11 December 2014

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

AEMC's Consultation Paper: National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015 (ERC0172)

Energex Limited (Energex) appreciates the opportunity to provide a submission on the Australian Energy Market Commission's (AEMC) consultation paper on amending the National Electricity Rules (the Rules) to allow distribution network service providers (DNSPs) to recover the entirety of their unpaid retail bills through the cost pass through arrangements. The changes proposed by the AEMC include:

- The costs associated with a retailer insolvency event to be passed through without being subject to the materiality threshold.
- A new definition for retailer insolvency costs to be inserted in the Rules to allow DNSPs to use the cost pass through mechanism to recover unpaid revenue, and not just the relevant additional costs incurred.

Energex's responses to the issues raised by the AEMC in the consultation paper are provided in **Attachment 1**.

Energex strongly supports the proposed rule changes for the following reasons:

- It will correct a drafting inconsistency in the Rules.
- It will provide DNSPs with greater revenue certainty following retailer insolvency events.
- Purchasing commercial insurance is costly and therefore considered less preferable.

Energex is of the view that the proposed amendments to the cost pass through arrangements should not be considered in isolation, and suggests that the credit support arrangements under the National Electricity Customer Framework (NECF), which will be implemented in Queensland from 1 July 2015, be reviewed as they place too great an emphasis on retail competition, resulting in reduced protection for DNSPs.

Energex has also contributed to the Energy Networks Association's (ENA) submission and is supportive of the views contained therein.

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Yours sincerely

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Attachment 1

Question 1: Allocation of risk

Is it appropriate for retailer credit risk to be reallocated from DNSPs to customers under the current regulatory framework? Is there a more appropriate way to allocate this risk?

Energex is of the view that the current regulatory framework fails to either allocate retailer credit risk to those who can best manage it (the retailers), or to provide the adequate means to manage such risk to those who are bearing it (the DNSPs). For these reasons, Energex is strongly supportive of the proposed changes to the cost pass through arrangements relating to retailer insolvency, in particular the removal of the materiality threshold, as they will address some of Energex's concerns. This is further examined below.

Allocation of credit risk to retailers

Credit support requirements between a DNSP and a retailer are defined in Chapter 6B of the Rules and are intended to balance the need to safeguard the commercial interest of DNSPs and the need to support full retail competition (FRC). The AEMC, in its consultation paper, states that "the arrangement to limit the amount of credit support is aimed at safeguarding against the possibility that DNSPs set the amount of credit support at such a level that it could potentially create a barrier to entry into the retail electricity market".[1] The AEMC also adds that "while the NER allows DNSPs to require credit support from retailers, it also regulates when it may be used and how it is calculated. This may lead to an outcome where the available credit support may be insufficient to cover all of the credit risk to which a DNSP is exposed".[2] Energex would go even further and suggest that the current credit support arrangements are inadequate and do not safeguard DNSPs from retailer credit risk.

Indeed, applying the credit support methodology set out in the Rules, Energex does not hold any credit support from any of the 26 retailers with whom Energex has contractual arrangements. Energex is therefore of the view that the current regulatory framework leans too much in favour of retailer competition by placing too great an emphasis on supporting FRC, thereby transferring the risk from retailers to DNSPs.

Allocation of credit risk to DNSPs

In considering potential options to mitigate the risk arising from the application of a materiality threshold to all cost pass through events, the AEMC has identified the creation of an ex ante insolvency allowance or setting up a self-insurance provision.[3] Energex is of the view that these options are not necessarily available to DNSPs for the following reasons:

- Creation of a separate ex ante retailer insolvency allowance –The scarcity of historical information available combined with the wide variety of retailer risk profiles would make it difficult to accurately estimate future potential losses. This would ultimately result in the DNSP being under- or over-compensated. As a result this option is not considered efficient.
- Setting up a self-insurance provision – This option applied to retailer insolvency risk does not meet the AER's criteria for assessing self-insurance allowances. To be covered by self-insurance, a risk event must be predictable and with losses

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[3] Australian Energy Market Commission, National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015, 30 October 2014, p.9 and p.20

measurable so that it is possible to estimate an amount (a premium) that needs to be allocated to pay for future uncertain losses.[4]

Energex is of the view that neither option is likely to be approved by the AER under the existing regulatory framework, demonstrating that DNSPs have limited means of mitigating retailer credit risk. Because of these limitations and the inadequacy of the credit support arrangements, Energex disputes the view that "DSNPs, as corporate bodies with regulated revenues and access to financial services, may have a greater capacity to absorb these short-term losses compared to their customers".[5] This issue is further compounded by the legislative requirement on DNSPs to provide network services to retailers regardless of their credit worthiness.

Allocation of credit risk to an external commercial insurance provider

In 2009, as a direct result of Jackgreen becoming insolvent, Energex found that its exposure to retailer insolvency risk did not align with its risk appetite, being that "Energex will manage risk in the pursuit of balanced commercial outcomes to a level that is 'as low as reasonably practical' within business constraints".[6]

In the absence of effective options available under the current regulatory framework, external insurance was considered as the most viable mechanism available to Energex in mitigating the rare and yet real risk of a retailer becoming insolvent. In the context of limited credit support to draw on, Energex was particularly concerned about the loss of cash flow resulting from retailer failure and the impact of the funding costs required to access considerable liquidity. In purchasing credit insurance policies, Energex elected to transfer some of the financial risk associated with retailer insolvency to an external insurance provider

This option has, however, limitations, namely:

- External insurance policies do not ensure full recovery of the revenue foregone;
- External insurance is costly; and
- Costs are passed on to customers irrespective of whether an event occurs.

The costs associated with the credit insurance premiums are incorporated in Energex's forecast operating expenditure allowance in its regulatory determination and recovered annually from customers over the five-year regulatory control period even if a retailer event does not occur.

Allocation of credit risk to customers

Under the current regulatory framework, credit risk can be allocated to customers through the pass through mechanism in so far as the revenue foregone to be recovered exceeds the materiality threshold (i.e. one per cent of a DNSP's annual revenue requirement per event in each year the costs are incurred). Assuming no other mitigation strategy is in place, this mechanism leaves the DNSP significantly exposed to retailer credit risk for the costs below the materiality threshold (approximately $18 million in the case of Energex). In circumstances where multiple retailers become insolvent during any year (each retailer constituting a separate event), the losses to the DNSP can be significant and can leave the entity financially exposed.

As discussed above, given the emphasis placed on FRC under the current credit arrangements and given the restrictions in DNSPs' ability to reallocate retailer credit

[4] Australian Energy Regulator, Draft Decision – Appendices, Queensland Draft Distribution Determination 2010-11 to 2014-15, November 2009, p.694.

[5] Australian Energy Market Commission, National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015, 30 October 2014, p.9 and p.15.

[6] Energex, Enterprise Risk Management – Risk Management Overview, November 2013.

risk to retailers, and the limited options available to DNSPs in managing that risk, Energex is of the view that it is appropriate for a DNSP to allocate that risk across its broad customer base.

This issue is also discussed in response to Question 3 in which Energex expresses its support for the removal of the materiality threshold.

Question 2: Recovery of revenue

(a) Is it appropriate to recover revenue foregone resulting from retailer insolvency through the cost pass through mechanism?
(b) What distinguishes retailer insolvency events from other pass through events that would justify the recovery of revenue, rather than just costs?
(c) Has the level of risk faced by DNSPs increased, or changed, such that allowing recovery of revenue in the manner proposed is warranted?

(a) Is it appropriate to recover revenue foregone resulting from retailer insolvency through the cost pass through mechanism?

As discussed previously, Energex considers that DNSPs have a limited range of options available to recover revenue foregone. These options include:

- Creation of a separate ex ante retailer insolvency allowance – this option is not considered efficient and unlikely to be accepted by the AER.
- Setting up a self-insurance provision – this option applied to retailer insolvency risk does not meet the AER's criteria.
- Use of external insurance – this option can be expensive and does not cover the entirety of the DNSP's revenue at risk. It is recovered from customers through the distribution charges, even if a retailer event does not occur.

Considering the limitations in these options, Energex is of the view that a pass through mechanism without a materiality threshold is the most efficient mechanism for the recovery of revenue foregone resulting from retailer insolvency for the following reasons:

- It would not rely on inaccurate estimation of future losses as a result of limited and uncertain information available;
- It would enable the DNSP to recover the exact revenue foregone only as a result of a retailer insolvency event;
- It would enable the DNSP to spread the risk across its broad customer base; and
- It would provide revenue certainty to DNSPs.

Notwithstanding Energex's support for the recovery of revenue foregone through a retailer insolvency pass through mechanism, Energex shares Ausgrid's concern that, depending on the magnitude of revenue at risk, the time taken to complete the cost pass through process (approximately 11 months) may result in considerable cash flow shortages, making it difficult for the DNSP to meet its obligations.[7] Therefore, Energex considers it essential that the credit support arrangements between DNSPs and retailers be reviewed so that DNSPs could have immediate access to reasonable levels of credit support following a retailer becoming insolvent.

[7] Ausgrid, Response to AEMC's consultation on NEM financial market resilience, 20 December 2012, p.3.

(b) *What distinguishes retailer insolvency events from other pass through events that would justify the recovery of revenue, rather than just costs?*

What distinguishes retailer insolvency events from other pass through events is that the failure of an insolvent retailer to pay outstanding network charges does not represent an increase in the cost of providing direct control services. Under the current regulatory arrangements, the revenue foregone as a result of a retailer insolvency event would not satisfy the definitions of "positive change event" and "materially", and may not be eligible for recovery under the pass through arrangements.

Energex also notes that the proposed rule changes do not specify whether the recovery of revenue foregone by DNSPs includes transmission related charges. Payment and recovery of transmission related charges follow different processes. Energex pays the charges to Powerlink and separately recovers them through its distribution charges consistent with the Energex pricing methodology. Should a retailer become insolvent, Energex would have to pay transmission related charges while not being able to recover them from the insolvent retailer.

For the sake of greater clarity, Energex supports the insertion of a new definition for retailer insolvency costs to allow for the recovery of revenue foregone and requests that the issue of the transmission related charge recovery be clarified.

(c) *Has the level of risk faced by DNSPs increased, or changed, such that allowing recovery of revenue in the manner proposed is warranted?*

The level of risk faced by DNSPs has increased with more retailers enter the market as a result of FRC, resulting in increased levels of risk exposure. The proposed amendments to the pass through arrangements are therefore welcome by Energex.

Question 3: Removal of the materiality threshold

Is it appropriate to remove the materiality threshold for considering pass throughs resulting from retailer insolvency events?

Energex considers that it is appropriate to remove the materiality threshold for pass through applications resulting from retailer insolvency events.

The imposition of a materiality threshold in the context of a retailer insolvency event was inadvertently included during the amendments to the NER to include the current definition of a positive change event.[8] A positive change event in Chapter 10 of the current NER is defined as:

For a Distribution Network Service Provider, 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.

The definition does not differentiate retailer insolvency events from other pass through events and applies a one percent materiality threshold automatically to all events. This does not accord with the original policy intent of the cost pass through provisions under the National Energy Customer Framework (NECF).

[8] Standing Council on Energy and Resources, Rule change request – Definition of Retailer Insolvency Costs, March 2014, p.2.

Energex notes the comments made by the Joint Implementation Group when coordinating the implementation of NECF by participating jurisdictions:[9]

The policy rationale for the retailer insolvency pass-through is an economic one. Distributors are unable to manage the risk of retailers defaulting on payment of their network charges (due to the regulated credit support regime, and the obligation to supply distribution services to all retailers).

Further, Energex understands that the rationale for applying a materiality threshold to the pass through mechanism is, inter alia, to incentivise DNSPs to manage as much as possible the costs of events that are not forecast. However, it is widely recognised that DNSPs have limited scope in managing revenue foregone resulting from a retailer insolvency event.[10] The presence of a materiality threshold to the cost pass through mechanism is to "incentivise distributors to manage the cost of events that aren't forecast but arise through the normal course of doing business in the energy sector. Distributors have no ability (again, for the reasons above) to manage the 'costs' of unpaid network charges. So the policy position is that no materiality threshold applies".[11]

Under the current pass through arrangements, Energex is unable to recoup from its customers the unpaid network charges that are owed by the retailers unless those unpaid charges amount to approximately $18 million (equivalent to one per cent materiality when applied to Energex).

It is noted in the AEMC's consultation paper that, in proposing the removal of the materiality threshold for retailer insolvency events, "the COAG Energy Council has sought to address the current limitations and clearly provide DNSPs with a mechanism to manage retailer insolvency risks".[12] Energex agrees with this statement and the COAG's intention. However, the removal of the materiality threshold is not sufficient on its own as it does not deal with the cash flow issue DNSPs may face in cases of retailer failure. As previously discussed, Energex has been using external insurance to mitigate some of its exposure to this risk.

Question 4: Recovery through credit support

Do the current credit support arrangements provide a sufficient means of managing the retailer credit risk faced by DNSPs? If not, would strengthening these arrangements lead to a more efficient or more appropriate outcome than amending the cost pass through provisions as proposed?

Energex notes that in the consultation paper, the AEMC states that "while the NER allows DNSPs to require credit support from retailers, it also regulates when it may be used and how it is calculated. This may lead to an outcome where the available credit support may be insufficient to cover all of the credit risk to which a DNSP is exposed".[13]

As at 31 October 2014, 26 retailers owed network charges to Energex, representing a total outstanding liability of almost $460 million calculated as per the network charge

[9] Joint Implementation Group, National Energy Customer Framework – Implementation issue no.0001: Retailer insolvency event and pass through, 8 February 2012.
[10] Ibid.
[11] Ibid.
[12] Australian Energy Market Commission, Consultation Paper - National Electricity Amendment (Retailer Insolvency events – cost pass through provisions) Rule 2015, 30 October 2014, page 4.
[13] Australian Energy Market Commission, Consultation Paper - National Electricity Amendment (Retailer Insolvency events – cost pass through provisions) Rule 2015, 30 October 2014, page 6.

liability method in the Queensland Electricity Industry Code.[14] Of the 26 retailers, 6 owed an amount greater than $18 million (Energex's one per cent materiality threshold); the remaining 20 individually owed Energex up to $12 million in unpaid network charges, and about $62 million in combined charges. Currently, in the event of any of these retailers becoming insolvent, Energex would not be able to draw on any credit support, even though two have below average credit ratings. This could represent a significant cash flow exposure for Energex.

Energex notes that concerns about this issue were previously communicated to the Queensland Competition Authority (QCA) when it undertook a review of the credit support arrangements to align with the NECF in 2010. Comments made by Energex and Ergon regarding the adoption of the NECF arrangements included:[15]

- It is highly unlikely that retailers with a credit rating lower than BBB- (who were required to provide credit supports under the previous arrangements) would need to do so under the proposed NECF arrangements;
- The proposed NECF arrangements would reduce levels of protection for distributors and ultimately would increase market costs;
- The proposed NECF arrangements did not provide distributors with a reasonable level of protection from retailer credit risk;
- The credit allowance percentages used under the proposed NECF were untenable from a risk management perspective; and
- Reliance on Dun & Bradstreet Dynamic Risk Score would not reflect the true risk of a retailer new to the market and with a lack of sufficient trading history.

With experience obtained since the QCA review, Energex is of the view that the concerns expressed in 2010 still hold and are even more relevant given the arrival in the Queensland market of a significant number of new retailers who represent a higher commercial risk. Also, Energex is not convinced that the Dun & Bradstreet Dynamic Risk Score is a reliable and accurate predictor of retailer credit risk. The affordability of the Dun & Bradstreet model makes it attractive to small retailers who also are the most risky. It is therefore concerning that the credit support arrangements place such reliance on this tool. Energex is of the view that, at a minimum, the percentages used to calculate a retailer's credit allowance should be recalibrated downward to account for what Energex perceives to be shortcomings with using the Dun & Bradstreet Dynamic Risk Score.

Finally, Energex believes that the absence of any credit support could, as Ausgrid stated, ultimately result in a "a perverse outcome and a significant moral hazard if the retailer's risk appetite, hedging or management shortcomings are transferred to other market participants".[16] This is considered an undesirable outcome that needs to be addressed.

[14] The credit support arrangements in the Queensland Industry Code align with the NECF which will be adopted from 1 July 2015.

[15] Energex and Ergon Energy's submissions re. Queensland Competition Authority's Draft Decision – Review of Credit Support Arrangements – September 2010, 15 October 2010.

[16] Ausgrid, Response to AEMC's consultation on NEM financial market resilience, 20 December 2012, p.3.

Question 5: Recovery through the regulatory determination process

Does the relative certainty, and smoothness, of recovery through the regulatory determination process outweigh the potential inefficiencies? Should DNSPs have the discretion to use this approach?

Given the difficulty in determining an efficient ex ante retailer insolvency allowance for inclusion in the regulatory determinations, it is difficult to envisage the benefits of the recovery through the regulatory determination process outweighing the potential inefficiencies. Likely scenarios include DNSPs potentially being significantly undercompensated or overcompensated overtime, with neither scenario being desirable for DNSPs and customers respectively. In relation to reducing price shocks, DNSPs can always work with the regulator to smooth out the pass through amount after an insolvency event has occurred and the exact amount determined.

Question 6: Recovery under the cost pass through mechanism

Is use of the cost pass through mechanism an appropriate approach to managing the risk of retailer insolvency events?

Please refer to responses to Questions 1, 2(a), and 3.

Question 7 Recovery through the corporate insolvency processes

Do the current processes under the NER and corporate insolvency procedures provide adequate clarity and certainty for DNSPs seeking to recover costs and foregone revenue from a retailer insolvency event?

Jackgreen was suspended as a market participant by AEMO in December 2009. Energex registered as a creditor under the insolvency process set out in the Corporations Act. In November 2010, Energex submitted an informal Proof of Debt, and finally in September 2011 received less than 4 cents out of each dollar of the bad debt.

As demonstrated above, there is a high level of uncertainty involved in the lengthy corporate insolvency processes compared to the processes set out under the NER. Energex is of the view that the processes under the NER should therefore proceed independently of the corporate insolvency process.

To prevent double recovery of costs, it is suggested that two distinct pass through events be defined, i.e. a positive pass through for the foregone revenue and a negative pass through for amounts recovered through the corporate insolvency process. This would ensure that DNSPs are neither better nor worse off.

The above example also demonstrates that the insolvency processes under the Corporations Act do not safeguard DNSPs against the financial risk they are exposed to in the case of retailer failure.