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

Submitted Electronically via www.aemc.gov.au

Dear Mr Pierce

National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 & National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.6 million household and business customers in NSW, Victoria, Queensland, South Australia and the Australian Capital Territory. EnergyAustralia owns and operates a multi-billion dollar portfolio of energy generation and storage facilities across Australia, including coal, gas and wind assets with control of over 4,500MW of generation in the National Electricity Market.

EnergyAustralia welcomes the opportunity to provide input in the AEMC's consultation on retailer-distributor credit support arrangements under the National Electricity Rules and National Gas Rules. We welcome a discussion on the appropriate allocation of risk and believe that the AGL Rule Change proposal explores a number of issues which were not addressed at the time the credit support provisions of the NER and NGR were developed. While we are not convinced that the AGL proposal is the optimal solution, we believe that thorough investigation of the current settings is warranted.

We believe that the Credit Support arrangements should adequately reflect the risk to distributors of retailer default but should also be mindful of the context in which other elements of the supply chain operate. For example, while distributors face the risk that a retailer will become insolvent, it is in fact the retailer who faces considerable credit risk given the range of regulatory constraints and reputational damage associated with collections and disconnections activity.

EnergyAustralia has also identified a source of potential confusion within the current arrangements relating to how the obligations apply with respect to different business structures. Where a single corporate entity holds multiple retail authorisations it is unclear whether any credit support payable should be calculated for each participant ID separately or in aggregate. We consider that any amendment to the current arrangements should provide more specific guidance on this issue.

We believe that the risks faced by distributors do not warrant the imposition of onerous credit support arrangements on larger retailers. While it is true that distributors face a degree of cashflow, revenue and cost risk, EnergyAustralia considers that the current credit support arrangements overstate these risks and inappropriately allocate a considerable portion of this risk to the retailer. Perversely, such arrangements do little to mitigate distributor exposure and simply increase the cost burden on the retail business that under the current framework is already considered to be at risk of default.

Minimising Barriers to Entry

The consultation paper outlines a number of principles for consideration in the design of credit support arrangements. While EnergyAustralia is in general agreement with the majority of the principles, we do not believe that the credit support regime should be used to deliver alternative objectives, namely to stimulate competition in the NEM. Although any credit support regime should not act as a barrier to market entry, we believe that the current credit support arrangements promote competition at the expense of prudence by placing greater credit support obligations on larger, established retailers while allowing smaller, new entrant retailers to operate in the market with little or no credit support liability. While this approach recognises that the greater revenue impact on a distributor in terms of forgone revenue if a large retailer were to become insolvent, it does not reflect the fact the inherent risk associated with a new entrant retailer which is not yet established in the market.

In the current environment of low wholesale prices and (largely) national retail authorisations in place of state based licences, the barriers to entry for new retailers are relatively low. In light of this, we do not believe that further stimulus of competition is warranted. In order to minimise risk to the distributor, credit support arrangements which require new entrant retailers to demonstrate financial viability would be more appropriate than a regime which effectively absolves them of such responsibility. If a credit support obligation is viewed as too onerous a requirement for smaller retailers it raises questions about their overall sustainability. This should be of greater concern to distribution businesses.

The main purpose of the credit support arrangements in identifying and allocating risk is undermined considerably by the objective of lowering barriers to entry. A free kick for potentially risky new entrant retailers may be a temporary boon for competition but is not in the long term interests of consumers. EnergyAustralia believes that changes to this aspect of the current arrangements will promote the National Energy Objective.

Incentives to Minimise Risk

Although a retailer default would likely lead to an immediate cashflow impact for the distributor(s), EnergyAustralia considers that the overall impact on revenue would be negligible as under current revenue cap arrangements any loss of revenue suffered by a distributor could be collected in subsequent periods. While we consider the appropriate allocation of risk to be fundamental to an effective energy supply chain, we do not believe that any one party should be completely free of risk which is effectively the situation for distributors under the current arrangements.

The consultation paper suggests that the current rules may provide incentives to lead retailers to take action to better manage theirs risks in order to reduce costs. While a retailer's credit rating is a key driver of the quantum of credit support which may be payable, sufficient additional drivers exist to ensure that retail businesses maintain as high a credit rating as possible. While the potential increase in the cost of providing credit support which accompanies a ratings downgrade is certainly an adverse outcome for retailers, it is unlikely that this is a deciding factor for retailers in making decisions which may impact their credit rating. Given the, in our view disproportionate, focus on ensuring that barriers to entry are minimised, the current arrangements provide little to no incentive to those retailers most at risk of default (new entrants) to improve their credit rating.

Similarly, we believe that the current arrangements offer little incentive to distributors to manage the risk of retailer default. These arrangements, coupled with the fact that distributors face revenue caps ensure that distributors are well insulated from the impact of any retailer default.

Although distribution companies are unable to refuse to service an appropriately credentialed retailer, if appropriate incentives exist they are able make operational decisions to minimise the risk of retailer default. This can be achieved through the imposition of specific provisions within use of systems agreements where a particular retailer is deemed to be at risk of default, or more broadly through greater coordination with retailers in general in recognition of the fact that retailers are the collection agents for the distribution charges. We have little evidence to suggest that the current arrangements provide these incentives.

The issue of coordination with retailers in general has been recognised by the AEMC through ERC0161 which requires distributors to consult with retailers on tariff structures to ensure that the retailers are in fact able to collect on the distributors behalf. The fact that this requirement had to be codified indicates that the current credit support arrangements do not provide an there is a lack of incentive for distributors under the to ensure that their agents (retailers) are in a position to collect distribution charges on their behalf.

Elements of an Optimal Credit Support Framework

Transparency

It is unclear how the current equation for the calculation of credit support adequately reflects the value at risk of a retailer facing default. The concept of a maximum credit allowance as a proportion of a distributor's total annual retail charges does not allow for the direct evaluation of the real risk faced by the distributor and is an imprecise benchmark. Further, EnergyAustralia sees no evidence that supports the decision to select 25 per cent as the threshold value. Any credit support regime which more accurately reflects the verifiable value at risk of an individual retailer would be an improvement on the current settings.

Clarity of Policy Objectives

EnergyAustralia strongly believes that competitive markets will deliver optimal outcomes for consumers and we advocate for policy measures and regulatory settings which allow competitive markets to flourish. We do not believe however that it is appropriate to use credit support arrangements as a means to stimulate competition. Any mechanism which seeks to optimise the allocation of risk is fundamentally compromised if additional policy objectives such the stimulation of competition are introduced.

While this policy objective may have been deemed appropriate during the formulation of the current regulatory framework and the potential tradeoffs justified (EnergyAustralia would argue not), the current highly competitive state of energy retail markets across the NEM would suggest that there is no longer a need to artificially lower barriers to entry at the expense of optimal outcomes related to the allocation of risk.

EnergyAustralia recommends that any future credit support settings are developed around a sole objective of the appropriate allocation of risk.

Removal of Cross Subsidies of Small Retailers by Large Retailers

By virtue of the current objective to continue to stimulate competition, larger retailers have disproportionately contributed to credit support as the current settings dictate that the bulk of a distributor's credit support is met by the larger, less risky retailers. It is unclear how policy makers believed that these arrangements would support distribution businesses in the event of a retailer insolvency event as any credit support amount is only payable in relation to the defaulting retailer.

The absence of a credit support regime which bases each retailer's credit support liability on their individual risk profile effectively hampers larger, efficient retailers that have achieved scale and subsidises less efficient operators. The analysis undertaken by SFG/Frontier in support of the rule change proposal indicates that a distribution business's risk profile does not necessarily change for the better as a result of a higher overall credit support; rather that this depends which retailers provide support and their individual credit-ratings. This suggests that overall market efficiency is compromised for no improvement in a distributor's risk profile.

Summary

EnergyAustralia supports a regime which appropriately allocates risk to those parties who are best able to manage it. The current arrangements however appear to be somewhat arbitrary in nature and disproportionally impact large retailers in an attempt to ensure that barriers to entry are minimal. We do not consider these arrangements to be in the long term interests of consumers and can potentially result into a worsening of distributors' risk profile as stable retailers are burdened with large credit support liabilities while smaller retailers are not provided with a sufficient incentive to curb risky behavior.

We welcome further discussion of credit support arrangements with a view to addressing the shortcomings of the current credit support regime by ensuring that credit support is calculated on the basis of each retailer's actual value at risk and consequently ensures that only the real cost of mitigating the risk to distributors of retailer default is ultimately borne by consumers.

If you require any further information with regard to this submission, please contact me on 8628 1731 or via email at joe.kremzer@energyaustralia.com.au

Yours sincerely,

Joe Kremzer
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