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18 June 2010

Mr E J Hall
Chief Executive
Queensland Competition Authority
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Brisbane QLD 4001

Email: electricity@qca.org.au

Dear Mr Hall

Review of Electricity Retailer and Distributor Credit Support Arrangements

Ergon Energy Corporation Limited and Ergon Energy Queensland Pty Ltd welcome the opportunity to provide a submission to the Queensland Competition Authority's consultation paper on the Review of Electricity Retailer and Distributor Credit Support Arrangements.

Ergon Energy has provided general comment as well as a response to each of the questions raised in the consultation paper on the possible form and substance that new credit support guidelines may take.

Should you wish to discuss any aspect of this submission, please do not hesitate to contact me.

Yours sincerely

[redacted]

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Ergon Energy Corporation Limited
and
Ergon Energy Queensland Pty Ltd

Review of Electricity Retailer and Distributor Credit Support Arrangements

Queensland Competition Authority

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This submission, which is available for publication, is made by:

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1 INTRODUCTION

Ergon Energy Corporation Limited (EECL) and Ergon Energy Queensland Pty Ltd (EEQ) welcome the opportunity to provide a submission to the Queensland Competition Authority's (QCA) consultation paper on the Review of Electricity Retailer and Distributor Credit Support Arrangements (Consultation Paper).

This submission is provided by:

- EECL, in its capacity as a distribution network service provider in Queensland; and
- EEQ, in its capacity as a non-competing area retail entity in Queensland.

In this submission, EECL and EEQ are collectively referred to as 'Ergon Energy'.

Ergon Energy has structured this submission in two parts:

Part A: Provides general comment on the possible form and substance that new credit support guidelines may take; and

Part B: Provides responses to each of the questions raised in the Consultation Paper.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the QCA require.

2 PART A - GENERAL COMMENTS

Historically, the primary failing of the credit support regime contained in clause 12 of the Queensland Default Coordination Agreement (Coordination Agreement) has been the absence of effective mechanisms permitting a distributor to enforce its terms, rather than the 'key elements' identified by the QCA in section 3.1 of the Consultation Paper (i.e. trigger mechanisms, form and amount of credit support, and credit support review).

It is a lack of enforceability that threatens to undermine a distributor's ability to manage the risk of retailer non-payment and the comfort provided to end-users that the regulatory framework reasonably ensures that retailers have the financial capacity to participate in the Queensland market.

Ergon Energy believes that it is imperative that the issue of enforceability is expressly addressed by the QCA as a 'key element' in the development of the Credit Support Guidelines (Guidelines).

It is the ability to enforce the provision of credit support once a trigger event occurs, rather than the triggers themselves that is the main issue of concern. Further to this, the Guidelines should provide for the following scenarios:

- the provision of credit support should be a pre-requisite to a retailer becoming financially responsible for customers connected to the distributor's network. While a retailer would not be precluded from undertaking marketing and customer acquisition activities upon market entry, financial responsibility for a NMI (i.e. the customer at the premises) should not transfer to the retailer until such time as it has provided credit support (where appropriate), thereby satisfying the conditions of its licence under 55DC(1) of the *Electricity Act 1994* (Qld); and

- a distributor should be entitled to request 'ongoing' credit support via credit support 'top up' in the event that a trigger event occurs. Ergon Energy believes that a retailer should be prevented from assuming financial responsibility for additional customers connected to the distributor's network if additional credit support is not provided. That is, the distributor should be permitted to object to the transfer of additional customers to a retailer until such time as the credit support is provided. This would not impact existing customers of the retailer but would assist the distributor to ensure that its level of exposure to the retailer does not increase.

At a high level, the credit support regime in Queensland should provide for:

- credit support to be calculated under a simple and replicable formula that takes into account the distributor's exposure to each individual retailer, recognising that distributors are subject to a regulated pricing regime which does not enable them to receive any benefit for taking on additional risk;

- the provision of credit support as a pre-requisite to a retailer becoming financially responsible for customers connected to the distributor's network;

- credit support to be adjusted on a regular basis as the retailer's liability increases or decreases (e.g. through changes in customer numbers or load); and

- incumbent retailers to be restricted from assuming financial responsibility for new customers in circumstances where credit support or credit support 'top up' is not provided.

3 PART B - RESPONSES TO ISSUES RAISED

3.2 Trigger Mechanism

The Authority seeks stakeholders' views on whether the current trigger mechanisms for requiring the provision of credit support:

(a) are too easy or too difficult for a distributor to activate;
(b) disadvantage smaller retailers that may have difficulty obtaining a suitable credit rating or accessing alternate forms of financial backing;
(c) disadvantage prospective retailers, as incumbents are more likely be able to obtain a suitable credit rating;
(d) create a barrier to entry into the retail electricity market in Queensland; and
(e) impose an adequate incentive for distributors to properly manage their accounts receivable.

The Authority also seeks stakeholders' comments on whether any other trigger mechanisms may be more appropriate.

Ergon Energy believes the trigger mechanisms contained in clause 12.1(a) of the Coordination Agreement are largely appropriate:

- for new entrant retailers - the trigger mechanism relating to a retailer's credit rating is necessary given that, of the five trigger mechanisms, this is the only mechanism that directly applies to new entrants. Without a history of successfully operating in the National Electricity Market (NEM), distributors and customers cannot be sure of the financial credentials of new entrant retailers - a credit rating is the most transparent means by which this assurance can be provided; and

- for incumbent retailers - while the number of trigger mechanisms is broader, this is simply reflective of the risks associated with market participation and the range of 'default events' that are indicative of the weakening of a retailer's financial position. However, this is balanced by the opportunity for a retailer to obtain a release from an undertaking after a reasonable period of time has passed (e.g. where timely payment can be demonstrated).

It is Ergon Energy's understanding that, Corporate Scorecard Pty Limited recently obtained their license to issue credit ratings. This brings the number of credit ratings agencies to four (the other three being Moody's, Fitch and Standard and Poor's) and this may mean increased competition and lower prices for retailers to obtain a credit rating.

It is also important to note that there is no 'incentive' created through the existence of these or other triggers that would serve to adversely influence a distributor's management of its accounts receivable.

3.3 Form and provider of credit support

The Authority seeks stakeholders' comments on whether an unconditional undertaking issued by a bank:

(a) is the most cost effective means of obtaining a guarantee; and
(b) disadvantages small retailers that may be unable to obtain an unconditional undertaking from a bank or may face significantly higher costs than a larger retailer, relative to their size.

The Authority also seeks stakeholders' comments on whether any other forms of credit support may be more appropriate.

Ergon Energy generally accepts two forms of credit support:

- Bank Guarantees; and

- Insurance or Surety Bonds.

It is understood that both these forms of credit support are similar in cost and are generally more expensive the lower the credit rating of the purchaser.

A possible alternative to the above traditional forms of credit support is for the retailer to provide a distributor with credit support in the form of a cash deposit and for the interest earned on the principal to be returned to the retailer periodically. Whether the net cost of this arrangement to the retailer is lower than the alternative cost of a bank guarantee is unknown and may depend on the retailer's specific circumstances.

Ergon Energy would not support an obligation on distributors to offer, or seek to acquire, trade credit insurance (TCI) on behalf of a retailer. While Ergon Energy is aware of the limited use of TCI interstate as an alternative to bank guarantees, it is understood that the market for TCI has hardened in recent years. As a consequence, a distributor is unlikely to be able to secure TCI for an appropriate ‘book’ of retailers (including small retailers or those with lower credit ratings who typically seek this form of cover) or for a price that is considered to be acceptable to the retailers participating in the arrangement.

Ergon Energy is unaware of any other forms of credit support which may be more cost effective than bank guarantees while providing the same level of protection for distributors and customers.

3.4 Amount of credit support

The Authority seeks stakeholders’ comments on whether requiring credit support equivalent to three months of estimated distributor charges:

(a) is appropriate given that retailers have different billing cycles and therefore pose different risks to a distributor;
(b) creates an unacceptable barrier to entry for new entrants to the retail market by imposing a significant cost on start-ups which does not reflect their potential default risk to the distributor;
(c) imposes too high a cost on incumbent retailers if they are required to provide credit support.

The Authority also seeks stakeholders’ comments on whether any other approach to determining the amount of credit support may be more appropriate.

The purpose of credit support is to assist distributors in managing their exposure to an individual retailer and thereby, in part, to insulate the market and customers from the impacts of a retailer’s non-payment of its statement of charges.

Accordingly, the amount of credit support should reflect the exposure that the distributor has to each individual retailer.

Credit support should be calculated in a similar manner to the maximum credit limit calculations that are currently performed under Chapter 3 of the National Electricity Rules (NER) (that is, using a reasonable worst case estimate of the aggregate payments due to the distributor by the retailer over an appropriate time interval representing the time between incurring the cost and the time when the accumulation of further costs can be stopped).

In this regard, the existing requirement to provide credit support equivalent to three months estimated charges is appropriate as it is:

- a simple methodology that is capable of replication by both parties. This assists the parties to understand the nature of the obligation that will exist and thereby reduce the potential for disputes;

- equitable between retailers. The value of credit support correlates to the value of the distributor’s statement of charges and therefore reflects the size of the individual retailer’s customer load:

  - for new entrants, this ensures that the value of the credit support is reflective of the specific retailer’s market entry and customer acquisition strategy, capable of adjustment up or down over time.

- for incumbent retailers, the credit support review mechanism ensures that credit support is released in circumstances where financial integrity is demonstrated.

  Ergon Energy therefore disagrees that the existing methodology poses either a barrier to entry for new entrant retailers or an unreasonable financial impost on incumbent retailers (regardless of size).

- symmetrical, in that the value of the credit support should increase or decrease in line with the retailer's acquisition, or loss, of load in the market; and

- a cost that is reflective of the risk of retail market participation in the NEM (e.g. wholesale market volatility risk) and the exposure that this creates for distributors and customers.

It is also important that the mechanism for calculating the total exposure covers all of the types of charges which are payable by a retailer to a distributor (including DUoS charges, TUoS charges, non-network charges, unregulated charges, interest, event charges, etc).

3.5 Review of credit support

The Authority seeks stakeholders' comments on whether other timeframes for reviewing credit support may be more appropriate.

Ergon Energy believes that it is critical to retain a period of six months from the initial provision of the credit support undertaking, prior to a request by the retailer for release. This period is required for the retailer to establish a proven payment history with the distributor that is reflective of its customer acquisition activities following market entry, e.g. the possible acquisition of a significant number of customers or load.

Ergon Energy would be amenable to a reduction in the timeframe for subsequent release requests from six months to three months, provided that the Guidelines contain clear and readily enforceable obligations on the retailer to provide a new undertaking in circumstances where the criteria contained in clause 12.1 (or equivalent) are not satisfied. In particular, the ability to obtain new or additional credit support should not be capable of being stymied by the inappropriate use of the dispute resolution process. This is discussed further below.

3.6 Other issues

The Authority seeks stakeholders' comments on whether the current requirements for drawing on credit support provide sufficient time for retailers to fulfil their obligations.

Ergon Energy believes that three business days is a sufficient period for a retailer to acquit the obligation that has triggered the right to draw on the credit support, should the retailer be able, or choose, to do so.

Ergon Energy notes that this is significantly more time than would be permitted to a retailer in circumstances where it has failed to comply with its prudential requirements in the wholesale market.

> The Authority also seeks stakeholders' comments on whether other requirements for allowing credit support to be accessed may be more appropriate.

As part of its risk mitigation, Ergon Energy monitors the financial status and if applicable, the credit ratings of retailers as well as the financial institutions through which any credit support is provided.

In this regard, distributors should also be allowed to preserve the value of a retailer's undertaking by requesting its replacement in circumstances where the financial institution providing the credit support is under financial pressure. For example, where the financial institution is placed under credit watch by a recognised credit agency. In these circumstances, a distributor should be permitted to require the replacement of the credit support within 10 business days (i.e. consistent with the existing arrangements for the 'top up' of credit support).

Ergon Energy believes that this would:

- be consistent with the distributor's existing ability to 'reasonably satisfy' itself of the suitability of the bank or other body providing the credit support at the time that the credit support is initially provided by a retailer, under clause 12.2(a) of the Coordination Agreement; and

- place appropriate incentives on retailers to ensure the ongoing integrity of the credit support provided.

> The Authority seeks stakeholders' comments on whether the existing dispute resolution process is adequate or whether alternate processes may be more appropriate.

While Ergon Energy is generally supportive of the dispute resolution process contained in clause 17 of the Coordination Agreement, it could be prone to abuse in circumstances where a dispute with respect to payment (e.g. statement of charges, initial credit support or credit support top-up) is not genuine.

Ergon Energy believes that the Guidelines should:

- permit a party to a dispute to refer the threshold question of whether an amount is genuinely in dispute to either the QCA or to an Independent Expert appointed by the QCA to be determined either prior to, or concurrently with, the processes provided for in clause 17.2 - 17.4 (inclusive).

  This would be an expedited version of the referral process for billing disputes contemplated by clause 8.5(g) of the Coordination Agreement - noting that the billing dispute process in clause 8.5 has been subsumed by the Queensland Network Billing Specification; and

- expressly provide that a retailer is required to pay the undisputed portion of the credit support or increase in the undertaking that has been requested by a distributor and that a distributor is required to reduce the undertaking to the extent of any undisputed portion when requested by the retailer (i.e. as provided for in clause 12.4 of the Coordination Agreement).

The Authority also seeks stakeholders' comments on:

(a) whether the current credit support arrangements reflect best practice or whether
 (i) there are other industries that may have adopted more suitable arrangements; or
 (ii) the credit support arrangements applying in any other jurisdiction are seen as providing a better model; and

(b) the extent to which the Authority should take account of the proposed national framework for credit support arrangements in developing its credit support guidelines.

Clause 12 of the Coordination Agreement was developed with specific reference to the credit support regimes existing in other jurisdictions at the time that Full Retail Competition was introduced in Queensland. Ergon Energy continues to believe that the existing Queensland credit support regime is largely appropriate as it strikes a balance between the need to protect distributors from the risk of default from retailers (operating in what could be an extremely volatile market - in the absence of appropriately priced contract hedging) and placing an undue or unnecessary burden on retailers.

While Ergon Energy notes the work that is occurring to develop a national credit support regime through under the National Energy Customer Framework (NECF) consultation, it is understood that this is the subject of ongoing and significant change and as such, its final form is yet to be settled. Ergon Energy does not support the credit support framework contained in the NECF Second Exposure Draft and believes that the methodology for the calculation of credit support is unnecessarily complicated, difficult to consistently apply in practice and unlikely to provide distributors with adequate protection against non-payment.

In particular, the NECF provides for allowances / discounts (off the calculation of credit support obligations) for retailers who effectively have junk status credit ratings. Ergon Energy considers that no discount should be allowed for retailers that have credit ratings below investment grade, as the risk of exposure is not sufficiently mitigated and the financial capacity of the retailer to operate in the NEM may be open to serious question.

Ergon Energy considers that the current Queensland arrangement is clearer and more capable of practical application.