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Mr John Pierce AO
Chair – Australian Energy Market Commission
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Dear Mr Pierce

Submission – rule change request for an extension of time for retailers to pay networks

The Australian Energy Regulator (AER) welcomes the opportunity to provide this submission to the AEMC. This submission follows our rule change request lodged with the AEMC on 6 May 2020. We proposed to amend the National Electricity Rules (NER) to temporarily grant retailers an extended period of time (6 months) to pay network charges in respect of customers placed on *COVID-19 arrangements* – being deferred payment arrangements entered into, or adjusted, in response to the COVID-19 pandemic and related economic shut down.

As proposed, the temporary new mechanism would apply to network charges incurred between 1 July 2020 and 31 December 2020. These arrangements would follow on from voluntary measures being offered under Energy Networks Australia's (ENA) Network Relief Package for the June quarter 2020.

Our rule change request noted that some key design issues for the proposed temporary mechanism required further consideration and analysis. Since lodging our rule change request we have given significant thought to how best to target retailers most in need of support while mitigating impacts on networks. We detail below our view that some retailers may be restricted from accessing the mechanism and that benefiting retailers should pay a material rate of interest to networks providing them with credit support. First, however, we discuss the need for intervention to support the retail sector during this difficult time.

Why do we consider the electricity retail sector needs support?

The COVID-19 pandemic and government response has impacted customers' ability to pay electricity bills. The full scale of this disruption is still unclear and we are gathering information from the retail sector in respect of customer debt and deferred payment arrangements. We note also uncertainty around developments both in the near term and foreseeable future. Given this uncertainty we have undertaken scenario modelling of the possible electricity retail sector impacts of COVID-19.[1]

Our low impact scenario assumes a drop in electricity retailer revenue (due to deferral of customer payments, or an increase in bad debt) of 2 per cent for commercial and industrial (C&I) customers, 5 per cent for small and medium-sized business (SME), and 5 per cent for residential customers, sustained for a six month period. Our medium impact scenario assumes revenue reductions of 5 per cent for C&I and 10 per cent for both SME and residential customers.

Our modelling assumes that retail cash-flow margins for each customer follow a normal distribution around the average retail margin reported by the ACCC, with slightly different distributions for residential, small business and large customer categories.

Using these assumptions, we estimate that under our low impact scenario, retailers with negative margins would service around 1.6 million residential customers. Under this scenario, the accumulated negative cash flow over 6 months (for residential, SME and C&I customers) would be around $270m.

Under our medium impact scenario, we estimate that retailers with negative margins would service around 5.3 million residential customers. Negative cash flow over 6 months under this scenario would be around $844m (for residential, SME and C&I customers). As discussed below, not all retailers facing temporary negative margins may require access to the financial support provided by the proposed fund.

It is important to note that our modelling is indicative only and only seeks to estimate sector-wide financial impacts. We have not sought to estimate the impacts on, including the solvency of, specific retailers. Note also that our modelling does not account for existing debt levels, or the cash reserves held by retailers or, where relevant, their parent companies. Nor does our modelling account for the ability of individual retail businesses to source credit.

We do, however, consider our modelling illustrates the scale of the issue facing Australia's electricity sector. We further consider it demonstrates the prudency of intervention to mitigate the risk of multiple, cascading, retailer failures which would be disruptive to retail customers and would likely reduce retail sector competition for some time.

Eligibility for the network charges deferral mechanism should be narrowed

As drafted, our proposed rule encompassed all retailers. However, our rule change request was clear that there would be benefits from narrowing the scheme to only those retailers whose viability would be threatened by the impact of COVID-19 on their cash-flows. Specifically, revenue impacts on networks would be reduced in proportion to narrowing the scheme's scope. This is important because networks and retailers have different exposures to risk. As we stated in our rule change request, we do not propose to change the allocation of risk between retailers and networks.

In considering how to narrow the scheme's scope, we have taken into account not only the impact of the COVID-19 pandemic on customers and therefore on retailers, but also the ability of different retailers to source credit if necessary. This reflects our view that the COVID-19 pandemic and related economic impacts will affect retailer liquidity temporarily

[1] Our low and medium impact scenarios are based on recent data published by the Australian Bureau of Statistics (ABS) and Reserve Bank of Australia (RBA) in addition to retail margin information reported by the ACCC in its Retail Electricity Price Inquiry (REPI) and customer data published by the Victorian Essential Services Commission.

and that short term credit will, if necessary, help retailers to bridge the period of revenue disruption until customer payments return to more normal patterns. With this in mind we recommend that some retailers, those least likely to require support, should be restricted from accessing the scheme. We would support NER amendments to restrict access to the scheme by government owned retailers and tier 1 retailers – those who have nominated and been registered as retailers of last resort (RoLRs).

Should government owned retailers experience financial distress they have obvious channels of support through their shareholders who can provide finance directly rather than indirectly through the proposed fund. Similarly, we expect tier 1 retailers Origin Energy, Energy Australia and AGL would also have access to credit through their parent companies or, at competitive rates, from credit markets. In restricting these retailers from the mechanism we expect to mitigate network impacts and maximise the scheme's value to customers by focusing explicitly on supporting retail sector competition.

We note there will remain a risk of low probability but high impact events such as the prospective failure of a government owned or tier 1 retailer. While not expecting such circumstances to eventuate for the reasons outlined above, we recognise that the AEMC may wish to establish a pathway for these retailers to access the network charges deferral mechanism if required. Within such a pathway the AER may be called upon to assess applications for support from otherwise restricted retailers. In this context we make two points. First, that any such assessment would likely be time sensitive as the retailer in question would be seeking urgent assistance to stave off insolvency – an AER assessment would necessarily be limited. Second, that receipt of support through the mechanism following an AER assessment should be a matter of public record – this would act as an incentive for retailers to pursue other options before seeking such support.

Applicable interest rate on revenue deferrals under the rule change

In providing support to retailers by deferring their network payments, networks will incur financing costs. To preserve networks' existing risk profile they should be compensated for these financing costs. Our rule change request described two possible approaches for this to occur.

We described option 1 as allowing networks to charge retailers interest. Under option 2 networks could recover their financing costs by bundling these into their general regulated revenues to be recovered from all customers. Our preference is to use option 1. Having further considered this issue we are now of the view that charging interest to benefiting retailers would serve a number of purposes and we support that approach in preference to passing costs through to network customers in another way.

Allowing networks to charge retailers interest would:

- ration access so retailers will only access the scheme if necessary
- better align scheme costs with the risk of retailer default
- provide an incentive for retailers to defer payments only as long as necessary
- compensate networks for the costs they will incur in providing credit support.

We propose that the interest rate for the network charges deferral mechanism be set at a material level, equivalent to that available to an entity with a sub investment grade credit rating. In our view this better reflects their risk profile in circumstances where retailers were accessing this credit support. We expect this may be different to the default interest rate currently established by the NER for late payments. We also expect this rate to be higher than rates ordinarily available to retailers affiliated with large corporate groups. We propose this rate because our policy goal is to provide a last resort avenue for retailers to obtain credit, rather than to provide an attractive alternative source of finance.

Mitigating network impacts

A benefit of option 1 described in our rule change request is that networks would not themselves incur permanently the financing costs associated with providing credit to retailers. That is, there would be no enduring risk transfer from the retail sector to the network sector. The regulatory framework's existing risk allocation between retailers and networks would be preserved, as we have intended.

We consider that applying an interest rate as described and restricting government owned and tier 1 retailers from accessing the mechanism would also mitigate concerns expressed to us by networks. Tier 1 retailers represent around 66 per cent of all customers. Government owned retailers represent around another 20 per cent (though largely focussed in specific jurisdictions). The filtering effect of restricting access to the scheme by retailers reflecting the majority of all customers and then applying a material interest rate to benefiting retailers would reduce potential disruption to network revenue streams.

To the extent that concerns continue to be raised about the network impacts of our proposed temporary mechanism, we note that the National Electricity Market (NEM) regulatory framework provides significant transparency, predictability and stability for networks and their investors. Our proposed rule change requires networks only to defer a portion of their revenues, not forego it, and we expect that application of an appropriate interest rate to deferred payments will cover network financing costs.

For further context, we note that network credit ratings have remained stable despite material changes in cash-flow over time as a result of revenue determinations or transient and material differences between revenue and costs arising from revenue smoothing.
To that end, so long as investors retain confidence that the revenue cap will be applied, we expect that networks should be able to manage short-term cash-flow impacts under the scheme.

How we may decide to extend the temporary new mechanism for a further period

Our rule change request proposed that the AER be able to make an administrative decision to extend the application of the mechanism for a further period. This decision would be conditioned upon the AER being satisfied that an extension is "reasonably necessary in all the circumstances". We propose that this remain as the sole consideration for the AER in making a decision to extend the mechanism. It is preferable to retain flexibility to respond to the circumstances of the NEM and broader Australian economy rather than be required to meet a number of specified considerations.

In making a decision to extend the mechanism for a further period we would undertake stakeholder consultation. However, the appropriate process for engaging stakeholders is currently unclear. As proposed, we need not make a decision to end application of the mechanism on 31 December 2020. The mechanism will cease on that date without any action on our part. To form a view to extend the mechanism we will monitor retail market dynamics and take-up of the network charges deferral mechanism during its initial 6 month phase. We may not form a view that extending the mechanism is necessary until close to 31 December 2020. As such, an abbreviated stakeholder consultation process may be required.

We prefer to retain flexibility with respect to the details of our stakeholder consultation, using an appropriate process to be determined at that time.

To inform our decision on an extension, and to improve transparency of scheme impacts for all stakeholders, we recommend that all affected participants under the scheme be required to report regularly (e.g. monthly) to the AER with a standard and publishable set of information, to be determined on development of the scheme but likely to include:

- numbers of customers whose network payments are deferred under the scheme
- total network payments deferred under the scheme.

Yours sincerely

Clare Savage
Chair

Sent by email on: 25 June 2020