A low risk of high cost

PIAC response to AEMC options paper National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 and National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015

26 November 2015

Kristal Burry, Policy Officer

Energy + Water Consumer Advocacy Program

Level 5, 175 Liverpool Street, Sydney NSW 2000
Phone: 61 2 8898 6500 • Fax: 61 2 8898 6555 • www.piac.asn.au

1. The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights;
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from NSW Trade and Investment for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

1.1 Energy + Water Consumer's Advocacy Program

This Program was established at PIAC as the Utilities Consumer's Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Tenants Union of NSW;
- Ethnic Communities Council of NSW;
- Physical Disability Council of NSW;
- St Vincent de Paul Society of NSW; and
- The Salvation Army Eastern Australia Conference.

2. Introduction

PIAC welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) options paper, *National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 and National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015* (the options paper).[1] This options paper was developed as an additional step in the rule change process due to the complexity of the issue, and the wide-ranging opinions from stakeholders during the initial consultation process. The proposed rule change is a consolidation of three rule change requests. The Council of Australian Governments Energy Council (COAG EC) submitted a rule change request related to the retailer-insolvency pass through provisions in the National Electricity Rules (NER). AGL Energy and Jemena each submitted rule change requests in relation to the retailer-distributor credit support requirements for the NER and National Gas Rules (NGR), respectively. As these rules deal with the same event – managing the risk of the default of a retailer – the rule change requests were combined.[2]

A brief summary of the proposed rule changes will provide context for the following submission and recommendations. AGL proposed that retailers with a Standard & Poor's (S&P) credit rating of BBB-or greater, regardless of their market share, not be required to provide credit support (previously this was credit rating of A-through to AAA).[3] Currently, a distributor can request credit support from a retailer if the retailer's network charges liability (billed but unpaid and unbilled charges) is more than the credit allowance. A retailer's credit allowance is determined by the distributor's annual network charges and the retailer's credit rating; a retailer with a higher credit rating will be asked for lower credit support. The credit support can be used, in the advent of a retailer defaulting, to cover the costs owed to the distributor by the failed retailer.[4]

AGL argued that:

- the requirement for a maximum credit allowance is arbitrary;
- credit ratings already included measures of risk;
- credit support may be a barrier to entry into the market or may limit competition;
- distributors' exposure from lower-rated retailers is not mitigated by acquiring credit support from higher rated retailers; and
- the costs of hedging risk is material and these funds could be used by retailers to invest in the electricity and gas markets.[5]

The COAG EC and Jemena proposals are similar, as Jemena proposed changes to bring the NGR in line with the NER with respect to recovering costs after a retailer default. The COAG EC proposal was to strengthen the cost pass through mechanisms to allow distributors to recover lost revenue. In line with both the options paper and the AEMC consultants report from Promontory Australiasia,[6] this submission will refer to both the COAG EC and Jemena proposals as the COAG EC proposal. However, the Jemena proposal was rolled in with AGL's proposal, as they both deal with the NGR, while the COAG EC rule change only deals with the NER. The main

[1] AEMC, *Options Paper. National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2015 and National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule*, 2015.
[2] Ibid i.
[3] Ibid 1.
[4] Ibid 8.
[5] Ibid 2.
[6] Promontory Australasia, *Principles and Options for Managing Retailer Default Risk*. Prepared for the Australian Energy Market Commission, 2015, 39.

change in this proposal is to reduce the materiality threshold and include retailer insolvency costs in the definition of what is acceptable in a cost pass-through mechanism.[7]

These changes would provide greater certainty to distributors that they will be able to recover these costs by passing them on to customers. At the moment, because of the materiality threshold and the resources required to apply to the AER to approve such a pass-through, distributors lack confidence that they will be able to recover their costs and will not be at risk of liquidity problems.[8] Additionally, it is agued that addressing problems with the system may reduce barriers to entry by new retailers and improve competition, as well as increase retailers', distributors' and customers' confidence in the system.[9]

The options paper has proposed four options with sub-options to improve risk management in the case of retailer default;

- Option 1: retain existing arrangements
- Option 2: strengthen the existing arrangements
    - Option 2.1: COAG EC proposal (to strengthen cost pass-through), and remove credit support
    - Option 2.2: COAG EC proposal, and AGL proposal to modify credit rating benchmarking
    - Option 2.3: COAG EC proposal with enhanced credit support
- Option 3: establish a retailer default fund
- Option 4: introduce a liquidity support scheme
    - Option 4.1: liquidity support scheme (market-share-based allocation of ongoing fees) with COAG EC proposal
    - Option 4.2: liquidity support scheme (risk-based allocation of ongoing fees) with COAG EC proposal.[10]

To evaluate the potential options, five principles were developed that were to be used in addition to modelled scenario outcomes to understand the ongoing costs before a retailer defaulted and the post-default impact. The three scenarios were the default of a large retailer in one distribution network, the default of a large retailer across all electricity and gas networks and the default of three small retailers with a market share of less than 5% across all of the electricity and gas networks.[11]

The principles used in determining which option to select are:
1. Stability: the rule should minimise potential financial contagion form a retailer default to its distributor;
2. Efficiency: the rule should efficiently allocate the risks and costs to parties in order to minimise the long-term costs to consumers;
3. Incentives: the rule should provide appropriate incentives to minimise the probability and impacts of retailer default;

7 Ibid 3.
8 Ibid 10-11.
9 Ibid 5.
10 Ibid 39.
11 Ibid 38.

4. Revenue and pricing principles: the rule should take account of any change in network revenue resulting from the option adopted and the application of the revenue and principle principles; and
5. Competition: the rule should consider any unintended or unwarranted impacts on barriers to entry for retail business.[12]

The only principle that directly addresses consumers is principle two, the efficiency of the mechanism proposed. While the other principles will impact on consumers, the links are less obvious. It would be beneficial for consumers to have more information about the wider impacts of a retailer default. Is there risk of wider societal costs associated with a retailer default? If, for example, the impacts of a retailer default were contained, then PIAC would respond to this options paper differently than if there were broader societal costs in terms of productivity and negative social impacts, particularly with respect to vulnerable customers. Proceeding with the information that is available, PIAC makes the following observations.

3. Risks and impact of a retailer default

In the event of a retailer defaulting, consumers will bear the cost of the revenue owed to a network by a retailer. However, taking a step back, it is important to understand the likelihood of a retailer defaulting. It is evident from Moody's analysis of the number and types of defaults over the past 88 years, with a particular focus on the period of the global financial crisis, there is a low chance of utilities defaulting. Moody's analysis indicates that during 2008 there were record numbers of defaults. A further breakdown of these numbers shows that there were no issuer counts of defaults in the utilities industry and only 6.9% of issuer counts, amounting to 2% of the dollar value of defaults, were in the energy and environment sector. These were much lower than the figures for the banking industry, which were 8.9% and 25.4% respectively.[13]

A domestic example of a retailer default was when the Australian Energy Market Operator (AEMO) suspended Jackgreen from the market in December 2009. This is an interesting case study of the impacts of a default on the industry and on consumers. PIAC does not have details of the financial impact of the default on the distributors, However, the Energy and Water Ombudsman NSW (EWON) has provided information about the impact on consumers.

Although EWON had noticed numerous signs that there were issues at Jackgreen it was not in the position to predict the collapse of the company. PIAC considers that the AEMC and the Australian Energy Regulator (AER) might be able to monitor potential warning signs and move to intervene with a retailer prior to a collapse.

EWON noted significant increases in customer complaints in relation to Jackgreen's marketing behaviour and its billing system. Jackgreen targeted low-income and vulnerable consumers, which meant that it had a higher proportion of vulnerable customers, which in turn put them at greater risk of default. Jackgreen also did not have an adequate hardship policy to deal with their vulnerable customers. EWON noted that many of the complaints about the company were about its billing system and record keeping, and in particular the smooth pay billing system. In 2006,

[12] AEMC, above n 1, 17.
[13] Moody's Global Credit Policy, *Corporate Default and Recovery Rates, 1920-2008*. Special Comment. 2009, 5.

IPART conducted an audit and investigation into Jackgreen's practices.[14] Eventually, due to a number of factors, Jackgreen failed to pay its bills to the distributor and filed for receivership.

EWON had particular concern about the way in which consumers were affected during the Retailer of Last Resort (ROLR) process, where customers of the defaulting retailer were transferred to the designated retailer of last resort in the local network.[15] EWON expressed concern that the ROLR process may not sufficiently protect consumers during a default event. It was particularly concerned with the credit default listing process erroneously listing Jackgreen customers, and the impact of the ROLR process on customers facing hardship.[16]

4 Preferred option

In terms of ongoing costs to customers, options one and 2.1 have the lowest ongoing costs to customers for gas (nil). For electricity, option one has $120,000 annual ongoing costs.[17] The most expensive options for gas are 2.3 and three, which have the highest annual ongoing cost, at $8.12 million annual costs each. For electricity, the most expensive option is option three, with $65.18 million in annual costs.[18] In terms of post-default costs, all the options have significant costs to recover forgone revenue and maintain network liquidity during the recovery time. The options that have the lower ongoing costs naturally have higher post-default costs. However, option three, which has the highest ongoing costs, also has a significant post-default cost. Analysis by Promontory Australasia indicates that the post-default cost for this option is $81.2 million for gas and $651.8 million for electricity, in addition to the ongoing annual costs to customers.[19]

From a purely economic perspective, option three is PIACs least preferred option. Additionally, PIAC has concerns about the long lead-time needed to establish the retailer default pool (approximately 10 years to reach the full pool), the operational costs of managing the pool, and the need to replenish the pool post-default. PIAC also has concerns about who would manage the pool, and the potential financial benefit to the manager of the pool from accrued interest. If this is the option selected, PIAC recommends that interest earned by this pool be used to support energy consumer advocacy programs through Energy Consumer Australia (ECA) or a similar program. PIAC notes that option three is not Promontory Australasia's preferred option due to the costs and the fact that it does not satisfactorily meet the principles used to guide the selection of the most suitable option.

In a summary of how each option measures up against the principles, Promontory Australasia notes that most of the options do not align with all five principles. Option 2.1, PIACs preferred option, only aligns with two of the principles, those being revenue and pricing and competition. PIAC is not overly concerned that this option does not align with the other three principles, as Promontory Australasia concedes that the likelihood of a retailer defaulting is low and that option 2.1 provides distributors more certainty about recovering their costs post-default, thus providing some stability in the market (principle one).[20] In addition, given this option has the backing of the

14 EWON, *Jackgreen – the failure of an energy retailer. The perspective of the Energy & Water Ombudsman NSW in dealing with Jackgreen customer complaints*, 2010, 6-11.
15 Ibid 15.
16 Ibid 24-26.
17 Promontory Australasia, above n 6, 75-76.
18 Ibid 75-76.
19 Ibid 77.
20 Ibid 80.

COAG EC, and provides increased certainty of recovering foregone revenue in the event of a retailer defaulting, it can be assumed that distributors will be able to raise liquidity at the time of the event to prevent potential contagion and wider impacts on other distributors and generators.[21]

Given the potential costs (ongoing and post-default) associated with all of the options, as well as the certainty provided to distributors to recover costs post-default, PIAC recommends that option 2.1 be the preferred option.

Recommendation 1

PIAC recommends that AMEC adopt option 2.1 as the preferred method of managing risk in the event of a retailer defaulting.

Recommendation 2

PIAC recommends that in the event that option three is the preferred option, that measures are taken to ensure that the manager of the default fund does not financially benefit from any interest accrued from the fund.

Recommendation 3

PIAC recommends that any interest that is accrued from a retailer default fund be used to support consumer advocacy or support, for example through ECA.

5. Conclusion

PIAC considers that the probability that large a utility company would default is low because utilities are generally well established, have high credit ratings, and are therefore not required under the existing system to provide credit support. While the likelihood of a smaller or second-tier retailer defaulting is higher, the impact of a smaller retailer's default would be immaterial.[22] On this basis, PIAC supports the adoption of option 2.1 of the COAG EC proposal as the best method of managing the risk of retailer default and the financial consequences of such an event. PIAC has particular concerns about option three, as establishing a default fund is the mostly costly solution and places the risk burden entirely onto customers, rather than shared by customers and the distributors.[23]

In the event that a retailer does default, it would not occur without warning and would not happen overnight. PIAC, therefore, recommends that measures be put in place that act as triggers for intervention before a retailer defaults. The warning signs are known and there are organisations with the relevant reporting requirements that may be adapted to facilitate this role.

21 Ibid 78-81.
22 Ibid 44-45.
23 Ibid 74.