

22 December 2016

Mr John Pierce  
Chairman  
Australian Energy Market AEMC  
PO Box A2449  
Sydney South NSW 1235

Dear Mr Pierce

**RE: AEMC DRAFT RULE DETERMINATION – NATIONAL ELECTRICITY  
AMENDMENT RETAILER – DISTRIBUTOR CREDIT SUPPORT REQUIREMENTS  
RULE 2016 (ERC0183)**

Endeavour Energy welcomes the opportunity to provide feedback on the AEMC's Draft Rules – *National Electricity Amendment (Retailer-distributor credit support requirements) Rule 2016* (Draft Rules).

We understand that the AEMC has made a draft decision to amend the relevant provisions of the National Electricity Rules (NER) and National Gas Rules (NGR) to:

- Enhance the operation of the retailer insolvency cost pass-through provisions such 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;
- Remove the requirement for a retailer to provide credit support, except in the case of a history of late payment of distributors' invoices by a retailer. In the event of late payment, a retailer may have to provide credit support in the amount of the last invoice received which triggered the late payment provision; and
- Retain the existing credit support provisions so that they continue to operate as between any distributor and retailer, where that distributor currently holds a credit support instrument from that retailer. This requirement exists given the accrued right of the distributor under the existing contractual arrangements associated with the credit support instrument.

We agree with the AEMC's view that a regulatory mechanism is necessary to address the revenue risk faced by distributors from retailer default, due to distributors' compulsory service obligations. As such, we support the enhanced retailer insolvency cost pass-through provisions.

However, it is uncertain that the AEMC's proposed ex-post retailer-distributor credit support arrangements will provide energy market confidence and financial stability, even with the improved retailer insolvency cost pass-through provisions. The key issue is that the regulatory framework does not provide distributors with sufficient access to short term funding to maintain mandated services in the event of a major retailer insolvency event. This is due to:

1. Late payment of network costs by retailers, which is a primary symptom of financial distress and it is often too late at this point for distributors to effectively and efficiently fully recover monies owed to them via an ex-post credit support arrangement;
2. The reality that a small number of retailers account for a significant proportion of Endeavour Energy's accounts payable and we are legally prohibited from diversifying away from this risk via alternative retailers;

3. The protracted nature of the cost pass-through request and approval process, and with the unders and overs regulatory mechanisms that result in distributors only accessing network payments, at best, one year after the retailer insolvency event occurred;
4. The difficulty in terms of cost and coverage for distributors to access insurance products that fully cover retailer insolvency events;
5. The uncertain and protracted nature of the corporate insolvency process; and
6. The increased risk, cost and uncertainty associated with sourcing additional short term debt and / or equity funding.

The most effective solution, in order to generate energy market confidence and financial stability, is to ensure robust prudential requirements are in force for all market participants.

Attachment A contains our detailed response. If you have any queries or wish to discuss this matter further please contact Jon Hocking, Manager of Network Regulation at Endeavour Energy on (02) 9583 4386 or via email at [jon.hocking@endeavourenergy.com.au](mailto:jon.hocking@endeavourenergy.com.au).

Yours sincerely



Scott Ryan  
**Acting Chief Executive Officer**

Attachments: (1)

## Attachment A

### DETAILED RESPONSE TO THE AEMC'S DRAFT RULE DETERMINATION – NATIONAL ELECTRICITY AMENDMENT RETAILER – DISTRIBUTOR CREDIT SUPPORT REQUIREMENTS RULE 2016 (DRAFT RULES)

#### Introduction

Endeavour Energy supports the AEMC's detailed analysis and consultation process on the retailer-distributor credit support rule change, including releasing an Options Paper, Consultation Paper and now a Draft Decision seeking stakeholder feedback.

These papers correctly identify that the core issue underpinning whether a retailer-distributor credit support arrangement is required, is to determine the most effective and efficient tool(s) to manage distributor's revenue, liquidity and systematic risks resulting from the regulatory framework.

Given this, we support the AEMC's Draft Decision to enhance the retailer insolvency cost pass-through provisions as a necessary mechanism to address the revenue risk faced by distributors from retailer default, due to the distributor's compulsory service obligations.

However, Endeavour Energy is of the view that the AEMC has not fully assessed the impacts on distributor's liquidity and systematic risk prior to removing the ex-ante retailer-distributor credit support mechanism.

It appears the AEMC has reached its view that an ex-ante mechanism is no longer required based on the incorrect premise that distributors, as regulated utilities, are best placed to manage liquidity and systematic risk due to:

1. Distributors receiving a guaranteed regulated revenue amount that includes a rate of return;
2. Distributors being able to quickly access funds from either internal or external sources to overcome cash-flow shortages caused by retailer default and non-payment of network charges; and
3. The regulatory framework guaranteeing the ability for the distribution business to collect this revenue in a timely manner, thus mitigating revenue risk.<sup>1</sup>

#### **Regulated revenue rate of return and assumed systematic risk under an ex-post credit support mechanism**

Endeavour Energy notes that the rate of return embedded in the regulated revenue requirement is based on an assumed level of systematic risk and reflected in the Weighted Average Cost of Capital (WACC). Restricting distributors' ability to request credit support until only after retailer non-payment of accounts, coupled with the distributor's legal obligation to continue service provision, enhances systematic risk and potentially increases end consumer prices, via the need for a higher revenue requirement. This is because late payment of business accounts is a primary symptom of financial distress and it is often too late at this point for distributor's to effectively and efficiently fully recover monies owed to it via a credit support arrangement.

Further, liquidity risk contagion is exacerbated under the ex-post credit support mechanism in the event of medium and large retailer financial distress. This is because a small number of retailers account for a significant proportion of distributor's accounts payable and the distributor is legally prohibited from diversifying away from this risk via alternative retailers. For example, the top four retailers in Endeavour Energy's network

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<sup>1</sup> Australian Energy Market Commission 2016, *Draft Rule Determination, National Electricity Amendment (Retailer-distributor credit support requirements) Rule 2016*, p. iv

area accounted for 87%<sup>2</sup> of total revenue billed over the period October 2015 to November 2016. This represents a combined total average daily account payable for these four retailers of approximately \$2.6 million dollars.

Endeavour Energy acknowledges that in the 18 year history of the National Electricity market,<sup>3</sup> retailer default has been an infrequent event. However, this is an irrelevant consideration to assess the effectiveness of existing risk mitigation mechanisms to manage potential future events. This is because apart from an adverse systematic industry wide event, historic retailer defaults are independent to, and have no bearing on, the probability of future retailer defaults.

### **Distributor's inability to access short term funding in the event of a retailer insolvency event**

Further, contrary to the AEMC's views, distributors are similar to unregulated businesses in that they are unable to quickly access funds from either internal or external sources to overcome cash-flow shortages caused by retailer default and non-payment of network charges, without impacting on its costs, or risk / return characteristics. This is evident after evaluating the options available to distribution businesses to access alternative funding:

#### **1. Retailer insolvency cost pass-through provisions**

The protracted nature of the cost pass through request and approval process does not provide an effective regulatory mechanism for distributors to manage liquidity risk caused by a large retailer default. As noted in the AEMC's Draft Determination, actual recovery of unpaid network charges by a distributor under this approach can take multiple years after the insolvency event occurred.<sup>4</sup> This accounts for approximately 42% of revenue in the case of Endeavour Energy's largest retailer.

It is acknowledged that the retailer of last resort process will come into effect which will limit future unpaid network charges in the event that a retailer becomes insolvent.

The retailer of last resort process could be complemented by an expedited retailer insolvency cost pass-through process and a supporting AER guideline that explains the practical process to all market participants.

#### **2. Overs and unders**

Similar to the retailer insolvency pass through provisions, the overs and unders process is an ineffective regulatory mechanism to manage liquidity risk arising from a retailer default. At best, this mechanism would allow a distributor to collect un-paid network charges caused by a retailer default the regulatory year after the event occurred. This timeframe could be extended if the amount is deemed significant enough that it must be recovered over multiple regulatory years, as it would otherwise result in unacceptable annual price variations.

It is also conceivable that the overs and unders mechanism is removed altogether if a distributor is moved from a revenue cap to a price cap form of regulation. For example, while Endeavour Energy's Distribution Use of System (DUOS) revenue is under a revenue cap, our Alternate Control Service fee revenue (some of which is exposed to retailer default) is currently under a Price Cap form of regulation.

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<sup>2</sup> The largest retailer accounted for 42% of overall revenue.

<sup>3</sup> Australian Energy Market Commission & KPMG 2013, *National Electricity Market: A case study in successful microeconomic reform*, National Electricity Development timeline 1991-1998, p. 5

<sup>4</sup> Australian Energy Market Commission 2016, *Draft Rule Determination, National Electricity Amendment (Retailer-distributor credit support requirements) Rule 2016*, p. 11

### **3. Insurance**

As noted by the AEMC, it is difficult for distributors to access insurance products that fully cover retailer insolvency events, due to prohibitive premiums and / or excluded coverage.<sup>5</sup> Further, self-insurance is at the AER's discretion as part of the regulatory determination process and may not be available at the time of a retailer insolvency event. Therefore, both insurance options do not alleviate distributors' liquidity or systematic risk caused by potential retailer insolvency.

### **4. Corporate insolvency process**

Similar to insurance, the corporate insolvency process is a poor mechanism for distributors to manage liquidity risk from unpaid retailer accounts caused by an insolvency event, as it is protracted and uncertain. As described by the AEMC, there is no guarantee that a distributor would actually recover its debt in full or in part as the debt is unsecured and will only be paid if the secured debt has first been paid in full.<sup>6</sup>

### **5. Equity injection or an increase short term borrowing / gearing**

Requiring an equity injection or an increase in short term gearing to overcome a non-diversifiable retailer default event automatically decreases the return on equity and / or increases the business risk profile.

Further, Endeavour Energy is subject to short term debt covenants and borrowing limits that restrict its ability to guarantee short term cash flow in the event of a large retailer default.

Therefore, the existing regulatory mechanisms do not alleviate distributors' liquidity and systematic risk.

### **Recommendations**

The most effective solution to generate energy market confidence and financial stability is to ensure robust prudential requirements are in force for all market participants. This is evident in the Australian banking sector which largely avoided major insolvency events following the global financial crises, due largely in part to effective prudential requirements.

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<sup>5</sup> Ibid, p. 7

<sup>6</sup> Ibid, p. 9