26 November 2015

Shari Boyd
Australian Energy Market Commission
PO Box A2449
Sydney South NSW

By email

Dear Shari

RESPONSE TO AUSTRALIAN ENERGY MARKET COMMISSION'S OPTIONS PAPER

1. Alinta Energy ("**Alinta**") appreciates the opportunity to submit its views on the Australian Energy Market Commission's ("**AEMC**") recent Options Paper ("**Options Paper**").

2. Alinta is both a generator and retailer of electricity and gas in the east and west coast energy markets. It has over 2500MW of generation facilities, and in excess of 750,000 customers (including 150,000 in east coast markets). Accordingly, as a "tier-two" retailer on the east coast, Alinta takes a significant interest in the AEMC's proposed rule-change.

3. Alinta recognises, and appreciates, the additional effort the AEMC has undertaken in extending the timeframe for consultation, and developing the range of options set out in the Options Paper. Having considered the Options Paper, Alinta submits that:

   a. there needs to be a demonstrable case, grounded in a strong cost-benefit analysis, for the AEMC to depart from the established status quo;
   b. where such a justification does exist, any alternative options must be assessed against their ability to promote the National Electricity Objective ("**NEO**") and the National Gas Objective ("**NGO**");
   c. any alternative option should also promote effective competition in retail markets. Dependency on credit ratings to inform potential options is not consistent with effective competition and may be inappropriate given the limitations of credit ratings;
   d. if the AEMC must depart from the status quo, Alinta submits that Option 2.1 is the Alinta's first preference, and Option 4.1 is the 'second-best' option.
   e. Alinta submits that Option 2.1 (with enhancements to the regulatory framework for recovering foregone revenue) is the most cost-effective solution and will produce competitive outcomes. With minor enhancements to the regulatory

framework Option 2.1 is also capable of managing the liquidity risk to distributors. As a second option, Option 4.1 provides a market-based solution which will also promote efficient and pro-competitive outcomes.

4. If you have any questions concerning this submission please contact me on (02) 93750968 or by email at john.philipson@alintaenergy.com.au

Yours sincerely

John Philipson
Regulatory Compliance Advisor
Alinta Energy

Retain the status quo

5. Alinta strongly supports the retention of the current credit support arrangements. Alinta believes a compelling justification, or a significant benefit to the long term interests of consumers (not just larger retailers), must be demonstrated in order to depart from a system which is currently adequately managing the default risk for distributors. Crucially, the benefit of any particular option must outweigh the costs of implementation associated with that option.

6. The combination of the existing mechanisms available (the retailer insolvency cost pass through, overs and unders process and the corporate insolvency process) can be adequately relied on to recover foregone revenue in the event of a retailer default. These arrangements have worked well to date and there is a lack of evidence to suggest that they are inadequate.

7. AGL's submission that its proposed rule change will "reduce costs to retailers of providing retail services, which will result in lower prices for consumers",[1] is not true for Alinta. In fact, Alinta's costs, and therefore prices for consumers, would significantly increase under AGL's proposal. From discussions Alinta has had with other similarly sized retailers, Alinta understands it is not unique in this regard. On this basis, the AGL proposal is better understood as "shifting" the costs to smaller retailers, "reducing" the costs for large retailers and increasing the costs for certain sections of consumers.

8. These operating costs for Alinta would be in addition to the general costs of implementing any new regulatory proposal and would ultimately be borne by consumers. Potential costs to industry could include:

    a. development of new regulatory instruments;
    b. notification and enforcement of new requirements;
    c. procedural changes;
    d. record keeping and resourcing costs for retailers such as Alinta; and
    e. transitional costs for industry and the AEMC.

9. When these total costs are taken into consideration, it becomes clear that the adoption of any new proposal will result in increased costs for retailers. Put another way, departure from the status quo will result in significant cost increases for consumers for arguable benefit. Where the costs of any such proposal exceed any benefit, it is clear that additional regulation is unnecessary and inefficient.

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[1] See page 3 of the Options Paper.

Promoting the NEO and NGO should be the AEMC's primary consideration

10. While it is of course important to compare the potential options against each other, ultimately the extent to which the options promote the NEO and NGO should be a primary consideration for the AEMC. Similarly, while the AEMC's stated design mechanism principles remain relevant, the NEO and NGO should remain the important "backstop" for any option considered by the AEMC.

11. Under the National Electricity Law ("**NEL**"), the AEMC has a statutory obligation to "have regard to the national electricity objective" when exercising any function or power under the NEL.[2] A similar obligation applies to the AEMC for gas.[3] In this way, the NEO and NGO provide an important safeguard, or frame of reference for any proposed rule change (or in this case choice of a potential option).

12. For this reason, Alinta's view is that the NEO and NGO should be crucial considerations in the choice of any option set out by the AEMC.

13. The NEO provides that:

> To promote **efficient** investment in, and **efficient** operation and use of, electricity services for the long term interests of consumers of electricity with respect to –
>
> (a) Price, quality, safety, reliability and security of supply of electricity; and
> (b) the reliability, safety and security of the national electricity system…
>
> **[emphasis added]**

14. There is a clear emphasis in the NEO (and NGO) on promoting efficient outcomes. In discussions with the AEMC, the AEMC has clarified that the efficiency referred to in the NEO is "dynamic efficiency" (ongoing efficiency) and should not be limited to the concept of "static efficiency". Alinta agrees with this approach, and has taken this interpretation when assessing each of the options put forward in the Options Paper.

15. Assessing the proposals against the concept of dynamic efficiency raises interesting issues. For example, as discussed below, proposals based on credit rating will drive negative competitive effects and are likely to deliver poor dynamic efficiency gains for the market (and the consumer). Under these circumstances consumers are incentivised to aggregate with retailers with a higher credit rating in the National Electricity Market ("**NEM**") – ie the big three (with incumbent market share). In our view, this illustrates the primacy of promoting effective competition *as a means of* achieving the NEO and NGO. We acknowledge the inclusion of

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[2] See section 32 of the National Electricity Law
[3] See Part 2, Division 1, section 72 of the National Gas (South Australia) Act 2008.

competitive principles in the AEMC's design mechanism principles, and contend that it is the crucial consideration for the AEMC when assessing each option.

Options should promote competition in retail markets

16. In Promontory's report it identified that only Option 1, 2.1 and 4.1 met the AEMC's competition principle.[4] This highlights the fact that any of the proposals in the Options Paper premised on credit ratings will create inequitable outcomes across retailers.

17. For example, where larger retailers with higher credit ratings provide smaller amounts of credit-support (or in the case of the AGL proposal – no credit support) and smaller retailers are required to provide more credit support, this will create a significant competitive advantage (or disadvantage). Similarly, requiring a smaller retailer to provide increased credit support will in practice cost smaller retailers more than it would larger retailers. The cost of providing this increased credit support will ultimately be borne by the consumer. Accordingly, Alinta and other smaller retailers will be at a significant competitive disadvantage to larger incumbent retailers under a proposal premised on credit-worthiness.

18. Alinta notes that in the AER's recent Annual Performance Report it stated that the "big three" retailers already command a significant market share (91% of electricity in NSW, 77% of electricity in South Australia).[5] It is hard to reconcile how proposals premised on credit ratings, which affect smaller retailers disproportionately and create an additional artificial benefit for larger retailers, could work to improve competition and outcomes for consumers. In reality, this competitive disadvantage could reduce the level of consumer choice, creating a barrier to new retailers hoping to expand their retail businesses. Such outcomes would be contrary to the NEO, NGO and the AEMC's stated competition design mechanism principle.[6] Further, it would also be inconsistent with the AEMC's identified indicators of effective retail competition – that is, the number and range of offers, and market entry and expansion.[7]

19. In Alinta's view the current status quo already produces good outcomes for consumers in the market. The affordability of electricity has increased across all National Energy Customer Framework ("**NECF**") jurisdictions except, for Queensland, which indicates a healthy level of competition across NECF jurisdictions.[8] Seventeen electricity retailers now compete in New

[4] *Principles and Options for Managing Retailer Default Risk,* Promontory Australasia, at p. 78.
[5] *Annual Report on the Performance of the Retail Energy Market 2014 – 15,* Australian Energy Regulator, released Monday 23 November 2015 at p 5.
[6] See p 17 of the Options Paper – the "Assessment Framework".
[7] AEMC 2016 *Retail Competition Review, Approach Paper*, 22 October 2015.
[8] *Annual Report on the Performance of the Retail Energy Market 2014 – 15,* Australian Energy Regulator, released Monday 23 November 2015 at p 5.

South Wales, with fourteen competing in South Australia.[9] Proposals based on credit risk unnecessarily threaten these good outcomes.

20. As outlined above, it is statutorily mandated that the AEMC when exercising its functions must do so to promote efficiency in the long-term interests of consumers. It is hard to reconcile this statutory requirement against any proposal which would increase costs for smaller retailers, reduce the effective competition between larger and smaller retailers, and also ***increase*** the prices for a significant section of the consumer market. Understandably, it is hard for Alinta to accept any such competitive disadvantage, or the removal of a level playing field.

21. In Alinta's view, the current arrangements apportion risk management to those retailers who are at most risk of causing systemic failure in a network or distribution area. Accepting any proposal largely premised on credit risk reduces (or removes) the emphasis on contagion or system risk. However, as outlined above, given the large market share[10] of the big three retailers, systemic failure remains a real risk. In fact, accepting any proposal premised on credit-worthiness will result in inefficient outcomes requiring smaller retailers with much smaller market share to shoulder an inequitable portion of the burden compared with larger retailers who pose a greater risk for system wide default.

22. In any event, Alinta also holds reservations about the appropriateness of using credit ratings to form the premise of credit-support proposal. Dependency on credit ratings could create a bias against smaller retailers.

23. The formal credit rating process of Moody's and S&P explicitly uses size/scale as an input into its rating methodology, with smaller companies assigned a detriment to their rating simply because they are small.

24. This provides a clear advantage to larger corporations based on a factor that is out of the direct control of the smaller corporation. Alinta believes, in addition to the competitive concerns raised above, this bias provides an additional reason why credit ratings should not be the driving factor behind any particular option.

25. Alinta also notes that the Promontory Report at various stages references the ability of some of the options to influence a retailer's behaviour in managing its credit rating. Speaking only from Alinta's perspective, Alinta already has enough incentives to maintain its credit rating **independent** of any proposed credit support regime. A retailer's creditworthiness has a direct impact on a retailer's wholesale market and trading activities, and it is a requirement to

[9] *Annual Report on the Performance of the Retail Energy Market 2014 – 15*, Australian Energy Regulator, released Monday 23 November 2015 at p 5.
[10] See paragraph [18] above.

retain retail authorisations. It is unlikely that the development of any proposal with the intention to influence retailers' credit behaviour would have any additional effect.

26. Such statements also imply that retailers have some degree of control over the credit rating process. While this statement is true to an extent, there are a myriad of factors that the retailer cannot control (for example size factors – as discussed at paragraph [23]). For this reason, and the reasons identified above, Alinta does not believe that a policy based on credit-worthiness, with the intention of influencing retailer behaviour, will necessarily deliver equitable outcomes.

Alinta's preferred options

27. If the AEMC must depart from the status quo, Alinta submits that Option 2.1 (with minor enhancements) would be Alinta's first preference. Alinta's second preference would be Option 4.1.

28. Alinta supports Option 2.1 for three main reasons:

    a. while Alinta supports the retention of the status quo, Option 2.1 has the potential to reduce the long-term costs (and prices) for consumers. Removal of the current credit-support regime would certainly reduce costs for retailers. These costs have been well documented in the submissions of AGL and also in the Options Paper.
    b. because Option 2.1 is not premised on credit-ratings, it creates a level playing field, does not reduce effective competition in the retail market and is consistent with the NEO and NGO. Further, the removal of all credit support arrangements (and the costs of providing them), removes a significant barrier to entry for potential new entrants into the retail market, further promoting competitive outcomes.
    c. Alinta considers the likelihood of retailer default as inverse to the expected level of financial impact to the NEM. Put another way, while the failure of a large retailer could result in a large financial impact, the likelihood of the event is low.[11] For this reason, Alinta supports Option 2.1 as the most cost-efficient (in terms of ongoing cost) in achieving risk mitigation.[12]

[11] Indeed we note that Promontory in its report acknowledges that it has "limited knowledge" of historic retailer default, see page 81 of the Promontory Report.

[12] Option 2.1 is particularly cost-efficient and will result in the lowest possible impact on the end-consumer. This view is consistent with the findings in the Promontory Report, which found that Option 2.1 would impose the lowest ongoing cost to electricity and gas consumers.

29. Alinta recognises that Option 2.1, as drafted, does not address the liquidity risk faced by distributors. Under the proposal distributors must wait to pass foregone revenue through to their respective regulatory revenues.

30. In preparing this submission, Alinta has had the benefit of reading Lumo/Red Energy's submissions on this point. We support Lumo/Red Energy's submission to enhance the current regulatory arrangements to permit a distributor to start collecting the approved cost pass through amount immediately following an approval by the Australian Energy Regulator. We also support the specific changes to the regulatory framework set out in the Lumo/Red Energy submission.

31. In Alinta's view this enhancement would remove the need for Option 4.1, preventing the costs to consumers associated with retailers paying for establishment, commitment, and utilisation fees.

32. In the alternative, Alinta recognises that Option 4.1 could also mitigate the liquidity risk associated with retailer default, in addition to managing the distributor's credit risk. A liquidity support scheme which requires the distributor to establish a facility with a financial institution has a number of advantages from Alinta's perspective:

    a. it would utilise the distributor's strong credit rating (reflecting its regular source of regulated revenue), allowing the distributor to potentially acquire the facility at a lower cost than if the AEMC was to rely on a number of retailers (with varying credit ratings) to provide the equivalent credit/liquidity support (for example as part of a retailer default fund under Option 3). This in turn means a lower cost for the consumer and more efficient outcomes in line with the NEO and NGO.
    b. it addresses the liquidity risk, and retains the ability for the distributor to pass the costs through in to its total allowable revenue as part of its operating expenditure.
    c. it removes the need for any complex regulatory regime to assess the amount of funding required in relation to any identified risk required (ie Option 3) – instead allowing the market to calculate the most appropriate facility for the identified liquidity risk.

33. Alinta concludes that, unless the AEMC can provide a demonstrable case that shows the benefits of a proposal exceed the identified costs, the status quo should be retained. Where the AEMC believes that the status quo should not be retained, Alinta submits that Option 2.1 is the option most consistent with NEO and NGO. Option 2.1 also promotes competitive outcomes, and as such is Alinta's first preference. In the alternative, Alinta would support Option 4.1 as a market-led, low cost alternative.