



DIRECTIONS PAPER

DEFERRAL OF NETWORK CHARGES RULE CHANGE

1. INTRODUCTION

On 6 May 2020, the Australian Energy Regulator (AER) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission). The request seeks to amend the National Electricity Rules (NER) to allow electricity retailers to defer the payment of some network charges incurred between 1 July 2020 and 31 December 2020 to distribution network service providers (DNSPs) for six months. The AER's proposal is intended to allow retailers to focus on the ongoing supply of energy as an essential service, and support for customers, as they deal with the cash flow pressures arising as a result of the COVID-19 pandemic.

On 28 May 2020 the AEMC published a consultation paper seeking feedback on a number of issues relating to the AER's proposal. The Commission commenced the rule change assessment under the expedited rule making process on the basis that the proposal should be considered as an urgent rule under the NER.¹ On 7 July 2020 the Commission extended the time for making a final determination from 23 July 2020 to 6 August 2020, due to the complexity of issues raised in submissions to the consultation paper regarding the design and implementation of the deferral mechanism. As such, a final determination is due to be published on 6 August 2020.

2. SUMMARY OF COMMISSION'S POLICY POSITIONS

The Commission proposes to make a more preferable final rule to allow certain retailers to defer the payment of network charges incurred in respect of certain customers between 6 August 2020 and 6 February 2021 to distribution network service providers (DNSPs) for six months. While the final rule may adopt some elements of the AER's proposal, it is proposed to also include additional safeguards to ensure that:

- the scope of the deferral mechanism is narrowed by imposing appropriate entry criteria and incentives on retailers, while still allowing payment deferrals to be administered in a timely manner
- eligible retailers can only defer the payment of network charges for residential and small business customers on a payment plan, hardship arrangement or deferred debt arrangement
- retailers will be required to pay interest on deferred network charges in order to allow DNSPs to recover the efficient costs they may incur as a result of the payment deferrals
- where a retailer defers the payment of network charges to a DNSP, the DNSP can also defer the payment of the relevant transmission use of system (TUOS) charges to the transmission network service provider (TNSP).

¹ An 'urgent rule' is defined in section 87 of the NEL as "a rule relating to any matter or thing that, if not made as a matter of urgency, will result in that matter or thing imminently prejudicing or threatening: (a) the effective operation or administration of the wholesale exchange operated and administered by AEMO; or (b) the safety, security or reliability of the national electricity system".

The proposed design of the deferral mechanism is discussed in more detail in section 4 of this paper.

The Commission considers that the implementation of a deferral mechanism with the design features discussed above is a necessary and proportionate response to the impacts of COVID-19.

This approach will achieve a number of key objectives, including:

- allowing retailers to continue to support vulnerable customers while managing the increased risk arising from the inability to disconnect customers for non-payment in light of the AER's Statement of Expectations²
- ensuring a framework is in place to help manage potential increases in customer non-payment in the second half of 2020.
- reducing short-term risks to retail market competition posed by COVID-19.

On this basis the Commission considers that the mechanism will, or is likely to, contribute to the achievement of the National Electricity Objective.

The Commission notes that the proposed design choices outlined in this paper have been informed by the extraordinary circumstances associated with COVID-19 and the need to have a framework in place as quickly as possible to assist the market in dealing with the impacts of the pandemic. The proposed rule change is being assessed on an urgent basis in order to achieve this objective and the proposed approach to determining eligibility criteria and implementation processes should therefore not be interpreted as setting a precedent for future decisions.

3. PURPOSE OF THIS PAPER

The purpose of this paper is to seek feedback on:

- how a deferral mechanism possessing the design elements discussed in this paper could be implemented in an effective and timely manner; and
- the proposed rule drafting at appendix A, especially the deferral of payments from DNSPs to TNSPs (section 4.3 below) and the processes by which payment deferrals will be administered (section 4.4 below).

The expedited rule making process does not require the Commission to publish a draft determination. However, there are a number of implementation questions relating to the proposed deferral mechanism which will need to be addressed to some extent in the final rule. The Commission considers it important to obtain feedback from stakeholders on these issues to ensure that the mechanism can be implemented effectively and in accordance with the policy intent. To facilitate this, this paper sets out the Commission's proposed positions on a number of key design elements for the deferral mechanism, as well as how the Commission proposes to give effect to those positions in the final rule.

² AER, *AER Statement of Expectations of energy businesses: Protecting consumers and the energy market during COVID-19*, 27 March 2020. Available at: <https://www.aer.gov.au/publications/corporate-documents/aer-statement-of-expectations-of-energy-businesses-protecting-consumers-and-the-energy-market-during-covid-19>.

4. KEY DESIGN ELEMENTS

4.1 Eligibility to defer payment of network charges

Retailer eligibility

Summary of proposed policy position: Retailers registered as a Retailer of Last Resort (RoLR) and government-owned retailers will be excluded from deferring the payment of network charges. All other retailers will be required to pay interest on any deferred network charges at a rate of 3% p.a.

The Commission proposes to limit access to the financial support provided by the deferral mechanism to those retailers that have a legitimate need for this support as a direct result of the COVID-19 pandemic. The Commission proposes to achieve this by providing that retailers that are directly or indirectly government-owned and retailers registered as a Retailer of Last Resort (RoLR) (as well as any related entities of these retailers) will be excluded from deferring the payment of network charges. The Commission considers that retailers falling into these two categories should be in a strong financial position and/or able to access alternative sources of credit to alleviate any cash flow issues they are currently experiencing. The rationale for excluding each of these categories is discussed further below.

The AER's Retailer of Last Resort statement of approach states that the RoLR scheme should result in the appointment of designated RoLRs with the financial and organisational capacity to carry out the role.³ In appointing default RoLRs, the AER considers a retailer's ability to access potentially large financial resources at short notice. The rationale and criteria for appointing a retailer as a RoLR therefore indicates that RoLR retailers should not need to access the proposed deferral mechanism. In particular, the Commission considers that, given their size, financial capacity and access to capital, currently registered RoLR retailers should be able to absorb any cash flow impacts of COVID-19 without resorting to deferring the payment of network charges. This view is consistent with statements made by a number of RoLR retailers in recent months. The objective of this rule change is to support retailers to continue to supply vulnerable customers in the immediate term while managing the changes to their risk profile in circumstances where alternative forms of cash flow relief are unlikely to be feasible. Allowing RoLR retailers to access payment deferrals would allow these businesses to commercially benefit from this regulatory change despite not having an immediate financial need for this support. This would be inconsistent with the above objective. On that basis, the Commission considers determining eligibility by reference to the RoLR framework to be an appropriate and pragmatic approach.

The Commission considers that a similar logic applies to government-owned retailers. To the extent that these retailers are experiencing cash flow challenges, this should be addressed through financial support provided by the relevant government in the first instance. The Commission notes that this is consistent with the position expressed by the Queensland Government in its submission to the consultation paper.

Retailers not falling into these two categories should automatically be eligible to defer the payment of network charges for eligible customers (discussed further below). These retailers should be required to pay interest on any deferred network charges at a rate of 3% per annum

³ AER, *Retailer of Last Resort statement of approach*, November 2011. Available at: <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retailer-of-last-resort-guideline-plan-and-statement-of-approach>.

The determination of this interest rate has been informed by the following considerations:

- Some stakeholders suggested the applicable regulated weighted average cost of capital (WACC) for each DNSP could be an appropriate interest rate to apply to deferred payments. However, the Commission understands that it would be necessary to use the inflation adjusted WACC to accurately reflect the rate of return earned by a DNSP. The inflation figures required to calculate the inflation adjusted WACC applying during the deferral period will not be released until late January 2021. As such, an interest rate based on the inflation adjusted WACC for each DNSP could not be calculated with certainty at the commencement of the deferral mechanism.
- While the actual inflation adjusted WACC of each DNSP could not be calculated until January 2021, an estimate of this figure can be calculated based on inflation forecasts published by the Reserve Bank of Australia. When using this approach to calculate the *estimated* inflation adjusted WACC, the median rate across all DNSPs that will be subject to the final rule is 3.00%. This rate is therefore approximately reflective of what the inflation adjusted WACC of a DNSP that is subject to the rule is likely to be.
- Analysis of business lending rates for recently funded new loans suggests that an interest rate of 3% is likely to impose appropriate incentives on retailers considering utilising the deferral mechanism, given that this interest rate is likely to be:
 - lower than the lending rate currently available to a small retailer in the NEM
 - higher than the lending rate currently available to some larger retailers in the NEM that are in a stable financial position but still meet the retailer eligibility criteria discussed in section 4.1 – these retailers are likely to be able to borrow funds more cheaply than a small retailer.

Based on the above analysis, the Commission considers that an interest rate of 3% will achieve a number of key objectives:

- Eligible retailers that can secure credit at an interest rate below 3% will have a financial incentive to try to obtain additional funds from the private sector prior to accessing the deferral mechanism.
- Networks will be able to recover the direct costs they are likely to incur as a result of the deferral of these payments.
- Eligible retailers will face an efficient price signal because they will be paying the cost of the finance that the DNSP is likely to incur.
- A fixed rate avoids the need for adjustments which would result from any difference in the rate the retailer is required to pay and the rate the DNSP is entitled to recover.

The intent of the proposed rule is that any interest payments received by an NSP would not be counted as revenue for the purpose of the NSPs' maximum allowed revenue (MAR). The Commission also expects retailers not to seek to pass through any interest costs to customers.

The Commission considers that the combination of explicit eligibility criteria with a requirement to pay interest on deferred network charges imposes appropriate entry requirements and incentives on retailers while still allowing payment deferrals to be administered in a timely manner.

Customer eligibility

Summary of proposed policy position: Eligible retailers will be able to defer the payment of network charges incurred in respect of residential and small business customers that are on a payment plan, hardship arrangement or deferred debt arrangement.

The Commission considers that the deferral mechanism should capture customers:

- whose ability to pay their electricity bill is most likely to have been impacted by COVID-19
- for whom retailers do not hold security or have the option of disconnecting for non-payment.

The AER's rule change request proposed that eligible customers be defined as those that enter into a payment plan, hardship arrangement or deferred debt arrangement between 1 March 2020 and 31 December 2020. The Commission agrees that customers on payment plans and hardship arrangements are likely to be the most financially vulnerable class of customers and therefore the most likely to be facing challenges paying their electricity bill as a result of COVID-19. However, the Commission also understands that many retailers have implemented COVID-19-specific deferred payment arrangements to assist customers during this period. This is likely to have contributed to the lower than expected increases in the number of customers on payment plans and hardship arrangements being reported by retailers to the AER in recent months.⁴ It is important that the deferral mechanism capture this third category of customers in order to allow retailers to effectively support the range of customers that are most impacted by COVID-19. As such, the Commission proposes to allow retailers to defer the payment of network charges for customers on a "COVID-19 customer arrangement", which will include customers that are on a payment plan, hardship arrangement or deferred debt arrangement at the time the statement of charges applying to that customer is issued to the retailer.

The Commission does not consider that it is appropriate to limit the support provided by the deferral mechanism to customers that entered into such arrangements from March 2020 onwards. Such a definition would exclude customers that were already on these types of payment arrangements prior to COVID-19 and were thus already financially vulnerable. These customers may be at an even higher risk of being unable to pay their bills due to the economic impacts of the pandemic on their already vulnerable circumstances. The Commission therefore considers it important that the final rule also allow retailers to defer the payment of network charges in respect of these customers. While this will result in a slightly higher proportion of customers being eligible for deferrals than the AER's proposed definition, this will still be a very small proportion of overall customers (approximately 2 per cent of residential customers) and the resulting cash flow deferrals are considered to be manageable for NSPs.

It is proposed that the definition of "COVID-19 customer arrangement" in the final rule will only include small customers, as defined in the National Energy Retail Law (NERL). In effect, this would capture residential and business customers with an annual electricity consumption below the statutory thresholds determined in each jurisdiction that has adopted the NERL. The Commission considers that retailers can manage cash flow issues relating to large customers through their commercial arrangements with those customers, including by drawing on security provided by those

⁴ The AER has called on retailers to provide additional data on a voluntary basis to enable us to have visibility of the effect of COVID-19 on the retail energy market. The data provides a high-level summary of changes in the retail market and is updated weekly. See <https://www.aer.gov.au/retail-markets/performance-reporting/weekly-retail-market-dashboards-covid-19>.

customers. In addition, the prohibition on disconnection in the AER's Statement of Expectations does not apply to large customers. As such, the Commission does not consider it appropriate or necessary for the deferral mechanism to apply to large customers. The existing consumption thresholds for small customers under the NERL are considered to be an appropriate and transparent reference point for differentiating between small and large customers in this context.

4.2 Deferral timeframe

Summary of proposed policy position: Eligible retailers will be able to defer the payment of network charges incurred for eligible customers for a period of six months from the commencement of the final rule. The payment of these network charges will be deferred for a period of six months. The AER will not have the discretion to extend the deferral period.

There are two elements relating to the deferral timeframe which must be considered:

- the period during which network charges can be deferred
- the length of time the payment of those network charges can be deferred for.

With respect to the first point above, the Commission considers that a period of six months from the commencement of the final rule is an appropriate timeframe to allow for network charges to be deferred. This period would therefore expire in mid-February 2021. This will assist eligible retailers to manage the immediate cash flow impacts of COVID-19 and continue to focus on the supply of electricity to customers during this period. Many stakeholders have raised concerns that the economic impacts of COVID-19 will continue to manifest in many sectors of the economy during the second half of 2020. In particular:

- A number of existing financial support measures are currently scheduled to expire during this period, including the Federal Government's JobKeeper Payment scheme and the mortgage deferrals implemented by Australian banks, both of which will conclude in September 2020. It is reasonable to expect that some electricity customers will experience increased difficulty paying their bills once the financial support currently being provided by these schemes is removed.
- There is the potential for the AER's Statement of Expectations to be extended beyond 31 July 2020, such that retailers may be expected to continue to not disconnect customers for non-payment for a period beyond this date.

Providing for the deferral mechanism to have effect for six months from the commencement of the final rule will give retailers the flexibility needed to continue to support vulnerable customers during this period. The Commission notes that the purpose of this rule change is not to address the medium to long-term implications for the energy sector of a broader economic recession. To the extent that broader economic outcomes continue to pose a material risk to the viability of the retail market in early 2021, it may be appropriate to consider alternative measures to address this issue. Based on analysis and feedback provided by stakeholders, the Commission also considers that the deferral of some cash flows under the mechanism for six months should be manageable for network businesses (particularly given the eligibility criteria for retailers discussed above).

With respect to the length of time the payment of network charges can be deferred for, the Commission considers that deferring payment for six months will provide sufficient time for retailers to adjust their operations as needed to manage the short-term impacts of COVID-19. The Commission proposes that the due date for the payment of network charges incurred in respect of an eligible customer within six months from the commencement of the final rule be taken to be

deferred by six months. The Commission notes that retailers should not be prevented from paying any deferred network charges before the deferred due date, should they choose to do so. Figure 1 provides a visual illustration of the length of the proposed deferral timeframes.

Figure 1: Proposed deferral timeframes



The AER proposed in its rule change request that it have the discretion to extend the period during which retailers can defer the payment of network charges beyond six months if it considers it reasonable to do so. It is proposed that the final rule not confer this discretion on the AER. Leaving open the possibility of requiring network businesses to defer the payment of network charges beyond February 2021 would introduce significant uncertainty for those participants. It is also not clear based on the evidence currently available that this will continue to be an appropriate or necessary measure to deal with the longer-term impacts of COVID-19. In addition, the deferral period under the final rule is proposed to extend beyond the period proposed by the AER. Specifically, the rule change request proposed that the initial deferral period expire on 31 December 2020, whereas Commission proposes that the deferral period under the final rule expire in mid-February 2021. As such, the final rule would provide additional time for retailers to adjust their operations to manage the impacts of COVID-19 prior to the expiry of the deferral mechanism. The Commission considers that this reduces the need to provide for any future extension of the deferral period.

The Commission notes that if it becomes apparent in late 2020 that it may be necessary to extend the deferral period beyond six months, this could be considered at that point in time through an expedited rule change process, should the relevant statutory test be satisfied.

4.3 Deferral of payments between DNSPs and TNSPs

Summary of proposed policy position: Where a DNSP is required to defer the recovery of network charges from an eligible retailer, the TNSP will defer recovery of the TUOS component of the deferred network charges from the relevant DNSP for the same period (with the application of interest).

The Commission considers it appropriate that the impact of payment deferrals be shared between DNSPs and TNSPs. The Commission notes that TUOS charges account for approximately 14% of the total network charges applying to an average residential customer’s electricity consumption.⁵ Allowing DNSPs to defer the payment of TUOS charges in proportion to the network charges deferred by a retailer will therefore substantially reduce the cash flow impact of this rule change on DNSPs. The Commission considers that it is practical and appropriate for TNSPs and DNSPs to agree on processes to facilitate these deferrals, rather than seeking to prescribe these arrangements in the NER.

⁵ Based on analysis included in the Commission’s 2019 Residential electricity price trends review.

To give effect to the policy intent, the Commission proposes to:

- impose a general requirement that provides for the payment of TUOS to be deferred by a DNSP in the circumstances described above
- require TNSPs and DNSPs to negotiate in good faith to implement arrangements that facilitate this as soon as practicable after the final rule is made
- require DNSPs to pass through interest earned on the TUOS portion of any deferred network charges to TNSPs.

Stakeholders have broadly expressed support for this approach in submissions to the consultation paper.

4.4 Practical implementation of payment deferrals

Summary of proposed policy position: Retailers and network business must negotiate and agree on arrangements to give effect to the payment deferrals within one week of the final rule being made. Retailers will be required to provide a statutory declaration confirming that any payment deferral request is in accordance with the definitions outlined in the final rule.

For the deferral mechanism to be effective, it is important that the processes used to administer payment deferrals are transparent, pragmatic and efficient. The Commission does not consider that it would be practical or appropriate for these processes to be prescribed in detail in the NER. This is consistent with feedback provided by stakeholders in submissions to the consultation paper.

The Commission understands that:

- retailers and NSPs have already gone through a process of negotiating and agreeing on processes to implement the support measures provided under the Network Relief Package
- these existing processes can be leveraged to allow for payment deferrals under the final rule to be implemented and administered efficiently.

It is proposed that the final rule not include prescriptive requirements about the processes participants must use to give effect to the rule. Rather, retailers and NSPs would be required to agree on such processes within one week of the commencement of the rule.

Commission also proposes a requirement for retailers to provide a statutory declaration confirming that any payment deferral request is in accordance with the definitions outlined in the final rule. The Commission considers that this is appropriate to facilitate the payment deferrals being processed expediently while still providing DNSPs with some assurance that the relevant customers are eligible for deferrals under the rules. This is also similar to the assurance retailers are required to provide to DNSPs to access support under the Network Relief Package.

4.5 Reporting requirements

Summary of proposed policy position: To increase the transparency of the deferral mechanism, eligible retailers will be required to report to the AER on the numbers of customers whose network payments are deferred under the scheme and the total network payments deferred under the scheme. The AER will also be required to publicly report on this data.

Given that a final rule would potentially introduce a new scheme to assist the retail market in dealing with the unprecedented impacts of COVID-19, the Commission considers there is value in

providing transparency to the market regarding the number of customers and quantity of network charges deferred under this mechanism. This will provide some visibility of:

- the extent to which the rule change is impacting on network businesses
- the extent to which the rule change is helping retailers to manage cashflow problems
- the number of customers that are on the types of arrangements identified in the rule.

This information may also be useful in informing the ongoing response to the longer-term economic impacts of COVID-19.

The Commission considers that the AER should be required to report this information to the market in a timely manner while the mechanism is in operation. The Commission notes the AER is currently receiving monthly information from retailers on the number of customers on hardship, payment or deferred payment plans. The same frequency of reporting on the overall use of the scheme would provide valuable data on the level of support that retailers are receiving and how that changes over time.

4.6 Other administrative issues

In addition to the key design elements described in the above sections, it is proposed that the final rule also include drafting to address a number of more minor administrative issues relating to the deferral mechanism, including to clarify:

- how the rules relating to credit support apply to payments deferred under the final rule
- that the deferral mechanism does not apply to network charges in respect of alternative control services or negotiated distribution services.⁶

5. IMPACT ON NSPs

Some network businesses have expressed concerns that the AER's proposal will have a material impact on their cash flow and that this could create risks of them breaching their debt covenants and/or having their credit rating downgraded.

The Commission has considered the impact of the rule change on NSPs' cash flows and any associated risks a network business may face as a result. While some retailers will be allowed to defer a portion of their network charges for six months, it is proposed that the final rule impose a number of limitations that were not included in the AER's proposal which will significantly reduce the financial impact on network businesses.

These elements of the mechanism are discussed in this paper and include:

- the exclusion of RoLR retailers and government-owned retailers from being eligible to access the deferral mechanism
- large customers (as defined in the NERL) will not be eligible for payment deferrals
- retailers can only defer payment of network charges for residential and small business customers on hardship arrangements, payment plans or deferred debt arrangements
- for any network charges deferred by a retailer, DNSPs will be able to defer the payment of the corresponding TUOS charges

⁶ Alternative control services and negotiated distribution services are services that are generally specific to, or requested by, a particular customer.

- the payment deferrals only apply to standard control services⁷
- the deferrals will only be able to be claimed for a period of six months and will defer payment for a six-month period.

The AEMC has undertaken a high-level assessment of the potential impact of the payment deferrals on the annual revenue for a representative DNSP (taking into account the design elements outlined above). This calculation, set out in Table 1 below, is driven by simplified and conservative assumptions based on publicly available data and so should only be used as an indicative assessment.

Table 1: Estimated impact of proposed deferral mechanism on representative NSW DNSP's annual revenue

Design element	Reduction in share of annual revenue impacted	Total annual revenue impacted	Source
6-month deferral	50%	50%	Assuming flat consumption across the year
RoLRs and government-owned retailers ineligible for payment deferrals	88% (of 50%)	6%	Market shares of these retailers for NSW (based on AER retail statistics)
Large customers ineligible for payment deferrals	10% (of 6%)	5.4%	Estimated large customer share of network revenue
Payment deferrals only for customers of eligible retailers on hardship arrangements, payment plans and deferred debt arrangements	90% (of 5.4%)	<1%	Upper estimate of 10% of eligible retailers' customers meeting these criteria based on AER retailer data dashboard (8 June 2020)
<i>Estimated share of total annual DNSP revenue deferred</i>		<1%	

Table 1 shows that the estimated impact of the proposed deferral mechanism on a representative DNSP in New South Wales is expected to be less than one per cent of that DNSP's annual revenue. The Commission acknowledges that this amount will vary for each DNSP and may be higher for DNSPs operating in distribution areas where the retailers excluded from the deferral mechanism have a smaller market share and/or eligible retailers have a higher proportion of customers on payment plans, hardship arrangements or deferred debt arrangements. However, the Commission considers that this analysis suggests the impacts of a deferral mechanism with the limitations described above should not present a material financial risk for DNSPs. This is also consistent with feedback provided by network businesses in submissions to the consultation paper.

6. LODGING A SUBMISSION

Written submissions on the policy positions discussed in this paper must be lodged with the Commission by 23 July 2020 online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ERC0302.

⁷ Standard control services are core distribution services associated with the access and supply of electricity to customers.

7. NEXT STEPS

On 7 July 2020, the Commission extended the period of time for making the final determination to 6 August 2020 under section 107 of the NEL, due to the complexity of the issues raised by stakeholders in submissions to the consultation paper in relation to how the rule could be implemented in the regulatory framework.

The Commission will consider feedback provided in submissions to this policy paper in developing the final determination and final rule for this rule change, which will be published on 6 August 2020.