;
• AEMO may invest money standing to the credit of a rule fund;
• AEMO must, in exercising the power of investment, exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of others;
• AEMO must ensure that all amounts received by AEMO that are required to be paid into the rule fund are paid into the rule fund, along with the income from any investment of money in the fund; and
• Money held in the rule fund may only be applied in payment of amounts that are required or permitted to be paid from the fund or to the liability or expense of the rule fund.</td></tr>
<tr><td colspan="2">Investment objective and investment mandate</td></tr>
<tr><td>Investment objective</td><td>The assets of the fund must be invested to ensure the fund meets the primary investment objectives of capital preservation and maintenance of highly liquid assets.</td></tr>
<tr><td>Investment mandate</td><td>The fund may only invest in the following instruments:
• Securities issued or guaranteed by the Commonwealth government or any State or Territory government;
• Deposits with authorised depositary institutions; and
• Medium and short-term senior debt securities issued by financial institutions for which there is a liquid market.

Debt securities and counterparty obligations must have a minimum credit rating of A+. In determining whether debt securities and counterparty obligations meet the minimum credit rating, S&P credit ratings must be used, where available.

All instruments must be denominated in Australian dollars. The use of derivatives for any purpose is prohibited.</td></tr>
<tr><td colspan="2">Winding-up of the retailer default fund</td></tr>
<tr><td>Winding-up provisions</td><td>Where the retailer default fund is wound-up for any reason:
• AEMO will pay out the balance of the fund to authorised retailers in the market at the time the fund is wound-up.
• Retailers will pass-through the refund to their customers.</td></tr>
</table>

Fund element	Design
Size of the retailer default fund	
Size of the fund	Electricity: $ 90.0 Million Gas: $40.0 Million
Contribution formulas	
Initial contribution formula	$$Cont_A = \left(\frac{Energy_A * RW_A}{\sum_i Energy_i * RW_i}\right) * Cont_{Total}$$
On-going contribution formula	$$Cont_{i,t} = \left(\frac{Market\ Share_{i,t} * RW_{i,t}}{\sum_i (Market\ Share_{i,t=1} * RW_{i,t=1})}\right) * Cont_{Total,t=1}$$
Process for the collection of contributions	
Collection of contributions	AEMO will collect the fund contributions from electricity and gas retailers as part of the participant fee process
Annual reporting requirements of retailers	Positive obligation on retailers to provide their credit rating or risk score to AEMO by 30 March of each year If the retailer does not provide its credit rating or risk score by this date, AEMO will determine the contribution based on the retailer being unrated
Annual adjustment of contributions payable	Where a retailer's credit rating changes substantially within a given year, it can request AEMO to recalculate its contribution for the remainder of the year The rules would limit this as follows: • Only one amendment per year is allowed; and • No amendment is allowed within three month of the determination date of participant fees for the following year
Accumulation period for the retailer default fund	
Accumulation period	Target period of 10 years. The actual accumulation period may change if investment returns and/or retailers' credit ratings change over time. This would result in total annual contributions of $ 9 million for electricity and $4 million for gas per year.

<table>
<tr><th>Fund element</th><th colspan="2">Design</th></tr>
<tr><td colspan="3">What constitutes a retailer default</td></tr>
<tr><td>Retailer default</td><td colspan="2">For the purposes of making a claim on the fund, the following events would constitute a retailer default:
• revocation of the retailer’s retailer authorisation;
• a suspension of the retailer’s right to acquire electricity or gas;
• an insolvency official is appointed; or
• an order is made for the winding up of the retailer.</td></tr>
<tr><td colspan="3">Claims process</td></tr>
<tr><td>Making a claim</td><td colspan="2">Distributors would submit a claim to the AER including the amount of unpaid charges and confirmation that the claim amount is valid.
The AER will provide a list of the total claims for each distributor to AEMO</td></tr>
<tr><td>Paying a claim</td><td colspan="2">AEMO would payout claims from the fund in full if there is sufficient money in the fund or, if insufficient, based on a proportionality formula set out in the rules.
AEMO will provide a list of the amount paid out to each distributor, and the total amount paid out, to the AER.</td></tr>
<tr><td colspan="3">Replenishment of the fund after a retailer default</td></tr>
<tr><td>Replenishment after the fund has reached its target size</td><td colspan="2">Contributions will be collected in the same manner as during the original (pre-default) accumulation period from all (remaining) retailers in the market.</td></tr>
<tr><td>Replenishment after the fund during the accumulation period</td><td colspan="2">Contributions will be collected in the same manner as if no default occurred with the target accumulation period being extended to allow for the collection of the extra funds required for the fund to reach its target amount.</td></tr>
<tr><td colspan="3">Retailer entry and exit</td></tr>
<tr><td rowspan="2">Retailer enters the market</td><td>During the accumulation phase</td><td>Retailer will contribute to the fund based on prescribed formula</td></tr>
<tr><td>Once the fund has reached its target size</td><td>No requirement for the new entrant retailer to contribute to the fund</td></tr>
<tr><td rowspan="2">Retailer exits the market</td><td>During the accumulation phase</td><td>No refund of contributions made</td></tr>
<tr><td>Once the fund has reaches its target size</td><td>No refund of contributions made</td></tr>
</table>

Fund element	Design
Cost-pass through provisions	
Cost-pass through provisions	1% materiality threshold removed for the purpose of determining the size of eligible cost-pass through amounts. Inclusion of foregone revenue as part of insolvency costs Cost pass-through amount to be reduced by amount to be paid out by the retailer default fund. Reduction of approved insolvency –related cost pass-through amount if a distributor could have claimed on the fund but did not and incurred additional costs as a result of not making a claim on the fund. A distributor has access to the cost pass-through mechanism or other statutory mechanism currently available to collect any unpaid charges which could not be paid out from the retailer default fund and any other costs incurred as a result of the retailer default.

4. Detailed design elements

Several of the design elements summarised above are more fully discussed below:

a. Fund size

The total fund size is recommended to be $90.0 million for electricity and $40.0 million for gas.

The fund size is set to mitigate the liquidity risk from the default of the largest retailer across both electricity and gas networks in the NEM using the following steps:

- averaging the working capital ratio across all distributors (gas and electricity), based on the assumed working capital ratios of each distributor, as shown below:

Working capital ratio – gas distributors

	G1	G2	G3	G4	G5	G6	G7	G8
Assumed working capital ratio	1.20	1.64	1.54	1.36	1.35	1.67	1.75	1.48

Working capital ratio – electricity distributors

	E1	E2	E3	E4	E5	E6	E7	E8	E9	E10	E11
Assumed working capital ratio	1.60	1.52	1.24	1.14	1.15	1.50	1.22	1.41	1.95	1.48	1.44

- the average working capital ratio was used to determine the positive cash flow position for each distributor over a 3-month period;
- the network charges liability for the largest retailer across the electricity and gas markets in each distribution network was determined;

- the amount by which the network charges liability exceeded the relevant distributor's cash-flow position using the average working capital was determined and totalled $131.76 million;
    - this was rounded to give a fund size of $130.0 million, assuming the fund related to both electricity and gas distributors; and
- the fund size for each of gas and electricity distribution networks was then determined based on the exposure of electricity and gas distribution networks, respectively, to the largest retailer across all electricity and all gas distribution networks
    - this gave a fund size of $90.0 million and $40.0 million for electricity distribution networks, and gas distribution networks, respectively.

b. **Contributions**

There are five elements to the design of how contributions will be calculated:

1. **Alignment of S&P ratings and D&B risk scores**

The following alignment of S&P ratings and D&B risk scores would be prescribed in the rules:

S&P rating	D&B risk scores
AAA to BBB-	
BB+	Minimal
BB	Very low
BB-	Low
B+	Average
B	Moderate
B-	High
CCC/CC/C	Very high/severe

2. **Initial contribution formula**

The following formula is proposed for determining the initial retailer contributions:

$$ {}_A = \left(\frac{Energy_A * RW_A}{\sum_i Energy_i * RW_i}\right) * Cont_{Total} $$

where:

$Cont_A$	=	Initial annual contribution for Retailer A
$Energy_A$	=	Energy usage over a 12 month period for Retailer A
RW_A	=	Risk-weight for Retailer A based on the credit rating or D&B risk score
$Cont_{Total}$	=	Total annual contribution required from all retailers
I	=	The index to denote the participating retailers

<u>Risk-weights</u>

It is recommended that the following risk-weights are used and would be prescribed in the rules:

S&P rating	D&B score	Risk-weights
AAA to A-		100%
BBB+		165%
BBB		240%
BBB-		375%
BB+	Minimal	475%
BB	Very low	600%
BB-	Low	750%
B+	Average	950%
B	Moderate	1200%
B-	High	1500%
CCC/CC/C	Very high/Severe	1900%
Non-rated	Non-rated	2500%

3. On-going contributions

Retailer contributions will generally be assessed once a year. This means any change in a retailers' market share or creditworthiness will not alter its contribution until the start of the next period (unless the retailer requests AEMO to update its contribution amount based on its updated creditworthiness).

After the initial contributions are calculated, AEMO would use the following formula for each year during the accumulation period:

$$Cont_{i,t} = \left(\frac{Market\ Share_{i,t} * RW_{i,t}}{\sum_i (Market\ Share_{i,t=1} * RW_{i,t=1})}\right) * Cont_{Total,t=1}$$

Where:

$$Market\ Share_{i,t} = \frac{Energy_{i,t}}{\sum_i Energy_{i,t}}$$

Where:

$Cont_{i,t}$	=	Annual contribution for Retailer i for year t
$Energy_{i,t}$	=	Energy usage for Retailer i over the 12 month period prior to the beginning of year t
$RW_{i,t}$	=	Risk-weight for Retailer i (based on the credit rating or D&B risk score) for year t
$Cont_{Total,t=1}$	=	Total annual contribution required from all retailers for the first year of the accumulation phase
i	=	The index to denote the participating retailers

The denominator $\sum_i (Market\ Share_{i,t=1} * RW_{i,t=1})$ once calculated will remain constant for the term of the accumulation period.

4. Annual reporting requirements of retailers

It is proposed that AEMO will determine, on an annual basis, the contributions payable by the retailer for that year through the contribution formula prescribed in the rules.

The formula is based on market share (energy usage) and creditworthiness. AEMO has access to retailers' energy usage, but does not have access to the retailers' credit rating. In order to address the lack of information regarding retailers' credit ratings, it is proposed that the rules include a positive obligation on retailers to provide their credit rating, S&P (or equivalent) or a D&B dynamic risk score, to AEMO by 30 March of each year. If the retailer does not provide its credit rating by this date, AEMO will determine the contribution for that retailer as if the retailer is unrated.

5. **Mid-year contribution adjustment**

A process would be set up whereby if a retailer's credit rating changes substantially within a given year, its fund contributions for that year could be recalculated. However, the process will be limited, in the following two ways:

- Only one amendment per year is allowed; and
- No amendment should be allowed where that amendment occurs within three months of the determination date of participant fees that would apply for the following year (namely after 15 March when the credit rating is to be supplied).

c. **Investment objective and mandate**

The investment mandate and policies for the fund would be prescribed in the rules and contain the following:

Investment objective: The purpose of the fund is to ensure that funds are available to assist in mitigating liquidity and revenue risk to distribution businesses in the event of a retailer default.
The assets of the fund must be invested so as to ensure the fund meets the primary investment objectives of capital preservation and the maintenance of highly liquid assets. To achieve this objective, a conservative investment strategy must be pursued with investments limited to assets that can be converted into cash within ten business days.

Investment mandate: The fund may only invest in the following instruments:

- Securities issued or guaranteed by the Commonwealth government or any State or Territory Government;
- Deposits with authorised depositary institutions; or
- Medium and short-term senior debt securities issued by financial institutions for which there is a liquid market.

Debt securities and counterparty obligations must have a minimum credit rating of A+. In determining whether debt securities and counterparty obligations meet the minimum credit rating, S&P credit ratings must be used, where available.
All instruments must be denominated in Australian dollars. The use of derivatives for any purpose is prohibited.

Investment restrictions: The following exposure limits apply to the fund's investments across all issuers' of a given type:

Type of issuer	Rating and Maximum Exposure Limits across all issuers of a given type (% of fund's investments)	Term restriction
Commonwealth government	100%	A term of more than five years is not permitted
State governments, and state government borrowing authorities	AAA: 80% AA-, AA or AA+: 65% A+: 10% Overall limit: 100%	A term of more than five years is not permitted
Medium and short-term debt securities issued by financial institutions	AA- or higher: 50% A+ : 30% Overall limit: 50%	AA- or higher: a term of more than five years is not permitted. A+: a term of more than two years is not permitted.
Deposits with authorised depository institutions	100%	A term of more than three months is not permitted.

The following exposure limits apply to individual issuers (or groups of related issuers) of a given type:

Type of issuer	Rating and Maximum Exposure Limits on individual issuers of a given type (% of fund's investments)	Term restriction
Commonwealth government	100%	A term of more than five years is not permitted
State governments, and state government borrowing authorities	AAA: 50% AA-, AA or AA+: 30% A+ : 10%	A term of more than five years is not permitted
Medium and short-term debt securities issued by financial institutions	AA- or higher: 30% A+: 10%	AA- or higher: a term of more than five years is not permitted. A+: a term of more than two years is not permitted.
Deposits with authorised depository institutions	AA- or higher: 40% A+: 20%	A term of more than three months is not permitted.

d. **Claims process**

Upon a retailer insolvency event, the NER and NGR would prescribe the claims process to be followed by all distributors who have a claim against the fund. The claims process would be as follows:

STEP 1: A distributor would submit a claim to the fund to the AER which would include:

- the total amount of unpaid charges arising from the retailer default;
- a statutory declaration from a senior officer of the distributor confirming the amount of unpaid charges; and
- a note/letter from the distributor's auditor confirming the total amount of unpaid charges.

STEP 2: The AER will publish a notice within two business days of receiving a claim pursuant to STEP 1 which informs parties that a claim on the retailer default fund has been made.

STEP 3: Other distributors impacted by the retailer insolvency event will have up to ten business days to submit their claims on the retailer default fund in accordance with STEP 1 above.

STEP 4: The AER will review the claims and make a determination (a 'retailer default fund claim determination') within ten business days of receiving the last distributor's claim pursuant to STEP 3 about the total amount of unpaid charges each distributor can claim against the fund.[73]

STEP 5: The AER would provide a document to AEMO which will outline each of the affected distributors' claims on the retailer default fund within two business days of making the last retailer default fund claim determination pursuant to STEP 4.

STEP 6: AEMO will payout the claims from the fund in accordance with the document provided by the AER in step 5 within ten business days of receiving the AER document. AEMO will provide a report to the AER on the amount of the payout to each distributor within two business days of the last payout from the fund.

If there is insufficient money in the retailer default fund to cover the full amount of each distributor's claim, AEMO will payout the fund based on a proportionality formula set out in the rules.

Paying out from the Fund

The following process would be prescribed in the rules and would be followed by AEMO in paying out from the fund:

STEP 1: receive the document of all distributors' retailer default fund claim determinations from the AER

73 The amounts determined by the AER in this process would be deemed to be final and binding for the purposes of any subsequent adjustments to a distribution determination. There will be a right for affected parties to appeal a fund claim determination; however, the appeal process will not delay any payouts from the fund. Rather, the claims would be paid out and then if the appeal was successful, the distributor would be required to pay back the fund.

STEP 2: calculate the following:

$$\frac{\text{Total claims by all distributors}}{\text{Total amount in retailer default fund}}$$

If this ratio is less than or equal to 1, then AEMO is to payout the full amount of each claim to each distributor

If this ratio is more than 1, then AEMO proceeds to step 3.

STEP 3: AEMO determines the amount each distributor receives based on the following calculation:

$$\frac{Distributor's retailer\ default\ fund\ claim\ determination}{total\ of\ all\ claims\ by\ distributors} \times Total\ amount\ in\ the\ retailer\ default\ fund$$

STEP 4: AEMO pays out the claims of distributors in accordance with the rules within ten business days of receiving the retailer default fund claim determination information from the AER.

STEP 5: AEMO prepares and provide a list of the total amount each distributor was paid from the fund and provides this information to the AER within two business days of the last payout from the fund.

Existing statutory mechanisms available to distributors to recover retailer insolvency-related costs

If there are insufficient monies available in the retailer default fund to satisfy the amount stated in a distributor's retailer default fund claim determination, and/or or there are other retailer insolvency-related costs that a distributor incurs, the distributor can utilise the following two existing statutory mechanisms:

1. the overs-and-unders process, for distributors under a revenue cap regime or recovery under the retailer insolvency cost-pass through mechanism, for distributors under a price cap regime; and
2. the corporate insolvency process.

e. **Replenishment of the fund**

Where a default occurs after the fund has reached its target size, retailers would be required to replenish the fund in accordance with the original contribution formula and for a period of time until the fund reaches its target size. The period of replenishment will be no longer than the original target accumulation period of ten years if the default results in the fund being drawn down to zero. The replenishment period will be lower than the target accumulation period if the payout from the fund is less than its current balance.

When a default occurs after the fund has reached its target size, the total annual fund contribution amount across all non-defaulting retailers would be the lesser of:

- the total annual contribution amount based on a fund size of zero ($9 million for all electricity retailers and $4 million across all gas retailers), where a retailer default results in the fund being drawn to zero; or
- the target fund size less the current amount in the fund, when the fund is not drawn down to zero. This amount is allocated to each retailer using the same contribution formula as that which applied prior to the default.

Where a default occurs before the fund has reached its target size, the total contribution amounts across all (non-defaulting) retailers would be the same as that which existed prior to default (i.e. $9 million and $4 million, for electricity and gas respectively). Consequently, the accumulation period will adjust beyond the target of ten years to allow for the collection of the additional contributions required for the fund to reach its target size, rather than contributions increasing in order for the fund to achieve its target size within the 10-year period.

f. **Collection of contributions**

Retailer contributions into the retailer default fund are to be included in AEMO's budgeted revenue requirement and are to be collected in the form of participant fees. The detailed design of the retailer default fund would not prescribe the methodology to be employed by AEMO to collect contributions to the retailer default fund. Rather, the rules would only prescribe that contributions are to be included as participant fees for which AEMO must collect and retailers are obligated to pay, with AEMO to decide the most appropriate methodology to collect fund contributions via the participant fee mechanism.

g. **Retailer default**

The rules would specifically set out what constitutes a retailer default for the purposes of a claim by a distribution business from the retailer default fund. Although the specific drafting has not been completed, it would be expected that the definition of a retailer default for the purposes of a claim on the fund would provide:

A retailer default, in relation to a retailer, means any of the following events or circumstances:

(a) The revocation of the retailer's retailer authorisation;

(b) In the case of electricity –

   a. The right of the retailer to acquire electricity from the wholesale exchange is suspended; or
   b. The retailer ceases to be a Registered participant in relation to the purchase of electricity directly through the wholesale exchange, as required by section 11(4) of the NEL;

(c) In the case of gas –

   a. The right of the retailer to acquire gas either in the declared wholesale gas market or in the short term trading market is suspended; or
   b. The retailer's registration as a Registered participant, in relation to the declared wholesale gas market or a short term trading market, is revoked; or

c. Where there is no declared wholesale gas market or short term trading market, the retailer's registration as a Registered participant in a retail gas market is revoked;

(d) An insolvency official is appointed in respect of the retailer or any property of the retailer;

(e) An order is made for the winding up of the retailer or a resolution is passed for the winding up of the retailer;