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Retailer-Distributor Credit Support Requirements

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Background

The AEMC has received rule change requests from AGL, COAG Energy Council and Jemena that all relate to the general question of revenue security for distributors in the face of insolvency of a retailer. The AEMC has wisely decided to consider these together.

As ECA understands the situation from the Issues Paper the current arrangements include two elements; “credit support” and loss recovery through the “unders and overs” process.

Credit support is identified as a requirement to provide security by way of bank guarantee or similar in relation to the credit provided by the distributor to the retailer.

The rules already provide for the distributor to be “made whole” following an insolvency event. Their costs (including revenue foregone, though the rule may need to be clarified) are recovered from other customers once the distributor can reset prices.

Issues with the current arrangements are the inconsistency of the credit support requirements, the potential that the distributor will not cover all losses and the threat of systemic risk created by the cash flow impact on the distributor of a major default.

The Interests of Consumers

The objective of the energy market arrangements is the promotion of the long term interests of consumers. The objective of the various laws is the promotion of the efficient investment in, and operation and use of, energy services for the long term interest of consumers with regard to price, quality, reliability, safety and security of supply.

In general the interest of consumers is best promoted by the promotion of effective competition where such competition is viable. In the case of markets where competition is not viable, e.g. distribution networks, regulation is applied to ensure that prices are no more than they need to be to provide agreed standards of service.

These are the core principles under which the scenarios proposed in the discussion paper need to be considered. In addition, the incentive of relevant participants to support the objectives under the various scenarios needs to be considered.

In this context the role of the distributor is critical. Given the stringent prudential requirements that apply in the wholesale energy market, the distributors are the largest commercial partners of retailers. The distributors are likely to be the largest party affected by the insolvency of a retailer. Arrangements that remove all risk from the distributor remove the incentive for the distributor to take action to trigger the insolvency event. Delay could result in the cost to be recovered from other industry participants to be greater than it needs to be.

In general credit support arrangements act as a barrier to entry to the retail market. Barriers to entry are one of the most significant impediments to the development of competitive markets, and the interests of consumers are not well served by the creation of such barriers.

An insolvency event is likely to occur because a retailer has simply applied a poor business model; primarily they sold energy below their costs. Their customers have got a good deal.

All customers are likely to have benefitted from the presence of this retailer, as other retailers responded. Providing for the distributors to recover their losses by placing a "levy" (the unders) on other customers (well retailers actually) is therefore relatively minor. This is the part where the rules need to ensure there is an incentive for the distributor to act. A flat 1% materiality rule doesn't work because it creates the perverse incentive for the distributor to delay taking recovery action until the losses are high enough.

While the idea that a large retailer with 30% or more of a distributor's customers could be insolvent sounds scary, the reality is that the retailer will have assets including its debt book that will provide cash in the liquidation process. In addition the recovery process may be spread over a number of years so the per-bill impact is low.

The only outstanding issue then is the liquidity required for the distributor until the recovery is complete.

The modelling of a liquidity support scheme needs to reflect that the system wide exposure is not the failure of each distributors' largest retailer. Both the formulas under sub-option 4.1 and 4.2 will overprovision for the risk of a single retail failure unless every distributor has the same largest retailer (they don't).

There is a slight conundrum in determining liquidity support. If the retail industry is highly concentrated retail margins are likely to be high and the risk of insolvency of the largest retailers will be low. If the retail industry is diverse the risk exposure from any one retailer is lower.

The quantum of liquidity support each distributor needs available is really based upon an assessment of the risk weighting of their retail portfolio. That is, it is the sum of the NCL weighted by creditworthiness of each retailer.

This support could be provided in two ways.

The first would be a level of cash that the distributor should be required to have on hand. From the point of view of the financing of the distributors this is an amount of cash that should be considered a prudent amount of the RAB, with the interest earned on the cash included in the revenue allowance.

The second would be by way of a finance facility which would incur ongoing charges to retailers that would be passed on to consumers. This is the option that is proposed in the AEMC option 4.

The third possibility is that there is a level of concern being expressed here that is irrelevant because the management of insolvency events is simply a requirement of management in undertaking their own risk assessment. In particular, in determining the appropriate gearing level for the distribution business provision should be made by management for the amount of additional debt that might need to be raised in these circumstances.

It is relatively inconceivable that a distributor would be completely unable to obtain a facility to provide cash following a retailer insolvency, though it may be an expensive facility. The use of the third possibility (that is, leaving it to the distributor to find the funds) opens up the simple fact that the cost of the funds required to provide liquidity needs to be recognised as an unexpected operating cost to the distributor and added to the cost recovered.

Preliminary ECA View

Energy Consumers Australia has not undertaken a detailed enough review of all the issues entailed in risk mitigation to make a firm recommendation for AEMC consideration.

However, the following principles of the long term interests of consumers should inform the Commissions considerations.

1. Credit support requirements can constitute barriers to entry to the retail market and are counter to the long term interests of consumers.
2. The rules on cost recovery for insolvency need to be clear that all the distributor's costs are included in recovery calculations, except in so far as an incentive can be found to discourage inaction. A materiality threshold is not the correct response, and it might just be that a figure of 5% of all costs has to be borne by the distributor.
3. Distributors should be able to manage a level of liquidity support within their overall debt budgeting. Unless distributors make a case for a specific rule change the AEMC should take no action on liquidity support.