21 December 2016

Mr John Pierce
Chairman
Australian Energy Market Commission
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Chief Executive Officer

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Dear Mr Pierce

RE: ERC0183 – Submission on Draft Determination: Retailer-Distributor Credit Support Requirements

Ausgrid appreciates the opportunity to provide comments in response to the AEMC's draft determination on retailer- distributor credit support requirements.

These draft rules (draft rules) substantially alters retailer credit support requirements (part B of chapter 6B) as well as the retailer insolvency cost pass through definitions in chapter 10. In relation to these proposed changes:

- Ausgrid supports the draft rule changes to the retailer insolvency cost pass through provisions (chapter 10); however
- Ausgrid *does not* support the draft rule changes to retailer credit support requirements in part B of chapter 6B.

Ausgrid submits that further changes are required to promote efficient outcomes for customers. Under the draft rule changes, distributors continue to be exposed to liquidity and revenue risk, due to uncertainty in terms of the timing and extent of recovery that might be achieved by a cost pass-through, which is dependent on the AER's approval.

If adopted the draft rules significantly constrain distributors' ability to manage the impacts of retailer default, particularly the associated liquidity risk.

The draft rule changes do not provide the best outcomes for customers, transfers risk from retailers to distributors and customers, will potentially incentivise inefficient behaviour in the market, and are based on assertions that we believe are incorrect.

Ausgrid is a strong advocate for strengthening the existing credit support regime and has raised this in several submissions to the AEMC. We have proposed strengthening the current rules by addressing two major issues, namely:

- Explicitly stating that credit allowances must be at parent entity level based on its corporate credit rating and apportioned between entities/ financially responsible market participants

(FRMP) within a retailer group, so that retailers can no longer receive multiple credit allowances; and

- Re-aligning Dun & Bradstreet ratings with Standard & Poor's to properly reflect the probabilities of default.

Credit support reduces the risk of cascading failure within the electricity sector if a large retailer was to fail. By removing distributors ability to obtain credit support the draft rules could increase the risk of systemic failure.

The most effective way of mitigating the potential credit and cash flow impacts from a Retailer failure is through having effective credit support arrangements that can be enforced and provide certainty to market participants.

The draft rules change the credit support provisions from an ex-ante framework to a severely restricted mitigant for 'late payment' risk. As a consequence it diminishes the distributors' ability to actively manage risk through credit support, even where a retailer's credit rating is deteriorating and/or rated 'speculative' grade (rated below BBB-).

Further to this, where AEMO makes a claim against a retailer's credit support due to payment default, such action served as a warning signal/ trigger for distributors to manage their risk and obtain credit support. This clause 6B.B3.5 (b) has been removed in the draft rules.

The draft rules also give retailers a perverse incentive to delay payment on 2 statements of charges each year without penalty, for up to 24 days, and limit the amount of credit support to the specific statement of charges not paid by the due date.

Where a retailer has defaulted, distributors have to bear the unrecovered network charges until the AER approves the pass-through of unpaid revenue (and associated costs) to consumers. This may involve significant emergency funding requirements for a considerable period of time, possibly up to three years.

Ausgrid recommends that instead the current credit support provisions be strengthened. Ausgrid's concerns in relation to the draft rules and recommended changes to the current rules are discussed in more detail in Attachment A.

If you have any queries or wish to discuss this matter in further detail please contact Joseph Pizzinga on (02) 9269 2121 or via email jpizzinga@ausgrid.com.au.

Yours sincerely,

RICHARD GROSS
Chief Executive Officer

Attachment A

The draft rule determination and draft rules replace the existing Chapter 6B Part B "Credit Support Rules" in its entirety, and make the following changes:

- Remove the materiality threshold applicable to retailer insolvency costs that may be claimed through the retailer insolvency cost pass-through event, thereby allowing the distributor to pass through these costs to customers (subject to AER approval).
- Remove any provision for distributors to request credit support from retailers regardless of their credit rating and/or exposure to the distributors, unless a retailer has a history of late payment within the previous 12 months.

In proposing the draft rules, Ausgrid notes that the AEMC are making the following assertions:

a) Given the low risk of retailer default, retailers do not have to provide credit support to distributors unless they have a history of late payment.

b) Distributors are best placed to manage liquidity risk, including that arising from retailer default. As a result distributors can best manage any revenue shortfall if a retailer fails, until such time as these costs are passed through and recovered from customers.

c) Customers should be liable to pay any unpaid network charges. In the long run, this will be a lower cost option than customers bearing higher charges associated with retailers' on-going costs of their credit support facilities.

Whilst Ausgrid supports the removal of the materiality threshold for retailer insolvency cost pass through events, Ausgrid does not agree with the removal of credit support regime nor the three assertions underpinning that removal, as outlined above, for the following reasons:

a) The ability of a distributor to actively manage credit risks through an effective credit support regime must be maintained

The first assertion reflects a view that all retailers should be treated as if they are of equivalent creditworthiness, which is clearly incorrect.

Distributors are presently exposed to substantial financial risk if a large retailer defaults. This risk will increase under the draft rules as distributors' ability to actively manage risk through credit support is severely diminished, even where a retailer credit rating is deteriorating and/or rated 'speculative' grade (rated below BBB-).

Credit support arrangements are an appropriate risk management tool, as they are based on the retailer's credit worthiness and the level of exposure to that entity. The current rules operate to mitigate the risk of a retailer failing by requiring them to provide credit support upfront while they are in a financially viable position to do so.

There are two key advantages to having credit support arrangements which will be diminished under the draft rules:

1. Credit support places a cost on a retailer that is reflective of their financial strength ; and
2. Credit support provides the distributor with an immediate source of funds to mitigate for the non-payment by the retailers.

The draft rules change the current credit risk management framework to a severely restricted mitigant for 'late payment' risk, and limits the amount of credit support to the specific statement of charges not paid by the due date.

While distributors would be able to request credit support from retailers who have a history of late payment, this provision is unlikely to be effective at managing risk. If a retailer is having cash flow issues and not paying their bills on time, it is unlikely that they will be in a position to obtain credit

support (in addition to providing the amount already owing) within the required 5 business days of the distributor issuing the request. This is likely to compound the issue of a participant experiencing financial stress as a retailer is likely to operate across more than one network area - meaning that it is likely to be late in paying multiple distributors and as a result is likely to receive multiple requests for credit support around the same time.

Therefore this willl mean that a distributor will be holding none or inadequate credit support at the time when a retailer experiences financial difficulties. Instead of the draft rule, the AEMC should consider maintaining the advantages of maintaining credit risk through credit support and strengthened the existing regime by:

- Re-aligning Dun & Bradstreet ratings with Standard & Poor's to properly reflect the probabilities of default; and
- Explicitly stating that credit allowances must be at parent entity level based on its corporate credit rating and apportioned between entities/ financially responsible market participants (FRMP) within a retailer group, so that retailers can no longer receive multiple credit allowances.

Ausgrid is also concerned that under the draft rules retailers will have perverse incentives that effectively allow them to delay payment on 2 statements of charges each year without penalty, for up to 24 days. There is no penalty under the draft rules for such behaviour and the distributor may have to resort to initiating civil proceedings[1] or issues statutory demand for payment.[2]

b) Placing liquidity risk onto distributors will increase costs for customers.

The AEMC asserts that distributors are best placed to manage increased liquidity risk as a result of their access to a stream of regulated revenue. Ausgrid disagrees with this assertion and stresses that the liquidity risk imposed onto distributors under the draft rules can add substantial costs for customers and be very difficult to manage depending on the size of the retailer.

Distributors, as with all businesses, have to manage liquidity risk as a normal aspect of business operations. In general distributors have tight liquidity ratios below 1, and can operate at lower levels of liquidity as they have access to regulated revenue streams, regulated rates of return and regular cash inflows. However this only holds true where cash flows are predictable and the distributors can mitigate liquidity risk by credit support.

Credit support provides liquidity in form that does not carry with it a liability to repay. It becomes a liability of the failed retailer thereby separating the cost of repayment from customers.

Under the draft rules without any credit support, distributors have few effective and commercial options to manage liquidity risk in the event of retailer failure. The longer the period, the less effective and more expensive those options become. In addition, distributors will have to incur additional costs associated with administrating a RoLR event during a retailer failure, for example, estimated reads and updating systems.

The insolvency process is complex and protracted and distributors may require substantial funding for a significant period of time. The availability, cost and timing of funding will depend on many factors, including the certainty (or otherwise) of recovering costs via the retailer insolvency cost pass-through.

We note this mechanism remains uncertain in both the amount to be recovered and timing because:

a) it is subject to AER's scrutiny and approval; and

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[1] Retailers' obligations to pay network charges under the National Electricity Rules are conduct provisions under the National Electricity Law. This means that any person (including distributors) may institute civil proceedings for breaches of conduct provisions and may seek to recover amounts for any damage or losses suffered.

[2] Part 5.4 Division 2 of the Corporation Act (2001) (Cth). Failure to comply with the statutory demand can form the basis for applying to the Court to have the company involuntarily wound up for insolvency.

b) the timing of when pass-through occurs will depend on when the AER makes its final decision in relation to the timing of the annual pricing proposal submission.

Ausgrid is concerned that the AER will delay initiating the cost-pass through provisions under after the insolvency proceedings have been completed given the uncertainty about cost recovery under such proceedings. This would add substantially to the timing gap between default and recovery thereby increasing the costs and risks to distributors of managing liquidity risk.

From previously precedents, Ausgrid considers that the timing gap would be three years. For example, in the case of GoEnergy failure the retailer became insolvent in April and the administrator's decision was entered into on 20 October. This would only leave the AER 3 months to complete its pass-through decision in time for the next year pricing proposal. If the AER fails to do make a decision in that timeframe, the recovery will then only occur in the subsequent year resulting in a timing gap of 3 years.

Furthermore, the cost pass through process cannot be triggered until an insolvency official has been appointed. If the retailer is large, there is likely to be pressure to allow time for a restructuring and sale of the business rather than insolvency and a retailer of last resort event, which is highly disruptive to the market as a whole. Consequently, if a retailer defaults on payment, distributors will be forced to take court proceedings to recover debt or trigger insolvency proceedings as this is the only viable option remaining to protect their exposure. This in turn could prevent the retailer having time to satisfactorily resolve its financial difficulties – and could be at odds with policy makers' attempts to manage the risks of such a failure. Ausgrid remains concerned that the various rule changes (Market Participant Suspension Framework and these draft rules changes) are not properly integrated.

These factors result in significant uncertainty as to the timing and magnitude of distributors' revenue recovery. Distributors do not typically have large cash flow contingencies and would have to seek external funding to manage this. It is also wrong to assume that a distributor would only incur costs associated with the increased liquidity funding ***after*** the event of a failure, as a distributor will also incur costs in setting up mitigation strategies for all scenarios.

Therefore by exposing distributors to liquidity risk, the draft rules will add costs which will ultimately be passed through to customers.

c) Customers are worse off under the draft rules as the risk is transferred away from the retailer – who are best able to manage the risk - onto distributors and customers

Ausgrid does not agree that the draft rule is a lower cost option for customers and that customers *should* be liable to pay any unpaid network charges as a result of retailer failure.

We are aware of the argument that retailers who are required to provide credit support will pass such costs onto the final consumer through higher charges. However, in a competitive energy market consumers can choose their energy retailer to avoid these charges, thereby facilitating competition and lower costs.

In conclusion, Ausgrid recommends strengthening the current rules and, does not support the draft rule changes related to retailer credit support for the following reasons:

- The draft rules transfers risk from the retailer to the distributors and customers;
- It removes the ability of the distributor to manage revenue and liquidity risk, does not address or mitigate systemic risk to distributors' in the event of a large retailer failure;
- It does not differentiate between high risk and investment grade retailers, entirely removes the ability of distributors to request credit support even when a retailers rating falls below investment grade or where AEMO claims against a retailer's credit support; and
- Increases the costs for distributors to manage risks and provides incentives to retailers to delay payments.