

Definition of Retailer Insolvency Costs

Rule change request

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1. Name and address of rule change request proponent

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2. Description of the proposed rule change

This rule change request proposes to:

- (a) insert a definition of *retailer insolvency costs* in Chapter 10 of the National Electricity Rules (NER) and italicise that term where it appears in clause 6.6.1(l) and clause 6.6.1(l) of transitional Chapter 6 in Chapter 11 of the NER; and
- (b) insert a new limb to the definition of *positive change event* in Chapter 10 of the NER that provides that, for a distribution business, a *retailer insolvency event* is a *positive change event*. The effect of this amendment would be that *retailer insolvency events* would not be subject to the materiality threshold that is applied to other *pass through events*.

A draft of the proposed Rule is set out in the Schedule.

The reason for the proposal in (a) above is to correct a drafting error in the final drafting of the rules amending the NER for the implementation of the National Energy Customer Framework (NECF). The then Ministerial Council on Energy (MCE) (now the SCER) intended that this definition be a part of the initial rules implementing the NECF at its commencement on 1 July 2012, but it was omitted from the relevant amending rule, the *National Electricity (National Energy Retail Law) Amendment Rule 2012*. The SCER has concluded that this omission was in error and seeks to correct it by proposing a Rule change, to insert the relevant definition in the glossary set out in Chapter 10 of the NER.

The reason for the proposal in (b) above is that as part of the *National Electricity (National Energy Retail Law) Amendment Rule 2012* (NECF amendments) the definition of *positive change event* was amended to provide that a *retailer insolvency event* is a *positive change event*. It was intended by SCER that, unlike the approach to other types of pass through events, a *retailer insolvency event* would not be subject to a materiality threshold. However, as part of the *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 No.9* (Network Regulation Rule), amendments were made to the definition of *positive change event* to prescribe what pass through events will be considered material for the purposes of distribution and to reflect the inclusion of a contingent projects regime for distribution. As part of these amendments the limb of the definition of *positive change event* inserted as part of the NECF amendments was omitted. The determination for the Network Regulation Rule does not specifically refer to the reason for omitting this limb of the definition.

3. Background to the rule change request

National Energy Customer Framework

The National Energy Customer Framework consists of: the National Energy Retail Law (NERL);¹ the National Energy Retail Rules and National Energy Retail Regulations which are each made

¹ The NERL is set out in the schedule to the *National Energy Retail Law (South Australia) 2011* (SA).

under the NERL; and relevant amendments made to the National Electricity Law (NEL)² and NER³, and National Gas Law (NGL)⁴ and National Gas Rules.⁵

The legislative package to implement the NERL, consisting of the *National Energy Retail Law (South Australia) Act 2011 (SA)* and the *Statutes Amendment (National Energy Retail Law) Act 2011 (SA)* (the Statutes Amendment Act), included relevant initial rule making powers for the purposes of empowering the making of rules for the NECF. The initial set of rules for NECF, including the *National Electricity (National Energy Retail Law) Amendment Rule 2012* mentioned above, commenced on 1 July 2012.

NECF distribution credit support regime

The NECF contains as an integral part, a set of provisions regulating the financial relationship between retailers and distributors. These provisions are largely contained in the new Chapter 6B which was added to the NER.

In the contestable retail market, retailers must pay the distribution network charges associated with the customers for which they are financially responsible in the National Electricity Market. These network charges are the regulated charges under Chapter 6 of the NER for *direct control services*, and are the main source of revenue for distributors.

As these charges are substantial and paid in arrears, distributors have historically required guarantees to be provided by retailers that may be drawn on in the event that a retailer defaults on its network charges obligations. Retailers, however, have different risk profiles (in terms of the size of their customer base, magnitude of outstanding charges at any point in time, and risk of default). The nature of credit support requirements can be a substantial barrier to entry and competition to some retailers.

The intent of the Chapter 6B arrangements is to balance the need to ensure that distributors are able to recover the regulated charges set by the Australian Energy Regulator and ensure that investment and financing of networks is not threatened by the insolvency of a retailer, the need to ensure that credit support obligations do not pose an unreasonable barrier to entry for retailers, and the need to moderate any impact of the insolvency of a retailer on consumers.

The Chapter 6B arrangements therefore require retailers to provide guarantees against the *required credit support amount*, which is calculated as the retailer's *network charges liability* less a *retailer's credit allowance* which is set to reflect a judgment of an acceptable level of network charges at risk taking into account the total distributor revenues at risk and the risk of retailer default reflected in its credit rating.

The implication of this regime is that in the event of a retailer becoming insolvent, there may be outstanding network charges which are not fully covered by credit support guarantees provided by that retailer. This would most likely be the case if a retailer unexpectedly became insolvent despite a good credit rating.

The overall nature of these arrangements is taken as granted and not the subject of this rule change application.

Retailer insolvency pass-through

The Chapter 6B arrangements strictly regulate the manner and form in which distributors can require credit support to offset the risk of retailer default. The network regulatory pricing rules under Chapter 6 simultaneously strictly regulate monopoly distribution network charges on a non-discriminatory basis. The sum total of this regulation is that distributors are not at liberty to price

² The NEL is set out in the schedule to the *National Electricity (South Australia) Act 1996 (SA)*.

³ These Rules are made under the NEL.

⁴ The NGL is set out in the schedule to the *National Gas (South Australia) Act 2008 (SA)*.

⁵ These Rules are made under the NGL.

the risk of retailer default in network charges or vary from the credit support arrangements set out in Chapter 6B.

Clause 6.6.1 provides for network charges to be adjusted to account for positive and negative *pass through events* which represent an increase or decrease (as the case may be) of the costs of providing regulated services. The pricing regime embodied in Chapter 6, though, is intended to incentivise distributors to manage cost risks wherever possible rather than passing them through to consumers. Therefore, tests and constraints are placed around the use of pass-through applications under 6.6.1 (j).

As a distributor's capacity to manage retailer credit risks are so limited by Chapter 6B, the MCE considered it appropriate to clarify that, in the event of a distributor facing unpaid network charges by an insolvent retailer which are not recoverable by drawing on credit support provided by that retailer or by recovering them from the administrator of the insolvent retailer, a pass through application could be utilised to recover these charges directly from network users. Under these circumstances the pass through would not be subject to the materiality threshold that applies in respect of other types of pass through events.

It should be noted that the provisions of rule 6.6 largely anticipate the lodgement of pass through applications in relation to unexpected changes in *costs* faced by distributors. In the event of a retailer defaulting on its network payment obligations, however, what is faced by distributors is a sudden loss of *revenue*. The MCE considered that it would be appropriate to treat the revenue impact of a retailer insolvency as if it were an increase in costs for the purpose of these provisions, in either scenario reflecting that the costs of running the network and the revenues provided for under the AER's distribution determination, which are set to reflect the efficient costs of providing *direct control services*, have diverged. The responsible intergovernmental policy working group, the Retail Policy Working Group (RPWG), developed amendments to the proposed 'rules to be made' for NECF (previously published by the MCE in late 2010) to reflect the agreed policy mentioned above. The revised provisions were workshopped extensively with stakeholders by officials on the RPWG. An RPWG paper setting out the proposed provisions was circulated to distributors in April 2012 (see **Attachment A**). This paper detailed revisions to the 'rules to be made' for NECF also reflected further discussions with stakeholders.

The relevant provisions proposed by RPWG consisted of:

- Amendments to clause 6.6.1 including provisions relevant to a *retailer insolvency event*.
- Relevant definitions to be amended or inserted in Chapter 10 to support these amendments including:
 - Amendment of *pass through event* to include *retailer insolvency event*
 - Amendment of *positive change event* to include *retailer insolvency event*
 - Insertion of *retailer insolvency event*
 - Insertion of *retailer insolvency costs*

Initial and amending rules for retailer insolvency pass-through

The Statutes Amendment Act, mentioned above, provided that the South Australian Minister could make amending rules to the NER for the implementation of the NECF:

90D—South Australian Minister may make initial Rules relating to implementation of NERL and NERR

- (1) The Minister in right of the Crown of South Australia administering Part 2 of the *National Electricity (South Australia) Act 1996* of South Australia (the ***South Australian Minister***) may make Rules for or with respect to the following:
 - (a) retail support obligations between regulated distribution system operators and retailers;

- (b) credit support arrangements between regulated distribution system operators and retailers;
 - (c) connection services;
 - (d) any other matter consequential on the making of the *National Energy Retail Law* or the *National Energy Retail Rules* or on the application of that Law or those Rules in a participating jurisdiction.
- (2) The South Australian Minister may make Rules that amend the Rules made under subsection (1) for any purpose that is necessary or consequential on the application of the *National Energy Retail Law* or the *National Energy Retail Rules* in a participating jurisdiction.

The rules made by the South Australian Minister pursuant to this clause (see **Attachment B**) largely reflected the proposal put forward by the RPWG in its policy paper representing the 'final' rules to be drafted. However, they did not include the definition of *retailer insolvency costs* proposed by the RPWG.

Definition of 'retailer insolvency costs'

The definition of *retailer insolvency costs* was:

retailer insolvency costs

Amounts a *Distribution Network Service Provider* is entitled to be paid (but which are or will be unpaid as a result of a *retailer insolvency event*) for the provision of *direct control services* including the revenue impact a *Distribution Network Service Provider* sustains or will sustain as a result of those unpaid amounts.

The intent of this definition was to clarify, as explained earlier, the need for any unpaid network charges flowing from a *retailer insolvency event* to be treated as if they were costs for the purposes of rule 6.6.1. This flows then to 6.6.1(l) which provides for the calculation of the *eligible pass through amount* in the event of a *retailer insolvency event*.

The SCER considers it is arguable that the proper interpretation of rule 6.6.1 should, in any event, ensure that distributors are able to recover the appropriate amount by a pass through application. However, the SCER considers that the omission of the definition of *retailer insolvency costs* in the final NECF amending rules as made was in error and, to put the matter beyond doubt, proposes inclusion of the definition in Chapter 10 through a change to the rules.

Note: It is important to be aware that the other amended definitions of *pass through event* and *positive change event* have subsequently been further amended by the Australian Energy Market Commission as a consequence of the *National Electricity Amendment (Cost Pass through for Network Service Providers) Rule 2012* and the *Network Regulation Rule* respectively and no longer reflect the definitions as initially made by the *National Electricity (National Energy Retail Law) Amendment Rule 2012*. The amendments made by the *National Electricity Amendment (Cost Pass through for Network Service Providers) Rule 2012* is not considered to affect the merits of this proposed rule change. However, as indicated in 2. above, SCER officials consider that the removal of the limb of the definition of *positive change event* that provided that a *retailer insolvency event* is a *positive change event* means that the pass through provisions, as they apply to *retailer insolvency events*, do not have the operation intended by SCER. This is because the effect of omitting this limb of the definition is that a materiality threshold applies to *retailer insolvency events*.

4. Nature and scope of issues the rule change request will address

The rule change will:

- clarify what *retailer insolvency costs* consist of, by expressly defining this term in the NER, and thereby ensure that the operation of clause 6.6.1 with respect to *retailer insolvency events* is clear; and

- reflect the intention of SCER that *retailer insolvency events* are not subject to a materiality threshold (unlike other types of pass through events).

5. AEMO's declared network functions

The proposed rule will not affect the Australian Energy Market Operator's declared network functions.

6. Expected costs, benefits and impacts of the proposed rule

Benefits

The benefits of making this change are expected to be that the ability of distributors to recoup unpaid network charges in the event of a retailer becoming insolvent is clear. Clarity about the ability of distributors to recoup the network charges which are set by the AER under Chapter 6, despite the default of a retailer, will make plain that the distributors are not subject to an uninsurable risk and give confidence to the businesses and their financial backers about the risk exposure of these businesses. This is in keeping with the general regulatory framework set out in Chapter 6 of the NER, which aims to ensure that network revenues cover the efficient costs of providing direct control services.

Costs

The proposed rule clarifies that in the event of a retailer becoming insolvent, that unpaid network charges which cannot be covered by credit support provided by retailers or are otherwise recoverable, will be recovered from end use customers by adjustment of network tariffs via a pass through application. The impact is consequently higher network prices. However, this is the logical consequence of putting in place a credit support regime which does not require higher prices of customers up front (particularly customers of smaller, higher risk retailers) in the form of credit support guarantees against a retailer's full *network charges liability* and which, in so doing, pose a barrier to entry to retailers and impacts on retail market competition which is to the benefit of consumers. Taking the credit support arrangements of Chapter 6B as read and reflecting the judgment of the MCE that this regime best achieved the National Electricity Objective, clarifying the nature of *retailer insolvency costs* and providing that *retailer insolvency events* are not subject to a materiality threshold, by expressly defining that term in the NER, is not expected to have any costs.

7. Summary of consultation

The rules concerning retailer insolvency cost pass through provisions were extensively consulted upon through exposure drafts of the NECF in 2009 and 2010 leading to the publication of "rules to be made" by the MCE in October 2010. Further amendments to the "rules to be made" prior to the actual making of rules by the South Australian Minister were extensively workshopped with affected stakeholders by the RPWG in 2011 and 2012 and are reflected in **Attachment A** which reflects the outcome of these discussions.

Schedule - Proposed Rule

- [1] In each of clause 6.6.1(l) and clause 6.6.1(l) of transitional Chapter 6 in Chapter 11, omit “*retailer insolvency costs*” and substitute “*retailer insolvency costs*”.
- [2] In Chapter 10, substitute the following definition:

positive change event

For a *Distribution Network Service Provider*:

- (a) a *pass through event* which entails the *Distribution Network Service Provider* incurring *materially* higher costs in providing *direct control services* than it would have incurred but for that event, but does not include a *contingent project* or an associated *trigger event*; or
- (b) a *retailer insolvency event*.

For a *Transmission Network Service Provider*, a *pass through event* which entails the *Transmission Network Service Provider* incurring *materially* higher costs in providing *prescribed transmission services* than it would have incurred but for that event, but does not include a *contingent project* or an associated *trigger event*.

- [3] In Chapter 10, insert the following new definition:

retailer insolvency costs

Amounts a *Distribution Network Service Provider* is entitled to be paid (but which are or will be unpaid as a result of a *retailer insolvency event*) for the provision of *direct control services* including the revenue impact a *Distribution Network Service Provider* sustains or will sustain as a result of those unpaid amounts.