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Thursday, 25 June 2020

Mr Ben Davis
Director
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Davis

RE: Consultation Paper - Deferral of network charges rule, 28 May 2020

ERM Power Retail Pty Ltd (ERM Power) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) Consultation Paper on the urgent rule change request for the deferral of network charges (Consultation Paper).

About ERM Power

ERM Power (ERM) is a subsidiary of Shell Energy Australia Pty Ltd (Shell Energy). ERM is one of Australia's leading commercial and industrial electricity retailers, providing large businesses with end to end energy management, from electricity retailing to integrated solutions that improve energy productivity. Market-leading customer satisfaction has fueled ERM Power's growth, and today the Company is the second largest electricity provider to commercial businesses and industrials in Australia by load[1]. ERM also operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, supporting the industry's transition to renewables.

http://www.ermpower.com.au
https://www.shell.com.au/business-customers/shell-energy-australia.html

Summary

ERM Power commends the AER for proposing this expedited rule change and provides the following summary views:

- Although the proposed rule change provides welcome cashflow relief so retailers can continue to extend payment plans for energy consumers in financial difficulty, it does not contemplate networks (or generators) sharing the burden of bad debts. We are supportive of the cash flow relief proposed but consider that the mechanism should also cover the sharing of bad debt. The retailers' risk premium does not cover the extraordinary circumstances of this pandemic. Retailers are facing the absorption of slowing cash receipts and rising levels of bad debt from consumers while continuing to meet all supply charges and payments (wholesale energy charges (generators), network costs, and green scheme costs). It's worth noting that Commercial and Industrial (C&I) retailing margins, which are a fraction of margins in residential retailing, create little scope for retailers to bear the financial burden alone;

[1] Based on ERM Power analysis of latest published information.

- It is unsustainable for retailers to simultaneously support rapidly growing numbers of customers in financial difficulty and carry the risks of the entire energy supply chain. The impacts of the pandemic are being felt economy-wide, detrimental to many companies' financial returns. Although wishing to preserve their return as a regulated monopoly, networks should not be immune to the financial impact and have a responsibility to share the burden. While businesses and entire industries are facing significant financial challenge and being forced to share in the burden of COVID-related economic impacts, networks are holding themselves to a different of set of standards which will ultimately be at the expense of energy consumers;
- Applying interest payments to the mechanism would exacerbate the financial burden of retailers with the accumulation of customer bad debts;
- Considering our observations above, we offer the following recommendations to share responsibility of the impact of the pandemic. We believe these measures to be in the interests of protecting the industry against retailer failure, ensure that all customers are treated equitably and that there is a sustained level of support to customers:
    - Defer network charges for retailers to share the burden of cashflow impacts from customer's non-payments to ensure that customers can be extended appropriate support in a sustained manner;
    - Ensure networks share responsibility in the burden of bad debts, given the extraordinary circumstances of the pandemic make the existing risk allocation in the 'shared customer model' unsustainable;
    - Allow customer eligibility to include large C&I customers who are served at very low margins that offer little scope for retailers to bear COVID19 impacts alone and noting that these large customers play an important role in supporting jobs, helping the economy recover; and
    - Allow any deferred payments to be free of interest payments which are counterproductive and do not support the concept of shared responsibility.

General comments

The energy sector is navigating through an extremely difficult period in which the COVID19 global pandemic has disrupted normal business operations and placed many retailers under financial stress, vulnerable to the liquidity and revenue risks from customers unable to pay energy bills. The pandemic has generated a period of uncertainty as the full impacts are still yet to be known. It is conceivable that economic impacts will be felt beyond the immediate crisis as recovery is predicted to be challenging.

In this unprecedented time for the industry, the focus has largely been on retailers providing support as they are customer-facing and are first to respond to calls for customer assistance. At present, retailers are absorbing customers' bad debts with networks and generators continuing to be paid regardless of whether the energy consumer pays the retailer. Although this has been a long-standing practice in 'business as usual' conditions, it is unsustainable for retailers to solely absorb the shocks stemming from the COVID 19 pandemic. The risks from measures to provide customer assistance could be more effectively and equitably addressed by being shared through the supply chain. We are supportive of the AER's recognition that networks must carry some of the risks of the pandemic, and we commend the AER's initiative to take steps to address the sharing of responsibility by proposing the urgent rule.

The proposed deferral mechanism is effectively temporary cash flow assistance to retailers, enabling networks to temporarily share a proportion of the liquidity risk of customer non-payment of network charges due to COVID-19. The rule change does not have networks bearing any of the burden of bad debts. Retailers will also continue to carry the cash-flow risks of other pass through amounts relating to environmental schemes and wholesale costs. It is clear the extraordinary circumstance of the pandemic has exacerbated normal operating risks, above and beyond those that may be recovered by existing risk premiums in retailer tariffs. We believe that risks from this extraordinary event should be shared.

Whilst the rule proposes measures that would support cashflow and assist retailers to provide flexible customer payment terms over the coming months, we believe unrecoverable customer debt stemming from the pandemic should also be shared by networks and covered by Rules. Ensuring networks share some of the debt burden will help to safeguard the ongoing viability of energy businesses and the ability for these businesses to sustain a program of relief measures to those customers that are impacted the most. We have sought to comment on aspects of the rule change proposal that will uphold the principle of 'shared responsibility'.

Sharing the burden of unrecoverable debt

As the Consultation Paper highlights, the National Energy Retail Law (NERL) and National Energy Retail Rules (NERR) have established that energy retailers are "required to make payments for non-retail supply chain components, including network charges, by defined time frames regardless of the level of non or late payment by customers" [2]. Essentially the 'billing and payment for services relationship' between retailers and networks is governed by the concept of a 'shared customer'. The arrangement of 'shared customers' is a unique and unusual one, whereby network services are not purchased by retailers as an 'input' to the retail provision, but rather network services are billed by retailers on behalf of distributors. In doing so, there is an arrangement of a shared service delivery but an inequitable levying of risks; networks do not assume all the commercial risks associated with the provision of their services.

Shared service delivery should come with shared responsibility when extraordinary external events disrupt the normal practice of risk management. The 'retailers assume all risk' model was established with the expectation that retailers will ordinarily charge a risk premium within their retailer tariffs to compensate for the costs of credit risk. However, these are not ordinary times. The extraordinary circumstance of COVID 19 has been a shock that will continue to raise risks beyond levels that are ordinarily recouped through a retailer's risk premia.

When the national market was designed with the feature that requires network charges to be levied via retailers, the disruption of a pandemic was not contemplated, just as it was not considered in the design of the ROLR mechanism. We have seen this global health crisis impact markets, leading to a worsening economic outlook, a suspension of business activity from 'lockdown', and employment impacts. In our view the retailer, at the end point of the supply chain, cannot unilaterally wear the credit risk of customer late payment and eventual bad debt due to the pandemic, as this is unsustainable.

While networks are benefiting from the existing arrangements, retailers' resilience is being tested by COVID 19, and to a much greater degree than the normal challenges of wholesale price volatility, demand movement and the economic cycle. Network charges are a substantial proportion of the customer's bill; for ERM Power customers, these charges represent approximately 35% of the total bill. In fact, generators, networks and green schemes are typically the recipients of 95% of a C&I retailer customer bill cost[3].

Whilst bad debts and debt collection are typically estimated to be approximately 22 per cent of a retailer's costs to serve[4], the circumstances of COVID 19 are expected to worsen the costs of customer bad debts. For large customer retailers, managing the bad debts from the crisis is further challenged by the narrow margins of C&I retailing. For mass market retailers, it is challenged by the removal of the ability to mitigate against spiraling customer debt and the recent decision of the AER that the Default Market Offer (regulated price) does not account for the impacts of the pandemic[5].

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[2] AEMC, Deferral of network charges, Consultation paper, 28 May 2020, Page 8

[3] ACCC, Inquiry into the National Electricity Market, 20 August 2019 Report, see page 93 Figure 4.21 'Comparison of residential, SME and C&I cost stacks, NEM wide, 2017–18, percentage of c/kWh cost stacks' which shows that C&I has a retail component of costs and margin of 5%.

[4] ACCC Retail Electricity Pricing Inquiry—Final Report, June 2018, page 225

[5] AER Final Decision on DMO 20-21, page 12

Retailers are currently working with customers to relieve the economic impacts of COVID-19. Many retailers will be burdened with the increase of operating costs of customer bad debt and write offs. This is consistent with the AER's expectations of energy businesses to:

• Not disconnect customers in financial distress;

• Waive fees;

• Defer referrals to debt collection agencies; and

• Offer payment plan assistance.

We agree with the AER's expectations that retailers should provide extraordinary support during this unprecedented time, including suspending disconnections to affected customers. However, we believe that networks should carry some of the burden of affected customer bad debt – being the network component. We believe the proposed mechanism falls short in this regard.

To address this issue, we recommend that the Rules should allow for the remittance of retailer network charges to be net of network charges that cannot be recouped from customers. Further, we see that it would be reasonable for unrecovered network charges, allocated as debt write off by retailers, to be substantiated by external audit. This approach would fairly distribute the burden of payment defaults and bad debts between retailers and networks and would ensure a more sustainable provision of relief to customers.

All retailers should be eligible for the mechanism

ERM Power believes that the eligibility for network deferral should be extended to all retailers. The consultation paper considers the circumstances in which the deferral of network charges might be limited to a subset of retailers, based on financial strength, ownership or size. The uncertainty surrounding the full impact of COVID 19 pandemic makes it difficult to determine a suitable criterion that may narrow the application of the rule. Government fiscal stimulus and assistance programs are projected to ease towards the end of the year, and this could result in a delayed effect on the capacity of customers to pay and place financial pressure on retailers that currently appear resilient to the pandemic. Further, determining eligibility by placing an onus on retailers to show legitimate financial need in the short term may be premature, as the immediate financial impact may understate the damaging effects of a sustained pandemic where multiple unpaid customer invoices accumulate over time.

Extending eligibility to all retailers is an important concept for the equal treatment of affected customers during this unprecedented event. The selective allocation may see an imbalance in the level of customer assistance provided between retailers as one retailer group has reduced capacity to extend support due to the larger burden of liquidity risk compared to its competitors.

It is probable that the pandemic will create fluctuations outside of the normal range of cash flow volatility and all retailers will be affected by this heightened risk. If the financial impacts of COVID are sustained, large retailers may not be immune, particularly dealing with cascading retailer failure and financial contagion resulting from defaults. ERM Power believes the extension of the deferral mechanism to all retailers as imperative to managing the risks associated with retailer default and preserving the level of competition in the retail market.

Interest levied on retailers

We do not support the levying of interest payments on retailers for the deferral mechanism as it is inconsistent with the concept of shared responsibility. The Consultation Paper considers charging retailers interest on the deferred payments at the default interest rate. The Commission suggests that this may allow distributors to recover costs and provide an incentive to minimise the scheme as some retailers would be able to secure financing at a lower rate than the default rate charged. Effectively this allows networks to be kept whole; suggests that networks regulated revenue should be immune to the impacts from the pandemic and transfers the financial burden solely to retailers. We do not agree with the presumption that networks are to be fully shielded whilst all other parts of the economy are sharing the burden of the pandemic.

It is our view that the Commission should consider networks are in a much better position to tolerate the liquidity risk from customers' late payments and have a responsibility to share the financial burden from the pandemic. Over 84% of the total number of distribution customers in the NECF region are serviced by distribution networks that are either state government owned, or where a state government has a significant level of ownership of the distributor[6]. It is conceivable that most distribution businesses would have reserves and be well placed to access funds to manage any cash-flow shortages arising from the late payment of network charges by customers. Further we believe distribution businesses should not be charging interest when providing cash flow assistance to retailers as part of a shared responsibility approach to this pandemic crisis.

The proposal of charging interest may worsen the circumstances of financially stressed retailers, against the very objective of the mechanism. With bad debt mounting, retailers may find themselves with a lack of working capital to meet interest liabilities as well as other outstanding amounts and prudential commitments. Retailers could be in an untenable position, eventually leading to retailer insolvency and the dire consequences for the NEM of multiple 'retailer of last resort' events. We believe charging interest has the potential to exacerbate the financial stress of retailers and could even increase the likelihood of market participant failures, a systemic risk that the Rules seek to alleviate.

Customer eligibility should be broad

We agree with the proposal to extend eligibility requirements to customers on payment plans, instalment arrangements and deferred debt arrangements. We support the inclusion of large commercial customers. Commercial customers are large employers and will help to sustain our economic recovery. Commercial and industrial retailers have extended customer payment terms beyond the contractual arrangements during this unprecedented time. This assistance needs to be provided by retailers despite the inherent low margins of the large customer group (approximately 3% as identified by the ACCC)[7] .

The economic impact of the pandemic is not isolated to small customers. Larger customers have been affected and will have increasing difficulty in meeting energy costs, particularly once government support eases. So far, the large customer group has been excluded from network assistance packages but are likely to require temporary relief that is both targeted and sustainable. Some of the most heavily disadvantaged large business customers are those with high network costs that have seen their demand charges locked to heights of their pre COVID 19 demand, yet consumption has fallen with a loss of business activity. For sustained support, eligibility should not exclude large customers and networks need to ensure the network tariff arrangements assigned to large customers are not deepening their debt.

Length of the deferral period should not place retailers at further risk

ERM Power agrees with the proposed length of the support, being to the end of the calendar year, but with the AER to be granted powers to extend the provision. This is prudent given the uncertainty surrounding the full economic impact of the pandemic and the risks of a resurgence. Importantly, remittance of affected customers' network charges by retailers should not create a new financial shock that threatens retailer solvency. As suggested, repayment should be spread with a six-month lag and not have interest applied. Further, remittance should be net of unrecoverable bad debt. If business retailers can recoup customer debt at a later stage through

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[6] This percentage is derived from the number of network customers and 'owner' in Table 3.2 – 'Electricity distribution networks regulated by the AER' in the AER's 'state of the energy market 2019 update data, - Chapter 3 Electricity networks November 2019. See https://www.aer.gov.au/publications/state-of-the-energy-market-reports/state-of-the-energy-market-%E2%80%93-data-update-november-2019

[7] Op. cit. ACCC August 2019 Report, page 93

corporate insolvency processes, retailers should reimburse networks proportional to the amount of network charges that have been recovered.

Please contact me if you would like to discuss this submission further.

Yours sincerely,

[signed]

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