25 June 2020

Endeavour Energy

Mr John Pierce
Chair
Australian Energy Market Commission (AEMC)
PO Box A2449
Sydney South NSW 1235

Dear Mr Pierce,

URGENT RULE PROPOSAL: DEFERRAL OF NETWORK CHARGES (ERC0302)

Endeavour Energy appreciates the opportunity to respond to the AEMC's consultation on the AER's urgent rule change proposal; *National Electricity Amendment (Deferral of Network Charges) Rule 2020*. This rule change is in response to the COVID-19 pandemic and its potential for material impact on retail competition. We support its intent to help protect customers.

Supporting customers remains our priority

Endeavour Energy has not been immune to the impact of COVID-19 on the community and recognises the hardship for many energy customers across Australia. As a responsible company, we have prioritised keeping people safe, keeping the lights on and keeping people in work. We have continued to deliver the services our regulators and customers expect, while taking steps to help customers facing hardship including:

- implementing the NSW Network Relief Package (NRP) designed to help retailers offer improved hardship programs by providing temporary relief or rebate from network charges for households and small businesses;
- working with retailers in temporarily suspending disconnections for non-payment in accord with the AER's Statement of Expectations; and
- increasing the use of generators while we undertake essential maintenance

We are strongly committed to supporting customers suffering hardship during these difficult times and will continue to do so. We have taken steps to manage our way through and mitigate the impact on our business and, most importantly, the service we deliver to customers. In light of the above, two key issues need to be addressed in assessing this rule change.

1. The impact of proposed measures on customers should be paramount.

If the AEMC agrees with the AER that a risk of cascading retail failure remains and a rule change is the best mechanism to prevent this, rather than adopt an overly broad and risky solution, it would be more productive and beneficial to customers to offer support on a targeted basis where it is needed the most.

This rule change will only benefit customers to the extent that it supports retailers in genuine hardship as a result of the COVID-19 pandemic. Customers will not benefit from supporting retailers with alternate sources of credit, that are susceptible to failure for reasons unrelated to COVID-19, or for which support will not prevent an exit. The rule change needs to be targeted and should not be about simply moving the financial stress from retailers to networks.

Endeavour Energy suggests an improved mechanism that provides retailers under financial stress with support while avoiding putting networks under financial distress. In making recommendations on a preferred rule, we respond to the particular questions raised in the consultation paper including:

- **Retailer eligibility:** we recommend that the deferral mechanism is limited to Tier 2 and non-Government-owned retailers and is subject to an eligibility criterion similar to the one adopted in NZ or the UK to ensure that support is only extended in cases of genuine need;
- **Customer eligibility:** we recommend that the mechanism is limited to residential and small business customers covered by the AER's Statement of Expectations that require support due to their limited capacity to manage their near term financial circumstances;

- **Deferral period:** we recommend that it is limited to the immediate impacts of the COVID-19 pandemic and does not extend to any subsequent economic downturn. We also recommend that the rule change be available on a once-off 6-month basis and cannot be extended.
- **Risk allocation:** we recommend that any arrangements in the event of a sustained period of challenges are considered separately. Changes in the allocation of risk would need to be considered in the context of current rate of return, credit support and ROLR arrangements; and
- **Network impacts:** we recommend that a principle and mechanism are established that ensure networks can recover costs and that the rule change does not place networks into a position of material financial distress. This will involve setting an appropriate interest rate on deferred payments; allowing networks to defer a pro rata amount of transmission charge payments; and reducing the scope of the rule change as per the above recommendations.

2. **A rule change should be fair and reasonable and targeted to the risks it seeks to address to ensure it will sufficiently meet real areas of need and not result in negative impacts.**

While this is an unprecedented situation requiring a collective response, Endeavour Energy urges the AEMC to be mindful of the developing economic environment and be fair and reasonable in addressing the immediate and long-term impact on customers.

The economic environment continues to change, with increasing signs that the nation is changing from the significant social distancing restrictions that existed at the lodgement of the rule change request. Other factors, such as Government assistance programs and a decision to continue, or not, with the JobKeeper program, will have a bigger impact on customers' ability to pay their power bills and, as a result, on retailers' financial positions than an AER rule change.

Preliminary data is now available to better understand whether there has been a material increase in customer non-payment or hardship program enrolments from a baseline position. While additional data points are required, the initial indication is that the number of customers entering payment plans and hardship programs has been lower than expected however, customer debt has increased more materially for Tier 2 retailers. We have experienced a similarly delayed or lower than expected take-up of our NRP.

We suggest that while this assessment needs to be carried out quickly, it is a strong market intervention that warrants careful consideration to avoid any potential errors or unintended consequences, Specifically, the AEMC should consider:

- Whether there is currently enough information to indicate that there is a significant risk of multiple retailer failures that would be exacerbated, rather than resolved by the Retailer of Last Resort (ROLR) scheme (or an amended ROLR scheme);
- How to design the rule to support retailers in genuine hardship as a result of the COVID-19 pandemic and avoid financing retailers in stronger financial positions with alternative sources of credit;
- How to ensure customers will be better off overall and avoid burdening them with more debt and unviable retailers in the long term; and
- How to remove risk from the NEM overall, rather than shifting it to another part of the supply chain and risking the financial sustainability of networks.

In the attached Appendix A we provide more detailed comments. If you have any queries or wish to discuss our submission further please contact Patrick Duffy, Regulatory Strategy Manager at Endeavour Energy on (02) 9853 4375 or via email at patrick.duffy@endeavourenergy.com.au.

Sincerely

Guy Chalkley
Chief Executive Officer

Appendix A: Endeavour Energy detailed response

In assessing the AER's proposed rule change, the first step is to decide whether a rule change is required. The advancement of the National Electricity Objective (NEO) should guide this assessment. Promoting the efficient and effective operation of the NEM in a manner that benefits the long-term interests of customers.

The AER considers that, as a result of COVID-19, there is a possibility of successive retailer failure at a time when many households are under financial strain. Whilst uncertain, the AER believes the impacts of this occurrence would be detrimental to both the immediate and long-term interests of customers. This is because customers may be dissatisfied by the transfer experience, struggle to obtain equivalent terms from new retailers and suffer the consequences of lower competition in the retail market.

To address this risk, the AER proposes that a rule change is urgently required to provide retailers a 6-month extension on payment of network charges (compared to the current 10-day limit). This would be limited to customers who entered a payment plan or hardship program after 1 March 2020 and cover the period from 1 July 2020 to 31 December 2020. However, this period could be extended further by the AER under the rule as proposed. The AER considers that supporting the financial viability of retailers through the COVID-19 pandemic will contribute to the NEO by[1]:

- *mitigating the risk of multiple retailer failures, which could undermine the confidence and stability of the NEM for the duration of the COVID-19 pandemic.*
- *promoting retail competition and supporting continued retail competition at current levels within NEM retail markets.*
- *encouraging retailers to offer hardship arrangements to customers, especially those retailers under financial pressure as a result of the COVID-19 pandemic.*

We note that retailers have an existing legal obligation to place customers on a hardship plan in accordance with their Customer Hardship Policy. We presume that the benefit is that retailers are not required to choose between meeting their obligations to offer customer support at the expense of their ongoing solvency.

In our view, the rule as proposed is unreasonably broad and unlikely to deliver these expected benefits without amendment. We suggest further consideration of:

1. **Whether there is a risk of multiple and successive retailer failure:** the available information[2] does not indicate that there is a significant risk of multiple retailer failures that would be exacerbated, rather than resolved by, the ROLR scheme.
2. **Whether existing mechanisms address this risk:** we understand there remain concerns with the ROLR scheme but question whether current circumstances warrant such concern.
3. **Whether support is required urgently:** whilst we accept the unprecedented nature of the COVID-19 pandemic, we caution against broad and immediate action without further review.
4. **Whether customers benefit from supporting retailers:** we are concerned that it could be distortionary, rather than beneficial, to competition to intervene in the market and underwrite retailer solvency through networks. This intervention could defer the exit of already unviable retailers and allow for the additional accumulation of debt by these retailers.
5. **How networks will be impacted by a deferral mechanism:** if support is required, it is important that networks are not placed in a position of financial distress thereby creating a new risk to the safe and reliable operation of the NEM.
6. **How the rule could be improved and implemented:** we have several suggestions on how the scope of the rule change could be amended to address some of the issues outlined above and how it could be implemented based on our experience implementing the NRP.

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[1] AER, Rule change proposal – Extension of time for retailers to pay network charges for eligible customers, May 2020, p. 6

[2] https://www.aer.gov.au/retail-markets/performance-reporting/weekly-retail-market-dashboards-covid-19

1. Is there is a risk of multiple and successive retailer failure?

In justifying the rule change, the proposal and consultation paper focus on macroeconomic trends in unemployment, underemployment and customer and small business sentiment. A case is also advanced that retailers have relatively low margins and therefore have a narrow financial buffer to manage the risks and wholesale volatility of the industry and at this stage are unable to disconnect residential and small business customers in accord with the AER's Statement of Expectations. In combination, the AEMC considers that these factors underscore the necessity and urgency of the proposed rule change.

The unique circumstances and compressed timeframes make it difficult to gather a large amount of evidence and prepare a detailed submission. However, we would still expect a rule change of this significance to provide more direct evidence in support of its need. For instance, on a quarterly basis[3], retailers are required to report on:

- Hardship Program Customer Numbers
- Payment Plan Customer Numbers
- Residential Customers Repaying Debt (not hardship)
- Small Business Customers Repaying Debt

Baseline data is available from the AER's Annual Retail Markets Report. In 2018, an estimated 3 per cent of all customers in the NEM had been on a hardship plan for one or more billing periods, and 7 per cent have been on a payment plan. In Q2FY20 there were 82,257 residential customers, or 1.2 per cent of all customers, on hardship payment plans across the NEM.

Figure 1: Proportion of residential hardship customers, Q2FY20

We are interested in understanding whether these figures have been increasing and what are the retailers' tolerance limits before assistance is required.

Preliminary data is now available to better understand whether there has been a material increase in customer non-payment or hardship program enrolments from this baseline position. Without additional data points, it is inappropriate to draw conclusions. However, the preliminary data[4] indicates that the number of customers entering hardship and/or payment plans has been lower than expected at this stage and customer debt has increased more materially for Tier 2 retailers (anecdotally, the AER considers these two trends could be related).

Additionally, we would expect retailers, at least confidentially, to provide information on their financial position and tolerance limits around customer non-payment to the AER and/or AEMC. Together, this information could be used to more readily demonstrate the need for and scope of this proposed rule change.

We question the premise that all retailers are vulnerable due to COVID-19. The consultation paper refers to an average EBITDA of four per cent in 2018-19. As recently as FY17, the ACCC noted that

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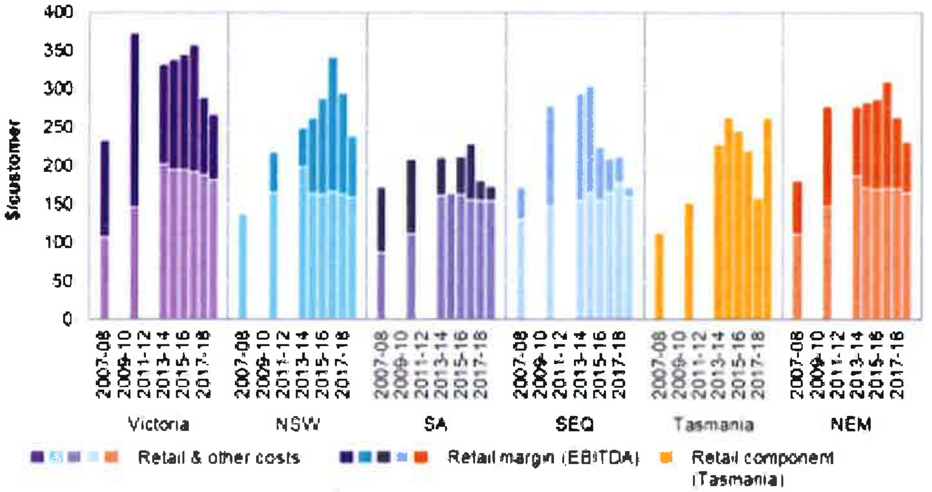
[3] We note that these reporting periods have been adjusted to weekly or monthly in the short-term.

[4] https://www.aer.gov.au/system/files/retailer-market-data-dashboard-18-may-2020-covid-19.pdf

Victoria and NSW had some of the highest EBITDA as a percentage of revenue in the world, with rates of 13 per cent and 11 per cent respectively[5].

The figure below shows that FY19 is an outlier in EBITDA performance, or at least a movement away from historical highs:

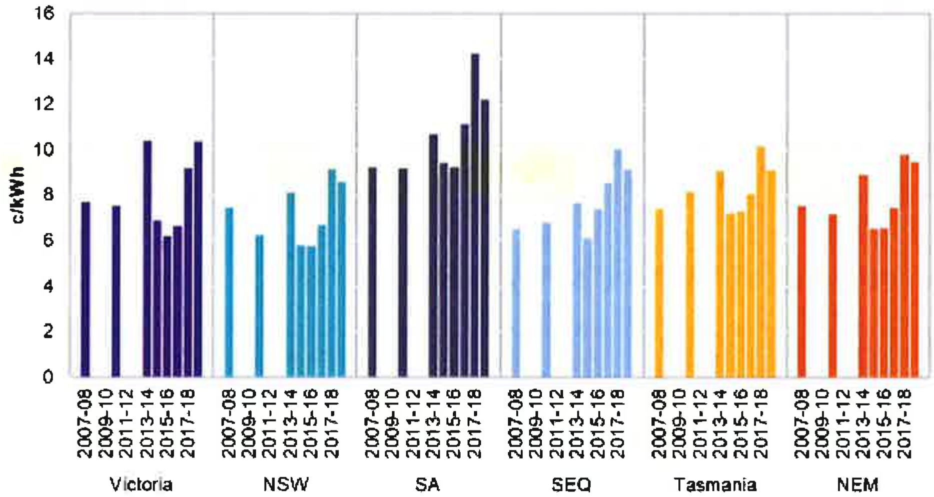
Figure 2: Comparison of retail costs and retail EBITDA margins per residential customer by NEM regions, 2007-08 to 2018-19, real $2018-19



Note: ACCC analysis based on retailers' data. Retailers reported negative margin for NSW in 2007-08. The ACCC considers that this reflects a new entrant retail margin and is unlikely to be reflective of the overall cost stack during this period.

It should also be noted that whilst retail EBITDA margins were lower in FY19, there has been a corresponding increase in wholesale prices as shown below.

Figure 3: Average effective price for wholesale costs per residential customers by NEM regions, 2007-08 to 2018-19, real $2018-19



Source: ACCC analysis based on retailers' data.

This is not to suggest the two trends are related, but to note that many retailers, particularly Tier 1, are vertically integrated ('gentailers'). Caution should therefore be exercised in relying on retailer EBITDA data to gauge their financial position. As the ACCC notes[6]:

> *There are limitations to examining EBITDA trends of retail businesses given a number of significant retailers are vertically integrated. The EBITDA for a vertically integrated retailer is*

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[5] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, p. 146.

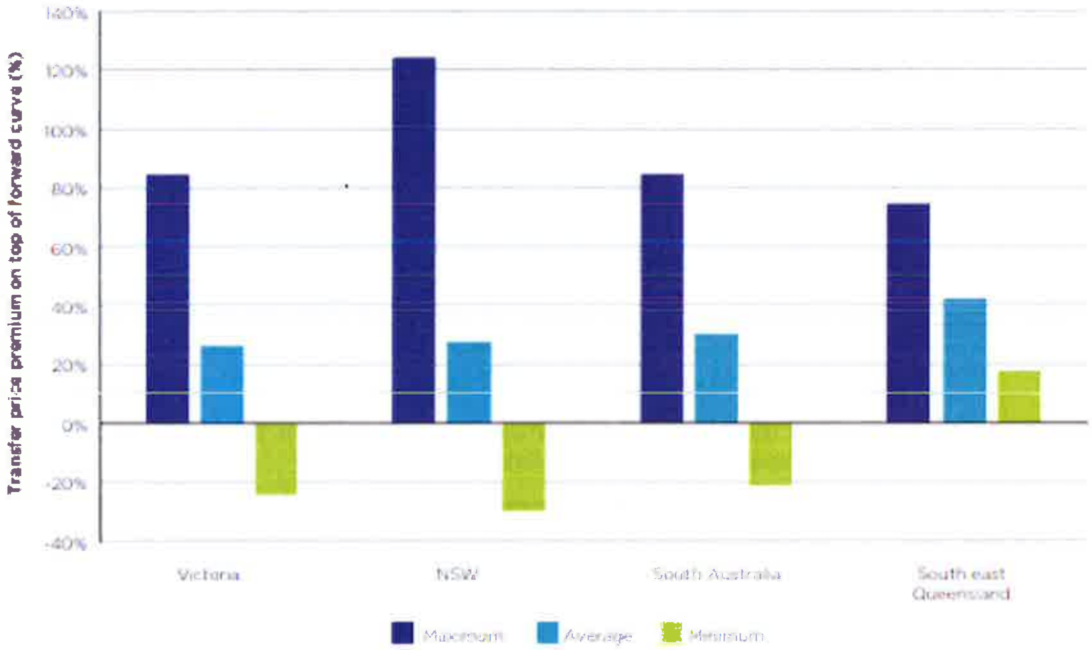
[6] ACCC, Inquiry into the National Electricity Market—November 2019 Report, November 2019, p. 69

likely to be largely dependent on the price at which it buys wholesale electricity from its wholesale division. As set out in chapter 5 of the final REPI report, the ACCC found that the majority of vertically integrated players set a transfer price well above the market expectation of average NEM prices.

And, as per the referenced Retail Electricity Pricing Inquiry (REPI) report, there is evidence that gentailers earn a premium in addition to their wholesale market profits[7].

The retail market has tended towards a dynamic in which competition primarily takes place between vertically integrated retailers, with standalone retailers mostly being new entrants. The efficiency advantages of vertical integration are likely to be a significant driving force in this trend. However, as noted in section 5.2.2, standalone and new entrants now have very few potential counterparties for some key risk management tools.

Figure 4: Transfer price premiums on top of forward curves, by region (%) (2015-19)



This analysis also provides a potential basis upon which retailer eligibility could be determined given the differences between gentailers and standalone retailers ability to manage risk, this is discussed further in section 6.1.1.

2. Can the problem be addressed by existing mechanisms?

We note that the rule change may be deemed necessary, in part, due to perceived deficiencies with the ability of the ROLR scheme to manage the failure of multiple retailers in succession.

The adequacy of the ROLR framework was most recently reviewed as part of the NEM Financial Market Resilience review in 2015 and several changes were recommended.

The recommendations were designed to address the potential for the ROLR scheme to exacerbate the risks of financial contagion, with a particular focus on managing cash flow risk and additional credit support requirements[8].

As part of COAG's Market Participant Suspension Framework rule change request, rule drafting advice was provided[9] to action the Market Resilience review. The recommendations from the Market Resilience review were considered as part of the Market Participant Suspension Framework and the Retailer-Distributor Credit Support Requirements rule changes. The latter in particular eased the

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[7] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, p. 124

[8] AEMC 2015, NEM Financial Market Resilience, Final Report, 6 March 2015, p. v

[9] COAG, Rule change request to amend National Electricity Rules and implement participant suspension recommendations, 9 December 2015, pp 8-31

financial burden on retailers, including ROLR retailers, by establishing triggers for the provision of credit support rather than it being required upfront as was historically the case.

We are therefore concerned that material issues are now being expressed about the ROLR scheme and the potential risk of financial contagion when this matter was considered in a previous review and partly addressed through a series of rule changes. The AEMC notes that some of the recommended changes have not yet been actioned as a rule change request has not yet been received.[10]

However, the risk noted in the Market Resilience review related to the failure of a retailer with a large customer base at a time of high wholesale prices and illiquid credit markets[11]. As discussed below and further in section 6.1.1, there does not appear to be any risk of a Tier 1 retailer failing. Given that Tier 1 retailers account for 60 per cent of the NEM[12], it is unlikely the circumstances considered in the Market Resilience review will arise.

Instead, it is more likely that small retailers may fail and this was not considered to be a serious risk as part of the Market Resilience review[13]:

> *Where a small retailer fails, these obligations may be absorbed relatively easily by the ROLR. In addition, the ROLR obtains longer term benefits from expanding its customer base without having to pay to acquire the additional customers.*

We would be interested to understand:

- how the AEMC considers that the risks considered in the Market Resilience review could apply in this circumstance;
- which unactioned recommendations could be implemented to alleviate these remaining concerns with the ROLR scheme; and
- whether this would better address the risk this rule change seeks to manage.

3. Is support required urgently?

If the AEMC is satisfied that retailers do require support, the question becomes what level of support is required (addressed in section 6) and when.

With respect to the latter, the AER has proposed an urgent rule change. Its urgency is established by reference to Prioritisation Objective 1 from the Joint Market Body Prioritisation Framework rather than the criteria in the NEL.

As noted in section 1, we would expect there to be more accounting, financial or economic evidence, anecdotal or otherwise, available to establish that there is an imminent and serious risk of financial contagion amongst retailers that requires urgent action.

There are also a number of unresolved matters within the rule change that make it difficult to assess it thoroughly. The AER defers to the AEMC's abridged consultation process to:

- analyse the potential impacts on network revenue streams;
- consider which retailers should be covered by the rule change; and
- potentially set an interest rate to apply for late payments that would be beneficial only to those retailers with higher financing costs.

An urgent rule change process is not well suited for consulting on matters so fundamental and central to the rules framework and to the need for the change itself.

We support the ENA's written request to the AEMC recommending the AEMC use its discretionary powers under s107 of the NEL to extend the 8-week rule change period to allow sufficient time for additional analysis and consultation. We consider a short extension, which still provides for an

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[10] AEMC, Consultation paper – Deferral of network charges, 28 May 2020, p. 23
[11] AEMC, NEM financial market resilience, Final report, 6 March 2015, p. 26
[12] Data source: AER Annual Retail Markets Report 2018-19
[13] AEMC, NEM financial market resilience, Final report, 6 March 2015, p. 28

accelerated entry into effect, would reduce the risk of implementing a flawed or inadequately tested solution.

For instance, a 3-4-week extension could provide:

- an additional month of data to better understand the impacts of COVID-19 on retailers over the May-July period;
- allow the AEMC an opportunity to assess the potential financial impacts on networks;
- allow the AEMC to briefly consult on draft rules and positions; and
- allow stakeholders to prepare and implement processes for implementing the rule change.

4. Will customers benefit from supporting retailer solvency?

We think it is necessary to further consider the vulnerability of retailers and how the transfer experience impacts customers compared to how preventing retailer failure through the deferral of network charges impacts customers. This will be important in establishing whether networks should bear retail market risk and if so, to what degree in order to benefit customers. As acknowledged by the AER[14]:

We recognise costs resulting from this rule change will be borne by all or a subset of networks or retailers, and ultimately their customers.

Customers should pay no more than what is necessary to support the achievement of the NEO. The rule, in its current form, is not well targeted to this principle. We are concerned that a broad deferral mechanism will impose costs on networks to act as financial underwriters of last resort to retailers in circumstances beyond what is essential.

We support effective retail competition and consider competitive tension is important in ensuring customers receive improved price and retail service outcomes. There are 49 retailers currently operating the NEM. It is difficult to quantify or isolate the impacts of any one retailer on competition. However, Tier 1 retailers have a market share of over 60 per cent and these retailers appear to not be at risk of failure as noted in section 6.1.1.

Customers will not benefit from networks providing credit support to retailers that have sufficient existing liquidity, can secure their own credit, have shareholder support or multiple mechanisms by which to manage risk (e.g. gentailers).

While it is more appropriate to limit network support to Tier 2 retailers, a question remains as to how many Tier 2 retailers does the NEM need for customers to benefit from the effects of competition. We also note the ENA response to this rule change which highlights that if the smallest half of NEM retailers were to fail it would increase the market share of Tier 1 retailers by 1.4 per cent. Endeavour Energy encourages the AEMC to consider whether a deferral mechanism should seek to prevent *any* retail failure or instead be limited to some *types* of retail failure.

In our view, while some retailers may fail, we would expect their customers would transfer to another retailer in the ordinary operation of the Rules and be no worse off. It is suggested that transferring onto the receiving retailer's standing offer, which will be the default market offer, could result in a higher charge than the customer was paying the failed retailer. It may then also take time to access a commensurate tariff. Such an experience could damage customer confidence in retail markets which could then permanently impact the structure and stability of the NEM.

Firstly, with respect to the receiving retailer's standing offer being higher than the customer's previous retail package, the opposite may equally be as true. Secondly, it seems unlikely that this could impact customer confidence in a way that imminently (or even more permanently) prejudices or threatens the safe and reliable ongoing operation of the NEM. Indeed, we are aware that all market participants have

[14] AER, Rule change proposal – Extension of time for retailers to pay network charges for eligible customers, May 2020, p. 8

implemented initiatives to assist customers during this period, and as a result we would expect that retailers are focused on ensuring a positive customer experience in transition.

If the AEMC forms the view that support is required for Tier 2 retailers, it must be targeted and conditional in order to benefit customers. Customers would not benefit from subsidising a fragile retailer that accumulates additional debt during the deferral period only to exit the market shortly thereafter.

It is for this reason that we consider an eligibility criterion should be established, similar to that applied in the UK or NZ, to ensure that the only eligible retailers are those that are in a position of financial distress due to the impacts of COVID-19 and that the deferral mechanism will result in their ongoing solvency. In section 6, we provide some suggestions for how a rule, if deemed necessary, could address some of these scope and design improvement opportunities.

Once the immediate impacts of the COVID-19 pandemic have subsided, we acknowledge that there may be a prolonged economic downturn. However, the latter is a risk that should be borne by retailers as part of the ordinary allocation of risk in the NEM framework. Retailer exit should be permitted in these circumstances and customers will not benefit from a permanent re-allocation of market risk.

In our view, the immediate impacts of COVID-19 have been defined by the strongest social distancing restrictions and the AER's Statement of Expectations. We encourage the AER to review and amend the latter as necessary as restrictions ease. We note that the Statement of Expectations is key in necessitating this rule change. If this statement is placing undue and unforeseeable risks on retailers that require network and ultimately customer support, a more direct solution may be amending it to allow for exemptions in certain circumstances or revoking it.

Relatedly, if the AEMC considers a rule change is necessary, it should consider whether the requirements of the Statement of Expectations should instead be made legally binding obligations in the rules. Otherwise, the rule change will place binding obligations on network businesses to support retailers whilst retailers would not have equivalent obligations to support residential and small business customers.

5. What are the impacts of the proposed rule on networks?

The objective of this rule change is to alleviate cash flow pressure on retailers to reduce the risk of multiple and/or successive retailer failure. The AER notes:

- that deferral of revenues will be temporary;
- it does not change the allocation of risk between retailers and networks. Retailers remain responsible for managing the risk of customer default;
- it does not change total earnings under a revenue cap but instead cash flows;
- networks could recover the additional financing costs via interest for late payments or a cost pass-through (subject to the materiality threshold being met or a subsequent rule change being made); and
- the operation of the revenue cap form of control will not be affected.

We do not agree with the above and believe that both the scope and severity of the impacts on networks requires further consideration.

The proposed rule change creates a definite reallocation of risk between retailers and networks. Networks will be providing credit to retailers under the rule change to manage the risk of customer non or late payment on behalf of retailers. This presents a financial risk to networks in four ways:

1. **Liquidity:** the rule change will reduce a network's cash resources and requires careful management, which may involve suboptimal strategies to be executed, including the retention of excess cash, or escalated debt drawings to cover the increased risk of cash shortfalls from operations. The uncertainty regarding the financial impact of the rule change, and COVID-19 more broadly, may influence the willingness and capacity of debt facility providers and capital markets to provide funding on reasonable terms (or terms commensurate with current funding arrangements).

2. **Debt covenants**: some networks have debt covenants, including Cash Flow Coverage Ratio (CFCR). Endeavour Energy's debt agreements contain a CFCR covenant which requires maintenance of a minimum ratio of net cashflow to interest costs. Broadly speaking net cashflow takes into account operational cashflow and capital expenditure which is not funded by debt. It is important to note that debt covenants can be (and are) measured and reported *during* the year rather than simply on the financial year end basis otherwise the nature of the risk transfer will be underestimated. It is critical for measuring the potential consequences of such risk transfer on market participants and financial market assessment of the strength of our regulatory regime.

The above two risks are not limited to the period of the rule change. Such a fundamental and unprecedented regulatory intervention would permanently impact how debt and equity investors and credit rating agencies view the stability and risk associated with Australian network businesses. We would expect such a change to be accounted for as part of the AER's next Rate of Return review.

3. **Credit concentration**: the rule change will create a credit concentration risk for networks at the time at which payment falls due. A retailer could create a large outstanding balance which it could then default on later, particularly if there is a prolonged economic downturn following the immediate impacts of COVID-19. A large bad debt for a network would again adversely impact its liquidity position and banking covenants.
4. **Revenue volatility**: the rule change could exacerbate the under-recovery of revenues by networks for the FY21 year. If there are material revenue shortfalls across the industry this could result in large one-off price increases for networks in FY22. If there is a recession following the immediate effects of COVID-19 this could result in a reoccurrence of the perceived risk being addressed by the rule change proposal.

Further, the financing costs associated with providing this credit do not appear to be recoverable by networks under the rule as currently drafted. Specifically, cl 6B.A3.8 has the effect of extending the *due date for payment* of interest payments on unpaid amounts under cl 6B.A3.4 from 10 days to 6 months after the statement of chargers to a retailer is issued by a network.

This appears to be at odds with the AER's stated belief in the rule change proposal that *networks could charge retailers for deferred network payments made after 10 business days at the default interest rate*[15]. The AER also suggests that these costs could be passed through to network customers, although an enabling rule change might be required to do so.

While networks will bear the short-term cost and cashflow impacts of these risks, customers will ultimately bear this cost. It is therefore critical to establish a framework or criteria so that this rule change is extended only to retailers that can demonstrate a need for support and that this support will benefit customers in a manner that outweighs the costs they will be forced to bear. In providing this support, networks must be made whole with respect to the costs they incur, and measures must be in place to ensure they are not instead placed under undue financial distress.

We provide confidential analysis in Appendix B that outlines the indicative impacts of the rule change as proposed. It helps demonstrate the risks to Endeavour Energy associated with a broad deferral mechanism in certain circumstances.

6. How should the proposed rule be amended and implemented?

If the AEMC decides to proceed with an urgent rule change, we would strongly recommend a preferable rule is made.

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[15] AER, Rule change proposal – Extension of time for retailers to pay network charges for eligible customers, May 2020, p. 8

In its current form, the rule is broad and would fail to advance the long-term interests of customers. Instead, if deemed necessary, a preferred rule should better target vulnerable retailers and reduce the exposure of networks while providing for full cost reimbursement.

6.1. Recommended changes to the proposed rule

6.1.1. Retailer eligibility

Whilst the rule as drafted applies to all retailers, the AER and AEMC both acknowledge the merit in narrowing the application of the scheme to only those retailers facing financial distress. The AEMC outlines three options for determining access to the deferral mechanism:

1. Expressly excluding certain retailers that are considered to be in a strong financial position or able to access alternative sources of credit. By way of example, the AER notes well established and large retailers and government owned retailers and the AEMC also notes ROLR retailers.

This is our preferred solution as it most clearly defines the scope of the deferral mechanism in the shortest possible timeframe with least administrative burden and therefore provides a ceiling on the potential impacts on networks as the population of eligible retailers is limited (noting this limitation is also reflective of the potential for genuine financial need). We consider extending support to large retailers will not provide a benefit to customers but it will impose costs. Expressly excluding certain retailers would be the most direct and expeditious way of limiting the financial impacts discussed in section 5 above.

This approach was adopted in the NRP which excluded Tier 1 retailers[16]. We would consider these to be large, well-established businesses many of whom are also registered ROLR retailers[17] and gentailers[18]. We suggest Government owned retailers are also excluded from the deferral mechanism given their access to alternative sources of credit and strong parental support.

There is no evidence available to suggest that larger retailers are in need of financial support from networks. Rather, many large retailers appear to be operating with cash on hand[19] despite the increased risk of customer non or late payment.

The AEMC notes the downside of this is that there remains a possibility that an excluded retailer faces unexpected financial distress and that this would carry more severe consequences for the market. We consider this risk to be low. However, it could be managed by allowing the excluded retailers to apply for inclusion by pairing option 1 with option 2 below.

2. Imposing preconditions on retailers' ability to defer the payment of network charges.

We would also be supportive of this approach as applied in NZ and the UK. This would have the benefit of ensuring that support is only extended to retailers that can demonstrate both financial distress and that they will remain viable if support is provided. This would presumably reduce the exposure of networks, and by extension customers, to undue borrowing costs and financial distress.

The limitation of this approach is that the scope of the rule change would remain uncertain and it could be administratively burdensome and time consuming to verify and approve eligibility. Further assurance could be provided by limiting the size of the scheme so that a network is able to comply with its financial covenants and credit metrics; this was a condition applied by Ofgem in its equivalent rule change.

We are supportive of preconditions being used in combination with option 1. Preferably so that Tier 1 and government owned retailers are excluded from the deferral mechanism and the remaining retailers

[16] As per the 2019 AEMC Retail Energy Competition Review this group includes: AGL, EnergyAustralia, Origin, Red/Lumo Energy, Simply Energy and Alinta Energy.

[17] https://www.aer.gov.au/retail-markets/retailer-failure/register-of-rolrs: AGL, Origin, EnergyAustralia and Aurora Energy (the latter in Tasmania).

[18] EnergyAustralia, AGL Energy, Origin and Red/Lumo Energy.

[19] https://www.afr.com/companies/energy/origin-inks-507m-uk-alliance-to-revamp-retail-20200501-p54ovh and https://www.asx.com.au/asxpdf/20200518/pdf/44hwyyz4m0fq21.pdf

could access the mechanism subject to satisfying preconditions. Alternatively (and less favourably), the preconditions could instead just be used in the case of excluded retailers that wish to apply for inclusion in the scheme as noted above.

3. Applying an interest rate on deferred network charges to incentivise its use where the retailer is unable to obtain credit from market sources.

The AEMC notes that this would be a more administratively simple way of ensuring that retailers only resort to deferring the payment of network charges in limited circumstances. As above, this means that the scope and potential impact of the draft rule is uncertain.

We view this as a complementary feature of the rule change rather than the primary means by which to manage the scope of the deferral mechanism. Without a detailed understanding of retailers' financial positions, there is a risk that retailers would utilise the mechanism even with a higher interest rate for unforeseen reasons. For instance:

- the mechanism could be used by the retailers as an overdraft facility;
- it is likely that any interest rate chargeable would be lower than the retailers comparable cost of equity, so would be a desirable mechanism to utilise to defer an equity raising; or
- it may still be more attractive to utilise than a retailer undertaking all the additional effort of raising new finance given the existing distressed state of the credit markets (i.e. debtors factorisation, new working capital or debt facilities, all take quite a long time, with quite significant on-costs, legal fees and potentially onerous terms and conditions attached).

Charging interest on the deferred payments, however, will be necessary to ensure networks are reimbursed for the costs and credit risks they will incur. And, despite the limitations noted above, the higher the interest rate charged, the greater the incentive to retailers to utilise the scheme appropriately.

It is therefore important to set the interest rate at a level to both compensate networks as finance provider of last resort and incentivise the appropriate use of the deferral mechanism. Some potential options include (with Endeavour Energy's figures for reference):

a) FY21 WACC (5.49%)
b) 2X FY21 Cost of debt (4.94%)
c) FY21 Updated trailing average Cost of debt (5.28%)
d) FY20-24 Cost of equity (5.80%)

We recommend using each network's prevailing WACC (i.e. the updated WACC used by each network for the pricing proposal that applies for the deferral period). We understand that this will vary across the industry in which case options b) through d) may also be viable and we are open to consulting on additional options other stakeholders may suggest. We note an interest rate of approximately 8 per cent has been applied by Ofgem to incentivise deferrals only as is necessary.

We also note that the annual pricing proposal process will not allow networks to recover the time value of money on revenue that has been deferred between regulatory years. We suggest that an interest cost recovery mechanism is included in the final rule change. A cost-pass through event with a zero-materiality threshold would be an administratively burdensome and untimely solution.

Instead, we propose an obligation be placed on retailers to pay interest on deferred revenue and an interest rate to be specified with the exact arrangements to be negotiated between parties and subject to the existing dispute resolution process in the Rules.

6.1.2. Customer eligibility

As with retailer eligibility, we consider there is a clear case to be made for the mechanism to be limited to residential and small business customers. The rule as drafted would technically be available to all customers and this does not align with the intent of the proposal.

As noted by the AEMC, the AER's Statement of Expectations does not restrict retailers from disconnecting large customers. Additionally, retailers are likely to hold security against these customers and industrial and commercial customers are likely to have alternative options available to them for managing the financial impacts of COVID-19.

Given this, there is no merit in retailers being able to defer payments associated with industrial and commercial customers.

In the event the rule change applies to residential and small business customers, there remain two key eligibility issues:

1. Targeting hardship customers

We consider the deferral mechanism should only apply to hardship customers. This would mean distinguishing between customers who have entered into a payment plan or instalment arrangement out of convenience/bill smoothing versus customers who have entered into a hardship arrangement due to payment difficulty. As noted previously, in 2018 an estimated 3 per cent of customers in the NEM had been on a hardship plan whilst 7 per cent have been on a payment plan. This represents a material difference in scope.

The rule change is intended to manage the risk of non or late payment arising from the immediate impacts of the COVID-19 pandemic. We would expect customers experiencing difficulty as a result of COVID-19 would be put onto a hardship plan which would also include a payment plan. As a result, we prefer precise language that defines customers experiencing difficulty so that only the targeted cohort of customers is captured, i.e. remove the reference to payment plans as it is a redundant term for the purposes of hardship.

We also consider this may reduce the risk of error in the application of the mechanism given the inconsistency between retailers as to what constitutes a payment plan and who is eligible. However, we are interested in feedback from retailers as to whether this is a reasonable assumption.

2. Defining small business customers

In developing the NRP, it became evident that the definition of a 'small business customer' varies between networks and jurisdictions. The NRP (Victoria) has defined small business customers as those that:

1. consume less than 40MWh or 400GJ per annum (based on 2019 consumption);
2. use less than 25 per cent of historical average consumption for the period from 1 April 2020 to 30 June 2020; and
3. have temporarily ceased trading over the period 1 April to 30 June 2020 as a result of COVID-19

The NRP (NSW) definition is: Small Business Customers must have consumed less that 40MWh per annum based on 2019 consumption and meet the Retailer's financial support or hardship assessment requirements.

We would recommend a consistent definition is used. In section 6.2, we discuss other ways in which the deferral mechanism could be aligned with the NRP to reduce the administrative burden and ease of transition between the two measures.

6.1.3. Length of deferral period

In considering the question of the length of the deferral period there are two questions to be addressed:

1. How long will assistance be required for?
2. What extension to payment terms should be applied?

While certainly related, these questions address two different issues that may not necessarily be the same time frames.

The first question goes to the issue of how long does the AEMC believe that the most significant COVID-19 restrictions will apply, limiting the ability of businesses to run and inhibiting employees from returning to work, and therefore constraining the ability to earn income.

As part of the industry NRP, we supported a rebate and deferral period until 30 June 2020. Since the introduction of the NRP, there have been indications that the initial impacts of COVID-19 are subsiding with the staged easing of social restrictions underway[20]. We are more supportive of a cautious approach to ensure networks and customers are not burdened by the costs of retailer support unnecessarily. If any support is required beyond 30 June 2020 we would recommend it is limited to 3 months with a clear criterion established for its extension (discussed further below).

The AER has selected a six-month period based on its expectation of when the immediate impacts of COVID-19 may subside. We have obtained analysis from Deloitte Access Economics (DAE) that suggests an economic recovery may commence sometime between June and December 2020.

Figure 5: DAE outlook, real GDP and national income growth

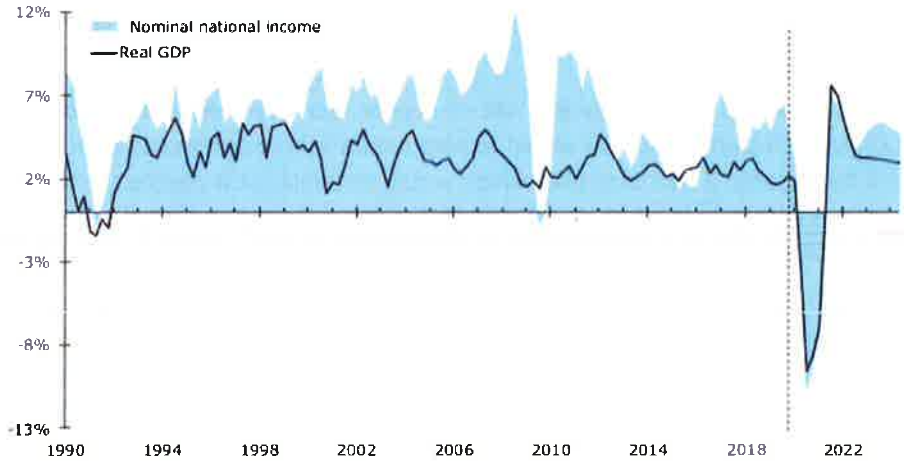

Figure 6: DAE employment outlook by industry, % change in total employment on year earlier - Australia

[20] https://www.health.gov.au/news/health-alerts/novel-coronavirus-2019-ncov-health-alert/coronavirus-covid-19-restrictions/easing-of-coronavirus-covid-19-restrictions

However, these are macroeconomic indicators, making it difficult to determine the extent to which residential and small business customers will experience difficulty in paying their energy bills at a level that could result in large and/or successive cases of retailer failure. As discussed in section 1, the inability to link these indicators to the perceived risk being addressed by the rule change makes it difficult to accurately set the scope and length of the deferral mechanism.

The AEMC acknowledges this uncertainty with respect to the length of the deferral period mechanism; it may be required for several more months or several less. The AEMC is concerned that if the deferral period is set too short the risk of financial contagion in the NEM could re-materialise.

What is unknown is how manageable the potential increases in hardship are for retailers and how long it is appropriate to extend support to retailers. Like other aspects of the mechanism, this decision is essentially a trade-off between reducing the risk of retailer failure whilst transferring costs to other market participants or increasing costs to the energy service chain. Amongst other issues identified, a longer deferral period will increase the likelihood that the network impacts outlined in section 5 materialise.

Ultimately, the selection of the time period is arbitrary. But given the rule change itself largely hinges off the AER's Statement of Expectations, we would appreciate clarity as to when the Statement might be amended and/or expire. The principles generally refer to a date of 31 July 2020 and potentially beyond (including the expectation to not disconnect residential and small business customers).

We assume that the Statement of Expectations was designed to coincide with the initial social distancing restrictions and/or Government assistance packages. As noted above, it would be appropriate to review the Statement of Expectations timeframe given the change in circumstances since March 2020.

The second question goes to the impact of cash flow and how, even under the current circumstances, does the AEMC expect payments be made to retailers for the bills accumulated. While without doubt many customers will face difficulty paying bills in the near term, it is unlikely that customers will simply stop paying bills as the accumulated debt would become unmanageable over time.

Indeed, we would also expect that retailers being conscious of such concerns would, wherever possible, be seeking to enter into arrangements that minimised the carry-over of outstanding balances between billing cycles.

In light of these policy concerns and practical customer centric issues, we would recommend that regardless of any decision on the term for which the retailer deferral mechanism is in place, that the term of payment extension for any individual bill be limited to 6 months as a once-off.

6.1.4. Extension of the rule change period

The AER proposes that it could extend the deferral period beyond 31 December 2020 (by publishing a notice) if it considers it is reasonably necessary to do so. In our view, conferring such power to the AER is inappropriate. Instead, the deferral mechanism should be limited to a once-off 6 month period. If any support is required beyond this period, there should be a separate and more detail consultation process to consider any longer-term changes.

Whilst the COVID-19 restrictions are easing, they may be followed by a recession. It is imperative that the deferral mechanism is limited to the immediate consequences of the COVID-19 pandemic and accompanying AER Statement of Expectations. It would not be appropriate for networks to provide prolonged support for retailers in managing the risk of non or late-payment by customers as a consequence of a recession, as this would suggest a more permanent solution to address market cycles rather than simply addressing the immediate impacts of the COVID-19 pandemic.

A recession is a risk that is generally foreseeable (and becoming so in this current context) and one that should be considered to be catered for within the existing regulatory infrastructure. We would expect that retailer exit during a recession would be an expected feature of effective markets and the competitive process and one for which the existing ROLR scheme should cater.

If longer-term changes are required, this should include a consideration of existing Rate of Return, credit support and ROLR arrangements.

6.1.5. Application to transmission charges

The AER and AEMC accept that if retailers are permitted to defer the payment of network charges to DNSPs, DNSPs would in turn withhold a reasonable portion of their payments of transmission charges to TNSPs.

We agree that, if networks are required to support retailers during this unprecedented event, the burden should be shared across all network businesses. Separately, we will continue to engage with the NSW State Government regarding jurisdictional scheme payments.

If a deferral mechanism is introduced, the clause above (and any others as required) should be amended to allow Transmission Network Users that have network payments deferred under the rule change to defer a reasonable (or equivalent) portion of charges for prescribed transmission services to the relevant TNSP by 6 months after the date specified in the bill.

This could involve amending cl 6A.27.3:

> A *Transmission Network User* must pay charges for *prescribed transmission services* properly charged to it and billed in accordance with the *pricing methodology* of the relevant *Transmission Network Service Provider* by the date specified in the bill.

Alternatively, a transitional rule could be made under Chapter 11 to establish a principle by which the DNSP could defer the TUOS component of NUOS charges deferred under this mechanism. This rule could also establish a principle of good faith negotiation between DNSPs and TNSPs in developing arrangements for this deferral.

To date, we have been working collaboratively with TransGrid in implementing the NSW NRP. However, given the legitimate concerns networks have with the scope and nature of the rule change, TNSPs may not be willing to mirror (either partly or fully) this rules-based deferral mechanism. It is also good practice for consistent and equivalent obligations to be imposed on networks, retailers and transmission networks as part of this rule change.

6.2. Implementation

The NSW NRP has highlighted a number of procedural and operational challenges with rebating and deferring network payments. We have been working closely with retailers and other networks in trying to coordinate and simplify our application of the NRP.

A rules-based approach is not well suited to the extraordinary, rapid and one-off changes required to implement the deferral mechanism. That is an additional reason why we consider collaborative industry efforts like the NRP should instead be relied upon. Failing this, direct Government subsidies are more implementable and preferable than amending the economic regulatory framework to have the customers of networks subsidise retailers.

Notwithstanding our objections, we have a number of key questions on the deferral mechanism and suggestions from our experience implementing the NRP:

- we recommend the use of the B2B Market Dispute process as the vehicle for retailers to send requests to defer invoice payments.
- a process will need to be established for assessing the eligibility of customers.
- a process will need to be established for verifying a retailers' designation of a 'COVID-19 customer arrangement' when requesting a deferral of network charges. Similar to the NRP, the final rule could require the retailer to submit a statutory declaration, signed by either the retailer's Chief Executive Officer or Chief Financial Officer, confirming that the request has been made in accordance with the eligibility criteria outlined in the final rule.

- we assume the deferral mechanism is applicable for bills sent to Retailers with Billing End Dates after 1 July 2020 (inferring that it "takes over" from the ENA package that runs April-June). The rule change may see retailers select invoices relating to June send in Statements of Charges in July.
- under the NSW NRP, retailers can select quarterly billed invoices with billing end dates during the period 1 July to 17 August 2020 for deferral (or rebate) and monthly billed invoices relating to June month sent in Statements of Charges in July 2020.
- the impacts of the rule change will need to be separately tracked from the NRP in order to properly assess its efficacy (which may form part of consideration of an extension). If both processes are managed using the dispute process, an additional comment will need to be defined to differentiate the schemes.
- retailers would defer payment on each invoice where a dispute is raised for 6 months from the dispute date. A process will need to be established to track disputed invoices and ensure payment six months from their dispute date and to monitor and manage any non-eligible late payments concurrently.
- if interest calculation is to be done by networks, this may require system changes for Endeavour Energy.
- internal reporting and specific process will most likely need to be developed to facilitate the deferment of transmission charges from TransGrid.

Many of these matters are not well suited to prescription in the rules; rather, it is likely that retailers and networks will need to agree on a process for implementing the deferral mechanism.

Considerable time and effort has been invested in implementing the NSW NRP. Ideally, this voluntary mechanism could continue (if necessary) rather than be replaced by a new mechanism which will create its own transition and implementation issues.

If a new mechanism is introduced, it should seek to replicate the scope and processes of the NRP to the greatest degree possible. This will provide the best prospects that the mechanism could be implemented in a timely and effective manner by retailers and networks.