Red Energy Pty Ltd - ABN 60 107 479 372

2 William Street
East Richmond, VIC 3121
T 131 806
F 1300 66 10 86
E enquiries@redenergy.com.au
W redenergy.com.au

30 June 2015

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted electronically

Dear Sir/Madam,

Re: (Retailer – Distributor Credit Support Requirements) Rule 2015

Red Energy welcomes the opportunity to respond to the Australian Energy Market Commission's (the Commission) National Electricity Amendment (Retailer- Distributor Credit Support Requirements) Rule 2015.

Red Energy is 100% Australian owned subsidiary of Snowy Hydro Limited. Red Energy sells gas and electricity in Victoria and New South Wales and electricity in South Australia and Queensland. We are currently one of the largest second tier retailers.

The current credit support arrangements under the National Electricity Rules (NER) and the National Gas Rules (NGR) makes provisions for allowing a distributor to request a retailer to provide credit support when a retailer's network charges liability exceeds its credit allowance.

A retailer's credit allowance under the current arrangements is a function of its Maximum Credit Limit (MCL). The credit allowance that it receives reflects the distributor's annual network charges and its credit rating with a higher credit rating equating to a higher credit allowance.

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

B: Recommendation

Red Energy does not support the rule change instead are proposing an alternative option that combines parts of the AGL model with the current arrangements creating a "hybrid" model.

The "hybrid" model is consistent with the National Electricity Objective (NEO) and the National Gas Objective (NGO) because it is more efficient than the current arrangements and the AGL proposal.

RE359V10315 RED51583 VRENG4037

The specific characteristics of our "hybrid" model include:

1. Retailers with a credit rating of between AAA and BBB- would be treated as they are under the current arrangements.

   A retailer's credit allowance would continue to be a function of the distributor's Maximum Credit Limit (MCL).

   Retailers with a credit rating of between AAA and BBB- would continue to receive a percentage of the distributor's MCL set at 25% of a distributor's total annual network charges.

   Retailers with a credit rating of AAA to A- would continue to receive 100% of their MCL.

   Those retailers with a credit rating of between BBB+ and BBB- would receive a lower percentage of their MCL as their credit quality declines.

   For example retailers with a credit rating of BBB+ would receive 52.9% of their MCL. Those with a credit rating of BBB would receive 37.5% of their MCL and those with a rating of BBB- would receive 22.0% of their MCL.

2. Retailers with a credit quality below BBB- (between BB+ and CC) would be treated as proposed under the AGL rule change.

   These retailers would pay credit support to the distributor so that the distributor's risk weighted exposure to the retailer's default would be the same as if that retailer was rated BBB-.

C: Why the "hybrid" model is consistent with the National Electricity & Gas Objective

Red Energy considers that the "hybrid" option is consistent with the NEO and the NGO.

The Commission applies the following criteria in its consultation paper to decide whether the rule change is consistent with the NEO and the NGO.

This includes the:

- allocation of risk to parties able to manage each risk in order to minimize the long term costs to consumers;
- risk of retailer default and the impact of default;
- tradeoff between regulatory flexibility and regulatory certainty;
- impact on barriers to the retail market;
- impact on consumers of changes in network revenue as a result of the revenue and pricing principles.

We apply the assessment criteria that the Commission has used to assess the AGL rule change to our "hybrid" option. The analysis provided below should help the Commission determine whether our proposal is consistent with the NEO and the NGO.

Allocation of risk to parties able to manage each risk in order to minimize the long term costs to consumers

1. Under the current arrangements AGL, Origin and EA's credit ratings allow them to access cheap credit support compared to retailers with lower credit ratings. Their access to low cost credit keeps the cost of providing credit support down and minimizes the long term cost to consumers.

2. AGL's rule change argues that Origin, EA and itself should not pay for credit support. It contends their credit ratings should absolve them of the requirement to pay for credit support. Such a decision by the Commission would deliver millions of dollars in savings. These savings would supposedly be passed through to customers, or alternatively as commercial entities AGL, Origin and EA could retain expected savings.

   Absolving AGL, Origin and EA however of the need to pay for credit support would expose distributors to an inappropriate level of risk. Without credit support a major retailer default could potentially lead to the following outcomes:

   - distributors lining up with other unsecured creditors under the Corporations Act 2001 as unsecured creditors where a retailer defaults. This would be time consuming and the amount of money that a distributor recovers would depend on where it sits in the order of creditors;

   - an inability to recover revenue on the part of a distributor which might risk the distributor defaulting on other payments. This could have implications for the wider economy.

   The significance of a failure of a major energy retailer to the economy would make this outcome inappropriate.

3. If the Commission approves this rule change absolving AGL, Origin and EA of the responsibility to pay for credit support it could force distributors into alternative more expensive ways to protect their revenue streams.

   Under the existing regulatory framework distributors could potentially:

   - request that the Australian Energy Regulator (AER) approve an allowance in their operational expenditure for them to buy insurance and protect them against a retailer default.

     Whilst a major retailer default is a low probability yet high impact event the costs to mitigate this risk through insurance could be significant.

   - demand a cost pass through under the regulatory arrangement. This mechanism would not be subject to the current limitation that exists in the NER that only allows a distributor to apply for such a pass if it is greater than 1% of a distributor's regulated revenues.

   Both of these outcomes would be inefficient and costly. So they would be inconsistent with the NEO and the NGO.

4. AGL, Origin and EA would continue to pay for credit support under the "hybrid" model where they have a significant market share. The effect of this would be to:

   - incentivize all of these players to improve their credit rating to a minimum of A- to minimize their exposure to credit support payments;

   - encourage all retailers to put in place alternative arrangements that reduce the risk of default. This may include paying their bills in advance to reduce their exposures above their MCLs;

   - allow distributors to call on credit support immediately where a larger rated retailer defaults. Distributors would get immediate recourse to a bank credit limiting their need to pursue debt through mechanisms allowed under the Corporations Act 2001 where an event of default has occurred.

5. Under the hybrid model retailers with a credit rating of between BB+ and CC would be required to pay for credit support so that the distributor's risk weighted exposure was the same as if that retailer was rated BBB-.

   Our view is the credit risk of retailers rated below BBB- is high. Hence, they should be required to pay for credit support to make sure that distributors do not face a credit risk below BBB-.

   Due to relatively low market shares of retailers with a credit rating of between BB+ and CC, and therefore the small amounts of credit support required, the cost impost to small retailers would be minimal.

Risk of retailer default and the impact of default

The "hybrid' model protects distributors' cash flow and revenue risk against both the "risk" and "impact" of a retailer default.

The "hybrid model":

1. ensures that retailers with a credit rating of between AAA and A- receive 100% of their MCL;

2. provides that retailers with a credit rating of BBB+ would continue to receive 52.9% of their MCL. Those with a credit rating of BBB would receive 37.5% of their MCL and those with a rating of BBB- would receive 22.0% of their MCL

3. requires that retailers with a lower credit rating (BB+ to CC) provide an appropriate level of credit support so that the distributor's risk weighted exposure to the retailer's default would be the same as if that retailer was rated BBB-.

These outcomes are consistent with the requirements of an effective rule change as espoused by the Commission in its consultation paper.

AGL's rule change would shift the burden of paying for credit support away from AGL, Origin and EA to smaller retailers with a lower credit rating. In contrast, under the existing arrangements, AGL, Origin and EA pay for the largest share of credit support. Smaller retailers with a lower credit rating pay for a small share of the total credit support required in the market.

Under the hybrid model both the smaller retailers with a lower credit rating and large retailers with stronger credit ratings contribute to credit support. As a result, AGL, Origin and EA would continue to pay for credit support as they currently do. Smaller retailers with a lower credit rating (BB+ to CC) would pay for a level of credit support so that the distributor's risk weighted exposure to the retailer's default would be the same as if that retailer was rated BBB-.

The trade-off between flexibility and regulatory certainty

The "hybrid" proposal provides the right balance of regulatory certainty with flexibility.

The administrative costs associated with a flexible rule are insignificant compared with the benefits of implementing a flexible rule that accurately adjusts and reflects the risks faced by retailers.

The "hybrid" proposal is flexible and would:

1. apply the current credit support arrangements to AAA through to BBB - which deliver the required flexibility needed to manage a retailer default;

2. provide more effective credit support arrangements to those retailers with credit ratings between BB+ to CC consistent with the AGL proposal.

The impact of barriers to entry in the retail market

The "hybrid" proposal should not deter retailers from entering the market.

There is a perception that imposing higher credit support arrangements on smaller lower rated retailers imposes unnecessary costs because financial institutions perceive these players to be more risky.

We do not see this as being an accurate representation.

The "hybrid "forces retailers with a credit rating of between BB+ to CC to:

1. consider the risks of entering the retail market carefully before making this decision to enter the market;

2. pay for the cost of credit support which is consistent with its risk profile to enter the market in order to protect consumers from an event of default.

These prerequisites for competing in the retail energy market are appropriate.

The impact on consumers of changes in network revenue as a result if the revenue and pricing principles

The "hybrid" proposal should not have an impact on network revenue under the revenue and pricing principles.

Nevertheless, if there was an impact on network revenues as a result of adopting the "hybrid" proposal then we would support:

1. distributors' rights to recover the costs of a retailer default and forgone revenue. We would also support distributors recovering prudent operating costs that may arise as a result of managing any remaining cash flows or revenue risks.

2. adjustments to the WACC for any "non -diversifiable" risks after accounting for efficient operational decisions when considering the regulated rate of return

Our support for this outcome is conditional on the AER been given the power to review and amend network costs from such an arrangement where it has decided that the costs are "prudent and efficient".

D: Conclusion

Red Energy welcomes the opportunity to respond to this consultation.

We are optimistic that our proposal will be considered in more detail going forward by the Commission. In this regard, we are hopeful that the Commission will give our proposal the due consideration that it deserves by including it as a viable "option" in the next phase of its consultation process.

We look forward to engaging further with the Commission in the future on this matter. Should you have any further enquiries regarding this submission, please call Con Noutso Regulatory Manager on 03 9976 5701.

Yours sincerely

Ramy Soussou
General Manager Regulatory Affairs & Stakeholder Relations
Red Energy Australia Pty Ltd