26 November 2015

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Subject: Options Paper – National Electricity Amendment (Retailer – Distributor Credit Support Requirements) Rule 2015

SA Power Networks welcomes the opportunity to respond to the Australian Energy Market Commission's **(AEMC)** rule change Options Paper on the National Electricity Amendment (Retailer – Distributor Credit Support Requirements) Rule 2015, issued on the 22nd October 2015.

The Council of Australian Governments Energy Council's **(COAG Energy Council)** rule change submission to the AEMC on 20 March 2014 sought an amendment to the National Electricity Rules **(NER)** in order to better reflect the original policy intent of the provisions drafted to implement the National Energy Customer Framework **(NECF).** The intent was to provide a mechanism in the NER for distributors to recover, via pass-through provisions of the NER, unpaid network charges following a Retailer Insolvency Event, and specifically with no materiality threshold being applied as part of the pass-through process.

In this regard, we urge the AEMC to issue a Final Determination earlier than the currently proposed date of 12 May 2016. While we appreciate the AEMC's reasoning for incorporating AGL's and Jemena's rule change requests (made on 19 January 2015 and 25 September 2015, respectively) into a single retailer-distributor credit support rule change process, we are nevertheless concerned at the delay in remedying an error in the Rules as to give effect to the policy intent of the COAG Energy Council .

Key messages

In summary, SA Power Networks:

- Supports the COAG Energy Council's proposed rule change to include a 'no materiality' requirement for a cost pass-through in the case of a retailer becoming insolvent. This rule change reflects the COAG Energy Council's original policy intent;
- Supports strengthening the credit support mechanisms especially as they relate to multiple retailer authorisations and realigning the Dunn & Bradstreet (**D&B**) dynamic risk scores (**D&B risk scores**) to Standard & Poors (**S&P**) credit ratings, to include additional factors (beyond just the probability of default) relating to the processes used to determine a retailer's creditworthiness under each of the rating systems;
- Supports the adoption of Option 2.3 which includes:
    - the COAG Energy Council's and Jemena's rule change requests;
    - the removal of the maximum credit allowance and a retailer credit allowance;

- an amended version of the AGL's rule change request whereby retailers with a S&P (or equivalent) credit rating below A- would be required to provide credit support compared to AGL's proposal that retailers below a credit rating of BBB- would be required to provide credit support. The amount of credit support in both cases varies based on their Network Charges Liability (**NCL**) and credit rating; and
- realignment of the D&B risk scores.

- Rejects retention of the existing retailer insolvency and credit support arrangements as it does not address the potential for market contagion for the failure of a large retailer. In addition, the risk that the existing retailer insolvency/credit support regime imposes on distributors is not reflected in distributors' Weighted Average Cost of Capital (**WACC**) in accordance with the Pricing Principles contained in the NEL clause 7A(5). Further, it is contrary to the intent of the extensive consultation undertaken by the COAG Energy Council prior to the implementation of the NECF.

SA Power Networks assessment of each of option against the AEMC's principles are summarised in Attachment 1.

Should the AEMC require further clarification of any of our comments, please contact Mr Grant Cox, Manager Regulatory Affairs, on (08) 8404 5012.

Yours sincerely,

Sean Kelly

Sean Kelly

General Manager Corporate Strategy

Attachment 1

SA Power Networks Assessment of AEMC Options

The Table below details SA Power Networks' score card assessment against the AEMC's stated principles for each of the options evaluated in the AEMC's Options Paper. This same framework was used by Promontory in their Final Report "Principles and Options for Managing Retailer Default Risk" dated 22 October 2015, page 78.

	Stability	Efficiency	Incentives	Revenue & Pricing	Competition
Option 1	×	×	×	×	✓
Option 2.1	×	×	×	✓	✓
Option 2.2	×	×	Partly	✓	×
Option 2.3	✓	Largely	✓	✓	Equitable
Option 3	✓- after 10 yrs	×	✓	✓	Equitable
Option 4.1	Partly	Partly	×	✓	✓
Option 4.2	Partly	Partly	✓	✓	Equitable

Key reasons for SA Power Networks' assessment as detailed above are:

Option 1 – Retain existing retailer insolvency and credit support arrangements

SA Power Networks' assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is <u>not met</u> as it does not address the potential contagion effects for the failure of a large retailer as modelled by Promontory and summarised by the AEMC in their Options Paper for Scenario 1 and 2. Under either the AEMC's Scenario 1 or 2 the working capital ratio for a large number of distributors falls below 1.0 which provides an indication that a distributor's viability could be threatened;
- Efficiency – principle is <u>not met</u> as in the event of a large retailer failure there is a liquidity risk for distributors and a significant cost increase for all the distributor's customers of up to 29%. In addition, under a price cap form of revenue control distributors will not be able to recover the lost revenue from a retailer default unless it exceeds the one percent materiality pass-through event threshold. Whereas, under a revenue form of control the distributor

may be able to recover the revenue shortfall (ie less than 1%) via the overs and unders mechanism subject to the AER's approval.

- Incentives – principle is not met as there is no incentive on retailers to improve their credit rating unless its distributor Network Charges Liability (**NCL**) exceeds its Credit Allowance (**CA**) provided by the distributor in accordance with the regulatory framework;
- Revenue & pricing – principles are not met as distributors are not provided with a reasonable mechanism to recover their revenue in the event of a retailer failure where their loss is below the materiality threshold. In addition, under a price cap form of revenue control distributors will not be able to recover the lost revenue from a retailer default unless it exceeds the one percent materiality pass-through event threshold. Under a revenue form of control the distributor may be able to recover the revenue shortfall (ie less than 1%) via the overs and unders mechanism which is subject to the AER's approval.; and
- Competition – principle is met, as retailers face minimal barriers to entry due to the provision of a CA by the distributor where they provide a credit rating.

Option 2.1 – Strengthening existing arrangements (ie adopt only COAG Energy Council and Jemena rule change requests)

SA Power Networks' assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is not met as it does not address the potential contagion effects for the failure of a large retailer. The impact of this option would be similar to Option 1 where the working capital ratio for a large number of distributors falls below 1.0 which provides an indication that a distributor's viability could be threatened;
- Efficiency – principle is not met as in the event of a large retailer failure there is a liquidity risk for distributors and a significant cost increase for all the distributor's customers;
- Incentives – principle is not met as there is no incentive on retailers to improve their credit rating unless its distributor NCL exceeds its CA provided by the distributor in accordance with the regulatory framework;
- Revenue & pricing – principles are met as distributors are provided with a reasonable mechanism to recover their revenue subject to AER approval. The AER's approval would be subject to the distributor mitigating their loss within the confines of the regulatory framework and acting prudently; and
- Competition – principle is met, as retailers face minimal barriers to entry due to the provision of a CA by the distributor where they provide a credit rating.

Option 2.2 – Strengthening existing arrangements (ie adopt Option 2.1 and AGL's rule change request)

SA Power Networks' assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is not met as it does not address the potential contagion effects for the failure of a large retailer. This option is similar to Option 1 as the majority of large retailers would not be required to provide credit support under this option. Consequently, the impact of this option would be similar to Option 1 where the working capital ratio for a large number of distributors falls below 1.0 which provides an indication that a distributor's viability could be threatened;
- Efficiency – principle is not met as in the event of a large retailer failure there is a liquidity risk for distributors and a significant cost increase for all the distributor's customers;

- Incentives – principle is partly met as it provides some retailers (ie retailers with a S&P credit rating of below BBB- or equivalent) with the incentive to increase their credit rating as it reduces their requirement for credit support, all other matters being equal;
- Revenue & pricing – principles are met as distributors are provided with a reasonable mechanism to recover their revenue subject to approval by the AER, which requires distributors to mitigate their loss within the confines of the regulatory framework and acting prudently; and
- Competition – principle is not met, as retailers with a S&P credit rating of less than BBB- (or equivalent) are required to provide credit support, which creates a barrier to entry for those retailers. In addition, it is not equitable as the largest retailers with the minimum investment grade rating are not required to provide credit support.

Option 2.3 – Strengthening existing arrangements (ie adopt option 2.1 and an enhanced credit support regime (ie amend AGL's rule change request))

SA Power Networks' assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is met as the majority of retailers are required to provide credit support that would largely prevent the risk of contagion, as highlighted by Promontory's analysis as supported by the AEMC in their Options Paper;
- Efficiency – principle is largely met as in the event of a large retailer failure there is a liquidity risk for some distributors and a small cost increase (less than 5%[1]) for all the distributor's customers;
- Incentives – principle is met as it provides the majority of retailers the incentive to increase their credit rating as it reduces their requirement for credit support, all other matters being equal;
- Revenue & pricing – principles are met as distributors are provided with a reasonable mechanism to recover their revenue subject to approval by the AER, which requires distributors to mitigate their loss within the confines of the regulatory framework and acting prudently; and
- Competition – principle is partly met (ie provides equity), as most retailers are required to provide credit support. It treats retailers equitably in the provision of credit support. Only retailers with a credit rating of A- or above are not required to provide credit support.

Option 3 – Retailer default fund (including COAG Energy Council rule and realignment of D&B dynamic risk score)

SA Power Networks' assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is met after 10 years when the retailer default fund has been fully funded. If a large retailer failed within the first few years after the rule change came into operation, it would have a similar result to option 2.1, that is, contagion is likely under the AEMC's Scenario 1 and Scenario 2. It would cater for Scenario 3;
- Efficiency – principle is not met as customers are required to fund the retailer default fund. It is the highest cost option for customers as determined by the AEMC's and Promontory's assessment, at least until the fund has reached the required amount;

[1] Refer AEMC's Options Paper Figure 4.11 pg.36

- Incentives – principle is met as the payments into the scheme are based on the on the retailers credit rating and NCL (ie improved credit rating means lower contributions to the fund);
- Revenue & pricing – principles are met, provided Option 3 incorporates the COAG Energy Council's proposed rule change request; and
- Competition – principle is partly met, as retailers with poorer credit ratings are required to provide a greater proportion of the retailer default fund based on their NCL and credit rating. That said, it does treat retailers equitability based on their credit rating.

Option 4.1 – Distributor liquidity scheme with equal payments based on a retailer's NCL including COAG Energy Council's rule and realignment of D&B dynamic risk score.

SA Power Networks assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is partly met as the liquidity support means that the majority of distributors would not be subject to a contagion risk if the scheme was capped at 50% in total of all retailers' NCL. However, customers would still face large increases in prices for the failure of a large retailer (ie like under Options 1 and 2.1);
- Efficiency – principle is partly met as the annual cost to customers is low, but customers are exposed to similar risk as in Option 1 and Option 2.1 as customers would be exposed to large increases in prices for the failure of a large retailer as in the AEMC's Scenario 1 and Scenario 2. In addition, distributors who are required to arrange a large liquidity facility (ie line of credit) may have difficulty when accessing future capital for their networks or may have to source the capital at higher interest rates;
- Incentives – principle is not met as distributors' liquidity facility will be funded based on a retailer's NCL;
- Revenue & pricing – principles are met as the option includes the COAG Energy Council's proposed rule change request; and
- Competition – principle is met as retailers fund the liquidity facility based on their NCLs.

Option 4.2 – Distributor liquidity scheme with retailer payments based on a retailers' NCL and credit rating including COAG Energy Council's rule and realignment of D&B dynamic risk score.

SA Power Networks' assessment for this option and each of the AEMC's principles is provided below:

- Stability – principle is partly met as the liquidity support means that the majority of distributors would not be subject to a contagion risk if the scheme was capped at 50% in total of all retailers' NCL. However, customers would still face large increases in prices for the failure of a large retailer (ie as under Options 1 and 2.1);
- Efficiency – principle is partly met as the annual cost to customers is low, but customers are exposed to similar risk as in Option 1 and Option 2.1 as customers would be exposed to large increases in prices for the failure of a large retailer as in the AEMC's Scenario 1 and Scenario 2. In addition, distributors who are required to arrange a large liquidity facility (ie line of credit) may have difficulty when accessing future capital for their networks or may have to source the capital at higher interest rates;
- Incentives – principle is partly met as retailers are required to fund distributors' liquidity facility based on their NCL and credit rating;

- Revenue & pricing – principles are met as the option includes the COAG Energy Council's proposed rule change request; and
- Competition – principle is partly met (ie provides equity), as retailers fund the liquidity facility based on their NCLs and credit rating and as a consequence retailers are treated equitably based on their credit rating.

Other considerations

SA power Networks considers that their needs to be incentives on retailers to pay distributors on time. Under the existing arrangements if the retailer is determined to be a poor payer in accordance with the rules then it is required to provide credit support for 100% of their NCL. Any regime adopted by the AEMC needs to include incentives on retailers to make payments on time, or otherwise they face a penalty.

That said, SA Power Networks is cognisant that at the time the rules permit a distributor to make a formal credit support request due to the retailer becoming a poor payer, if the retailer is exhibiting signs of financial distress at that time the opportunity for the distributor to secure credit support has most likely passed.

This situation occurred in practice in the SA market immediately prior to the Jackgreen RoLR event.

Conclusion

SA Power Networks concludes that Options 2.3 and 3 should be treated like insurance where electricity customers are required to pay slightly higher ongoing costs of up to 1.6% (varies between 0.07% and 1.62%) to significantly mitigate the costs associated with any retailer failure, and especially the failure of a large retailer. Option 2.3 has slightly lower ongoing costs to customers than Option 3. In addition, Option 2.3 has lower costs than Option 3 in two of the three scenarios for retailer default as modelled by Promontory. Further, for the more likely scenario where a poor credit risk retailer fails Option 2.3 minimises the consequence to customers as that type of retailer is required to provide credit support for the majority of their NCL.

Option 3 does not become fully effective until the retailer default fund approaches its designed fund size. Consequently, in the early years of the fund other mechanisms like a retailer insolvency pass through event, overs and unders mechanism, and corporate insolvency would be required to ensure stability of the market for a large retailer failure.

SA Power Networks considers that the AEMC could initiate the COAG Energy Council Rule change and the realignment of the D&B dynamic risk scores immediately, whilst further investigating other potential options like Option 3.

The other options considered by the AEMC (ie Options 1, 2.1, 2.2, 4.1 & 4.2) have lower ongoing costs to customers (excluding the retailer default costs) than Option 2.3 and 3 but don't address the AEMC's principles as well as Option 2.3 and 3. In particular they:

- do not mitigate the significant costs increases to customers in the event of a large retailer failure (ie Scenario 1 & 2); and/or
- do not address the contagion risk for the failure of a large retailer except options 4.1 & 4.2.

As a consequence of its analysis, SA Power Networks supports the adoption of Option 2.3, as it provides the greatest benefit in terms of the NEO.