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03 March 2006  
Re: AGLE Response to Credit Support Issues Paper

Dear David

AGL Electricity Limited (AGLE), in its capacity as a holder of a Victorian Electricity Distribution Licence, is pleased to provide the following response to the Commission's 'Retailer DUOS Credit Support Review - Issues Paper', (January 2006) (the Issues Paper). A separate response will be provided by AGL in its capacity as an Electricity Retailer.

#### Effect of Credit Support as a Hurdle to Retail Entry

While the Allen Consulting Group report "Review of Retailer DUoS Credit Support Arrangements (January 2006) (the ACG Paper), which accompanied the Issues Paper, observes that current hurdles applied to electricity retailers "appear high" relative to telecommunications services resellers, AGLE notes that higher credit requirements may well be appropriate in consideration of the relative risks.

AGLE also notes that the number of new retail entrants which have established themselves in Victoria in the past three years would not suggest that there are any significant barriers to entry inherent in current UoS arrangements.

Based on performance of competitive retail market in Victoria, AGLE does not see any justification for reducing current levels of required credit support. Additionally, AGLE does not believe a need has been demonstrated to require retailers with good credit ratings and good payment histories to start paying credit support.

#### Pass Through for Distributor Losses

AGLE believes that the ability of Distributors to pass through the losses they incur as a result of the failure of a retailer so that the Distributor remains 'economically neutral' is a necessary requirement. Further, AGLE believes that Distributors need to be able to pass through the Transmission component of the losses immediately.

However, as it is end consumers that benefit from competition, it is appropriate that customers also pay the costs. AGLE believes that either retailers must be able to adjust their prices to customers to reflect the increased network charges due to the pass through or the pass through should take the form of a 'levy' that is outside of distribution charges to retailers and for which retailers charge directly to customers.

#### Assessment of the Amount at Risk

The potential losses to be recovered through the pass through of retailer insolvency are likely to exceed the current requirements for credit support of 3 months distribution charges.

AGLE agrees with the ACG concept of incentivising retailers to minimise their accounts payable to distributors, but does not agree with the presumption that 3 months charges is an inappropriately high reference point.

### Consequences of Non Compliance

New mechanisms are required to address non compliance with the provision of credit support under the UoSA. AGL considers that the OFGEM approach of restricting churns for retailers in default of the UoSA would be an appropriate change, and also submits that the Commission should play a role in determining in resolving disputes as to whether or not alternative credit support arrangements proposed by retailers are satisfactory.

Attached is a more extensive discussion of the Issues Paper and ACG report.

Kind regards,

Rohan Jones

Manager Regulatory Affairs

Electricity Networks

# Retailer DUoS Credit Support Review Issues Paper

## Response by AGL Electricity Limited (Distribution)

3 March 2006

AGL Electricity Limited (AGLE) provides this response to the "Retailer DUoS Credit Support Review - Issues Paper" (the Issues Paper), in its capacity as the holder of a Victorian Electricity Distribution Licence. AGL, in its capacity as a Retailer, will provide a separate response.

### Pass Through Provisions

AGLE strongly supports the implementation of 'pass through' provisions in regard to losses experienced by a distributor in the event of the failure of a retailer. While AGLE accepts that a distributor has a responsibility to mitigate the extent of any such losses, distributors are not funded for bad debts due to retailer failure<sup>1</sup>. It is necessary, in order to maintain the integrity of the regulatory framework and the reliability of electricity supply that, as long as the distributor has done all that is reasonably within its powers to mitigate losses, distributors do not incur any losses due to retailer failure.

AGLE notes that the Pricing Controls contain the principle that in deciding the pass through amount, the Commission must ensure that the financial impact on the distribution business is economically neutral (EDPR 2006 Determination clause 5.4.1 of Volume 2). The principle that distributors should be able to recover all losses (including costs) incurred due to the failure of a retailer which are beyond the reasonable control of the distributor to mitigate is necessary because:

- the ultimate size of losses is beyond the control of the distributor;
- distributors have not been compensated for carrying any risk of retail failure as part of their allowed costs; and
- the means available to distributors to manage their exposure are determined by the credit support arrangements set out in the standard UoSA. Distributors should not be required to absorb any additional costs arising from the failure or any inadequacy of credit support arrangements set out in the standard UoSA.

While AGLE notes that the Commission does not intend to formally set out any rules relating to the approval of pass through amounts, AGLE believes that the Commission's approach should include the following considerations:

- The pass through amount should not be capped at the Credit Allowance as the distributor cannot ultimately control the amount of losses. Losses will only cease when RoLR is initiated, which is outside the control of the Distributor. AGLE notes that the Price Controls do not contain any cap on the pass through amount, but rather that the Distributor is 'economically neutral';
- It should not be assumed that the Distributor will act in the absolute minimum timeframe. It should be seen as reasonable for a Distributor to attempt to address matters in an 'informal' manner (such as a telephone call to a retailer

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<sup>1</sup> Issues Paper, page 1

reminding them of a due account) before taking formal steps of issuing notices of breach.

It is AGLE's experience that many late payments of network invoices are due to oversights, system failures or resource issues (such as people on sick leave) rather than inability or unwillingness to pay. It is prudent for time to be allowed for these matters to be addressed informally prior to the issuing of formal notices under the UoSA.

- While it is possible for the Distributor to remain "economically neutral" by delaying or spreading the pass through over a number of years, the Distributor will still have to pay transmission charges in relation to the customers of the failed retailer. The Distributor should not be required to carry this 'cash flow' risk. The distributor should be able to pass through, as a minimum, the transmission component of the losses immediately.
- In order for the distributor to remain 'economically neutral', any pass through amount that is not able to be collected in the year that the loss is incurred must be escalated by the pre-tax WACC as well as CPI.

However, it must be recognised that the pass through of the distributor's losses to retailers may put financial strain on the remaining retailers (and possibly cause the financial failure of other retailers), unless retailers have the ability to pass the distributor's losses through to customers. AGLE believes that either retailers must have the ability to adjust their prices to customers to reflect the distributor pass through or the pass through should take the form of a levy on customers that is in addition to the retailer's prices. As "competition in retail is expected to deliver a number of important benefits to customers"<sup>2</sup>, it is appropriate that customers also pay the costs of competition.

With respect to the specific questions that the Commission requested responses on, AGLE provides the following comments.

Whether the Credit Support Amount of Three Months Distribution Charges is the appropriate value at risk to the distributor. Should a new definition for the distributors' value at risk be established

It is not possible to determine, before the event, the size of the losses the Distributor may incur in the event of retailer failure. The size of the losses depend on a number of factors, not least of which is the time period between identifying that the retailer is unable to pay their bill and the initiating of RoLR. The length of this period of time is ultimately beyond the control of the Distributor. Other factors that are outside the control of the Distributor that will impact the amount of the losses include:

- The amount of credit support provided compared to the minimum amount required;
- Whether the Regulator has instructed the Distributor to delay termination of the UoSA;
- The mix of three monthly and monthly read customers;
- How the financial failure of the retailer occurs (eg does the retailer go into voluntary liquidation or does the retailer continue to trade but not pay its bills);
- The number and size of customers transferred to and from the retailer since the last invoice; and
- The consumption of the retailers customers.

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<sup>2</sup> ACG Paper page 4

To understand the limited control that Distributors have over the size of the losses incurred due to retailer failure, it is necessary to look at the process that is likely to occur.

In the event of a retailer not paying its Network Charges when they are due, the distributor may issue a notice of the breach of the UoSA (under clause 12.2(a) of the UoSA), giving the Retailer 21 days to remedy the breach. If the breach is not remedied in this time, the distributor may issue a notice to terminate the UoSA, giving the Retailer a further 7 days to remedy the breach. If the breach is not remedied, the distributor may terminate the UoSA. Thus it will be a minimum of 28 days from the time the retailer bill is due until the UoSA is terminated. However, under clause 4.10 of the Distributor's Licence, the Regulator may instruct the Distributor to delay the termination of the UoSA, thus increasing the amount of the losses incurred.

Even though the UoSA has been terminated, the Distributor must continue to provide distribution services to the retailer's customers and is not able to reject the transfer of new customers to this retailer. Consequently, the size of the debt will continue to grow.

The effect of a termination of the UoSA is to put the Retailer in material breach of its Retail Licence. The Commission may issue an enforcement order under clause 3.4 of the Retailer's Licence, giving the Retailer 20 business days to comply. If the Retailer does not comply with the enforcement order, the Commission may terminate the Retailer's Licence and instigate Retailer of Last Resort. It is only when RoLR is instigated that another retailer takes financial responsibility for the Retailer's customers and the Distributor's losses stop increasing. However, there is no obligation on the Commission to act in this time frame, or at all, to instigate RoLR.

In any case, the amount of the losses is very likely to be more than three months worth of network charges. Even if the Distributor and the Regulator act in the shortest possible timeframe, it will take a minimum of 8 weeks from the time that a Retailer's bill is due and unpaid to the cessation of the distributor's losses. In respect of customers that are billed quarterly by the Retailer, the Distributor's losses will be a minimum of about 5 months worth of network services and in relation to monthly billed customers, in excess of 3 months. Even if the retailer had provided a bank guarantee or equivalent for 3 months of network charges, the distributor will still incur significant losses for which it is not funded.

Consequently, the amount of the losses is uncapped and cannot be controlled by the Distributor. This is why, along with the fact that distributors are not funded to carry this bad debt, it is necessary for distributor to have pass through of losses and why the amount of the pass through must not be capped. Rather, the amount of the pass through should ensure that the distributor remains 'economically neutral', in accordance with the Price Controls.

Although ACG have concluded that three months DuoS revenue is a relatively high hurdle in comparison to the telecommunications industry<sup>3</sup>, AGL notes that:

- electricity retailers trade in a volatile pricing market and it is conceivable that the apparent financial health of a retailer could change from low risk to actually insolvent over a short period of time and without warning or opportunity for creditors to implement additional risk controls;

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<sup>3</sup> ACG Paper, pages 13 and 14

- distribution revenues include the recovery of transmission charges, and therefore the likely insolvency losses significantly exceed charges for use of the distribution network only; and
- Telstra has greater powers to stop providing services to a failed retailer's customers or to take over the provision of these services themselves (as was the case in the failure of OneTel), thus mitigating the size of the losses, than electricity distributors do.

Considering these differences, AGLE is not convinced by the ACG report that a simple comparison with the telecommunications industry provides an "obvious" measure that 3 months DUOS is inappropriately high.

AGLE also notes that the number of new entrants to Victorian electricity market relative to other jurisdictions in recent years does not suggest any significant barriers to entry. The majority of new entrants have been prepared and able to provide credit support in accordance with the UoSA.

Noting that a distributor's losses are likely to exceed 3 months charges, AGLE does not agree with the ACG report that the VAR should be calculated with reference to a lower measure.

#### Are There Other Options for Credit Support That Should be Considered

The ability of a retailer to propose an alternative form of credit support and the criteria against which this alternative is assessed are contained in Clause 7.10(o) of the UoSA. This clause states that:

*"The Retailer may nominate an alternative method of credit support ... which provides equivalent credit assurance and to which the Distributor consents provided that such consent must not be unreasonably withheld."*

AGLE's experience with the current provisions of the UoSA is that no retailer has been able to put forward an alternative to a bank guarantee that provides equivalent credit assurance. However, negotiations over alternative forms are usually lengthy matters, and are susceptible to a stalemate over what is or is not 'unreasonable' (even though the distributor demonstrates that the proposal does not provide 'equivalent credit assurance'). During the period of negotiations, which often extends for 12 months or more, the distributor provides network services to the retailers customers without any credit support from the retailer.

While AGLE sees merit in allowing the possibility of the retailer proposing alternative forms of credit support that provide 'equivalent credit assurance', AGLE believes that the current approach needs to be enhanced to ensure that the matter is resolved in a timely manner and that the distributor is not at risk during the negotiation period if the retailer fails without the provision of the required credit support. AGLE believes that a dispute resolution mechanism needs to be added to the current process.

AGLE proposes that if either party is not satisfied with the outcome or process, that party is able to refer the matter to an Arbitrator acceptable to the Regulator for a binding resolution. Should the Arbitrator find that the proposed alternative does represent 'equivalent credit assurance' the distributor will give its consent to the proposal and this alternative will be recognised as acceptable credit assurance in determining the amount of the pass through should the retailer fail. If the Arbitrator finds that the proposal does not constitute 'equivalent credit assurance' then the Retailer will withdraw the proposal and will provide Credit Support under clause 7.10(b) of the UoSA.

AGLE believes that the OFGEM approach of preventing retailers from churning customers in the event being in default of the UoSA also has merit as a means of incentivising retailers to comply and to mitigate the size of losses should this retailer ultimately fail. AGLE believes that it would be appropriate for distributors to have the power to object to transferring existing customers and energising new customers on the request of a retailer who has been issued with a notice of breach of the UoSA and who has not rectified that breach.

### ***The OFGEM approach***

AGLE believes that, from a distributor's perspective, the most important aspect of the review of credit support is the pass through provisions. Further, AGLE does not believe that the evidence shows that the current credit support provisions represent a significant barrier to entry of new retailers or that a need has been demonstrated for imposing credit support requirements on retailers with good credit rating and good payment history.

Notwithstanding, AGLE wishes to make the following comments about the OFGEM approach and its applicability to the Victorian market.

#### Recognition of payment history

AGLE believes that the Credit Allowance for each retailer should recognise the retailer's payment history. The Credit Allowance should have scope to increase, up to a certain cap, for each year of full payment on time, and should decrease for repetitive poor or overdue payment.

#### The Value at Risk (VAR)

As a minimum, the VAR should continue to be based on 3 months distribution service charges. As demonstrated above, due to the duration of the process from non-payment to RoLR and the quarterly billing of customers, the losses that a Distributor will incur will be in excess of 3 months in the event of a retailer not paying network charges.

However, in order to incentivise retailers to reduce the risk exposure, AGLE would support the ability for a retailer to apply for their VAR to be reduced to reflect their particular circumstances. Circumstances which may lead to a reduction in the VAR period may include tighter payment terms in the UoSA, shorter notice periods for termination, or a high proportion of monthly billed customers.

#### Parent Company Guarantees

It is not clear from the Issues Paper if the OFGEM approach allows parent company or other company guarantees. AGLE believes that the use of parent company or other entity guarantees should continue. However, under the OFGEM model it will be necessary to apply the VAR to the Guarantor, not just the retailer.

Under the current credit support arrangements, if a retailer, or a guarantor to the retailer, has a BBB- rating or better then (subject to other conditions such as payment history) the retailer is not required to provide any credit support irrespective of the retailers network charges. However, under the OFGEM approach, an entity's credit rating is effectively given a value, which is used to determine the Credit Allowance. For example, a credit rating of BBB- has a value of 0.36% of the Distributor's RAB. Thus, in the situation where one entity provides a guarantee for more than one retailer, it will be necessary to apply the

implied Credit Allowance inferred by the guarantor's credit rating to the guaranteed retailers together, not individually.

#### Credit Support from Large Retailers with Good Credit Ratings

AGLE understands that the OFGEM approach takes account of both the likelihood of a particular retailer failing and the impact of that failure, as opposed to the current approach, which only looks at the likelihood of failure. However, the implications of the OFGEM approach is that a number of large retailers with very good credit ratings will be required to provide Distributors with substantial amounts of Credit Support due to their large presence in a Distributor's area. This will particularly apply to host retailers but will also apply to multiple retailers who rely on a parent company guarantee from one parent company.

AGLE's modelling shows that, under the OFGEM approach, the proportion of the VAR that is required to be covered by Credit Support for a large retailers with good credit rating is likely to be significantly more than for small retailers. Thus a customer of a large retailer with a good credit rating will be paying more to ensure that their retailer pays the necessary distribution charges than a customer of a small retailer with a worse or no credit rating. This does not appear to be an equitable outcome.

#### Alternative Credit Scoring Systems

AGLE accepts that there is a need for alternative methods for assessing the ability of small retailers to pay network charges. As long as distributors have the ability to pass through losses due to retailer failure, AGLE has no problem with the approach proposed for unrated retailers (using the Dun & Bradstreet Dynamic Risk Score) and the ratcheting Allowable Credit Limit based on payment history.

#### Monitoring

AGLE believes that it is not practical for distributors to monitor retailers VAR on a daily basis. Retailers are generally billed monthly for distribution charges. AGLE believes that monthly monitoring is appropriate.

Additionally, it will not be practical to be continually changing credit support amounts were a retailers VAR fluctuate around their Credit Allowance plus provided credit support. AGLE proposes that there be a band around the Credit Allowance plus credit support such that the Distributor will not request additional credit support unless the retailers VAR exceeds the band and the retailer cannot reduce credit support unless the VAR is below the band, such as is contained in clauses 7.10 (d) and (e) of the current UoSA.

In respect of changes to credit ratings, the onus should be on the Retailer to inform the Distributor if their credit rating changes. Distributors' should have the right to review the Retailer's credit rating and should be able to charge the Retailer for one 'reassessment' of their Dun & Bradstreet DRS per annum. If the Distributor wishes, it may have more than one DRS assessment done per annum but this would be at the Distributor's cost.