

11 February 2015

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

Dear Mr Pierce

The NSW DNSPs response to the *National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015 Consultation Paper*

The NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) welcome the opportunity to provide this joint submission in response to the *National Electricity Amendment (Retailer insolvency events – cost pass through provisions) Rule 2015 Consultation Paper*.

We note that there are two main elements to this rule change and the NSW DNSPs support both:

- to enable cost pass through applications for retailer insolvency events to be approved by the Australian Energy Regulator (AER) without being subject to the materiality threshold that is usually applied to cost pass through events; and
- to amend the distribution cost pass through provisions in the National Electricity Rules (NER) to allow DNSPs to recoup their unrecovered revenue for direct control services that have been provided, but remain unpaid by retailers that have become insolvent.

As noted by the Joint Implementation Group which coordinated the implementation of the National Energy Customer Framework (NECF) for participating jurisdictions¹:

“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). Therefore, any amount they cannot otherwise recover (by drawing on credit support or by recourse to other commercial law recovery options) should be passed through to customers.

The reason for not applying a materiality threshold here is that the presence of a materiality threshold is part of the incentive regulatory regime. It acts to incentivise distributors to manage the costs 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.”

In addition, and as noted by the AEMC in the Consultation paper², the removal of a materiality threshold better deals with circumstances where several retailers become insolvent as a chain of insolvency events. This is because a materiality threshold could have the effect of disqualifying some of these individual events from consideration.

¹ Joint Implementation Group. National Energy Customer Framework Implementation issue No.0001 Retailer insolvency event and pass through, p 1.

² AEMC 2015, Retailer insolvency events - cost pass through provisions, consultation paper, 30 October 2014, Sydney, p 18.

The NSW DNSPs note that following the adoption of the NECF in NSW on 1 July 2013, the National Electricity (National Energy Retail) Amendment Rule 2013 came into force in NSW. As has been noted, the effect of this rule was to include the “retailer insolvency event” as a positive change event directly without the need for the event to materially increase the cost of providing direct control services. As this rule came into force in NSW after the National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, then it would seem arguable that in NSW, a retailer insolvency event may already be a positive change event. However, the uncertainty in this regard is acknowledged and therefore this element of the rule change is supported for the reasons noted above.

This uncertainty has arisen due to the fact that jurisdictions have adopted the National Energy Retail Law and National Energy Retail Rules (NERR) and associated NER amendments at different times so the AEMC may not have been conscious of the fact that different versions of the NER operated in different jurisdictions depending upon the timing of the adoption of the NECF legislation. For this reason, it is strongly recommended that following this rule change, the AEMC publish on its website a state-based version of the NER and NERR applicable to every jurisdiction that has adopted the NECF, to ensure transparency and to assist with adhering to compliance requirements.

The NSW DNSPs support the second element of the rule change related to the recovery of foregone revenue through the cost pass through mechanism. This is because the cost pass through provisions of the Rules should provide for the full recovery of foregone revenue which is the recovery of payment for the provision of regulated distribution services provided to a retailer, but which remain outstanding, following the insolvency of that retailer.

The NSW DNSPs agree that this amendment is necessary as revenue certainty is an influential factor in decisions to invest in, and to maintain the network. We also note that it is consistent with the COAG Energy Council’s original policy intent³.

“The COAG Energy Council has stated that the recovery of revenue foregone following a retailer insolvency event is appropriate given that, under the NER, DNSPs are subject to a mandatory obligation to supply regardless of the risk profile of the party requesting that supply. DNSPs are also restricted in how they can manage that counter-party risk and although Chapter 6B provides for credit support, these arrangements are also highly prescribed.”

More generally, the NSW DNSPs note that the Consultation Paper makes reference to that fact that the NER imposes particular obligations of supply on DNSPs but limits their ability to independently manage the commercial risks associated with such supply. This is due to both the highly prescribed nature of the credit support arrangements and the fact that recovery through the regulatory determination process requires a forward estimate of an unknown risk to determine the ex-ante allowance⁴.

Furthermore, we would like to point out that while DNSPs can potentially recover unpaid network charges through a retail insolvency pass through, the remedy may be a slow one due to the likely delays in DNSPs recovering these costs. Depending on when in the period a Retailer of Last Resort (RoLR) event occurs, a DNSP may have to absorb this cost (and the interest that accrues on this debt) for up to 14 months before it can undertake adjustment through its annual pricing proposal to recover the outstanding network charges.

³ AEMC 2015, Retailer insolvency events - cost pass through provisions, consultation paper, 30 October 2014, Sydney, pp 16-17.

⁴ *Ibid*, p 15, 17 and 22.

While it is appropriate that the eligible pass through amount would exclude any amount recoverable from a retailer or retailer's guarantor under any relevant credit support as required by clause 6.6.1(l) of NER, there are issues with the current credit support arrangements as we detail below. Nevertheless, a cost pass through is likely to be more preferable than pursuing the recovery of debts from an insolvent retailer through the insolvency process under the *Corporations Act 2001 (Cth)* which would be uncertain in terms of timing and the likelihood of recovery of debts⁵.

There is also some uncertainty regarding whether indirect costs are recoverable under the retailer insolvency pass through event. We note that clause 6.6.1(l) of the NER refers to "retailer insolvency costs" in calculating the eligible pass through amount. It is not clear under the NER what is meant by "retailer insolvency costs" particularly when it encompasses both the unpaid network charges and indirect costs from a RoLR event.

In the event that indirect costs fall outside this definition, it is not apparent how these costs would be captured by another pass through event. Consequently, DNSPs may be penalised from absorbing these costs under the Efficiency Benefit Sharing Scheme (EBSS). We therefore submit that as part of this rule change review, the AEMC consider the recoverability of indirect costs and amend the Rules as necessary to provide this clarification. This would provide the AER with the scope to exclude both direct and indirect costs incurred as a result of this event for the purposes of determining the EBSS, meaning that they would be excluded from the base year in a subsequent regulatory determination.

Given the AEMC's acknowledgement in the Consultation Paper about the limitations on the ability for DNSPs to manage commercial risks under the NER (and more generally under the insolvency process under the *Corporations Act 2001 (Cth)*), we are concerned that these issues have not been sufficiently addressed in the AEMC's current NEM Financial Market Resilience Review ('the Review'). This is of concern because the Review's Second Interim Report contains a recommendation to defer any requirement for the ROLR to provide increased credit support to the DNSP for five weeks.

The NSW DNSPs have previously written to the AEMC in the context of the Review stating that the current credit support arrangements do not provide a sufficient means of managing credit risks faced by DNSPs⁶. In our submissions, we outlined that there is significant risk to NSW DNSPs in the event of a large retailer failing, particularly as there are three large retailers that dominate the Australian energy market, and collectively account for 70+% of energy consumption. As such, we have strongly argued for the need for robust credit support arrangements and ROLR provisions to manage retailer credit risk that also ensures that there is no undue delay to DNSPs accessing appropriate levels of credit support (following a ROLR event) or delay to the settlement period for the designated ROLR to pay network charges to DNSPs; otherwise there are likely to be adverse consequences in terms of DNSPs' cash flows, credit rating and financing costs and may give rise to the risk of broader NEM financial contagion.

As noted previously in these submissions, the most effective way of mitigating the potential credit and cash flow impacts from a retailer failure is through having credit support arrangements that can be enforced (for example ensuring that conduct provisions and the ROLR provisions are properly integrated). We have therefore urged the AEMC to examine the effectiveness of current enforcement options as part of its Review as well as strengthening (not weakening) credit support arrangements available to DNSPs.

⁵ We note that the cost pass through provisions of the NER (see Clause 6.6(j)) mitigate against the risk that a DNSP could double recover the unrecovered revenue or costs arising from a retailer's insolvency.

⁶ NSW DNSPs response to the NEM Financial Market Resilience Review, p 3.

In particular, we requested the AEMC to reconsider the current draft recommendation in the Second Interim Report to defer any requirement for the ROLR to provide increased credit support to the DNSP for five weeks.

If you would like to discuss our submission further or arrange a meeting with NSW DNSP representatives, please contact Ms Jane Smith, Manager Network Regulation at Ausgrid on (02) 9269 2023 or Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249 3120.

Yours sincerely



Vince Graham
Chief Executive Officer
Ausgrid, Endeavour Energy and Essential Energy