14 May 2020

Dear

Urgent Code amendment: debt deferral for qualifying retailers

I am writing to follow up the letter I sent to each of you on Monday last week, and in response to the letters many of you wrote to me during the week.

I would like to confirm the Authority Board has decided to implement an urgent Code change as outlined in my previous letter requiring you to offer deferred debt payment terms to qualifying retailers. A copy of the urgent Code is attached. This is not a decision we have taken lightly. The Board and I acknowledge the concerns you have expressed. However, it remains our view that the change we are making is a proportionate response to the extraordinary circumstances arising from the COVID-19 pandemic and is consistent with the Authority's mandate.

Given the points you have raised, many of which overlap, I thought it would be useful to write back to you collectively. I suggest we then meet to discuss the concerns as a group.

The Authority's rationale for making this change

I note the concern expressed that the Authority is seeking to protect individual retailers, rather than the process of competition, and that in doing so we are essentially protecting shareholders of small retailers with flawed business models.

This is not the Authority's intent, and not the effect of the scheme we have designed.

We agree that our role is to protect competition as a process. We understand individual retailers can and do fail and expect there will be retailer exit subsequent to the COVID-19 lockdown period. What we are concerned about is not individual failures, but rather a material collective failure, potentially with a contagion effect, of multiple retailers, which would reverse decades of progress to establish robust retail competition. Failure of numerous retailers who were otherwise financially sound would have a material impact on competition, and on future entry. That's why we have taken the measure we have.

It is our strong view that consumers benefit from diversity in the retail market. This is not limited to the distinction between independent retailers and gentailers, but also diversity within the independent retailers and gentailers. Whether independent retailers have hundreds or tens of thousands of customers, they are innovation engines in the retail sector, and play a key role in exerting downward pressure on retail electricity prices, encouraging greater consumer participation, and unlocking the benefits to consumers of technology developments. I note that in its final report the Electricity Price Review Panel similarly emphasised the importance of small retailers in ensuring consumers get the benefits of competition in the electricity sector.

We have sought to limit the financial exposure to your businesses from this change, which in our view is modest. The design principles underlying the change specifically seek to protect you by:

- Offering limited debt deferral only – this is not a waiver of the debt, and only seeks to address an immediate problem arising from the lockdown. This is not intended as a long-term solution.

Level 7, Harbour Tower, 2 Hunter Street, PO Box 10041, Wellington 6143, New Zealand TEL + 64 4 460 8860 FAX + 64 4 460 8860 WEB www.ea.govt.nz

- Limiting the pool of retailers eligible for the scheme. It is not intended for retailers that are part of a publicly listed group or have access to a parent company with sufficient capacity to provide additional capital or loans to successfully manage new overdue debts. While we will consider any applications in good faith, realistically that means the six largest retailers (Meridian, Mercury, Genesis, Contact, Trustpower, Nova), making up the vast majority of sector billings, will not be eligible, and some others are also unlikely to qualify on this criterion.
- Specifically seeking to address the concern you have identified about helping failing retailers. To qualify a retailer must:
    - have, or be likely to have over the next 6 months, a genuine liquidity problem
    - the liquidity problem must be related to COVID-19 and not pre-existing poor debt management
    - the retailer must have satisfied the solvency test as set out in section 4 of the Companies Act 1993 as at 31 December 2019, and
    - it must be more likely than not that the retailer will be able to pay its due debts within 12 months.

  Regarding liquidity, the retailer needs to show its overdue receivables have increased by at least 25% relative to the same month last year, or March 2020 in the case of a new retailer or high-growth retailer (a retailer with a revenue increase of more than 25% since the previous year). This ensures the level of debt is extraordinary and not just a result of normal fluctuations in debt levels.
- Requiring retailers to pay some of the costs of any application to the scheme. This is not a 'free hit' for retailers, which should deter frivolous applications.

Given these criteria, we strongly disagree we have made the six largest distributors the 'lender of last resort' for retailers, or that this is a 'regulatory taking'. Rather, we are putting in place a very targeted and time-limited scheme, recognising the extraordinary COVID-19 circumstances, that simply eases the terms of existing debts owed to your businesses. The scheme has a strong parallel with the Government's business debt hibernation scheme and is broadly consistent with the deferral approach many distributors have taken when making COVID-related offers to assist targeted groups of end customers.

On two other related points:

- While we have attempted to limit the financial impact of the scheme on distributors, we have introduced a prohibition on all distributors' ability to increase prudential for qualifying retailers for the duration of the urgent Code amendment. We have introduced this change to ensure the urgent Code amendment achieves its intended objective of providing breathing space for qualifying retailers. This will not occur if prudential requirements are increased for qualifying retailers as a result of them qualifying.
- We note that a further limiting criterion has been suggested: that retailers qualifying for the scheme should be prevented from acquiring new customers to limit the debt exposure of distributors subject to the scheme. We have decided not to include this element. The design of the scheme already seeks to limit it to retailers capable of resolving their debts by the time the scheme concludes. Such a non-acquisition condition would unhelpfully constrain qualifying retailers and limit the ongoing competitive pressure they exert in the retail market.

‘Pain sharing’ concerns

Another concern raised is that, because the scheme does not apply to debt owed through the wholesale market, the generation part of the sector is not ‘sharing the pain’. In our view this misunderstands how the incidence of any customer default impacts the sector.

The Authority has elected not to impose any debt deferral requirement on the wholesale market. We would generally be cautious about doing this given the consequences, both in terms of immediately triggering wholesale market exit provisions, and the potential flow on for spot market pricing and generation investment signals.

Generators are bearing a significant share of any costs arising from customer default related to COVID-19. Nearly all generation in New Zealand is provided by integrated gentailers. Those same gentailers make up the vast majority of retail electricity billings in New Zealand. Realistically, those gentailers will not qualify for any relief under the scheme we have put in place, ie, they will have to absorb all of the customer defaults associated with their own retail books.

While it is difficult to predict exactly what the customer default trend will be (size, concentration versus spread over time), it is very plausible that this could amount to tens of millions of dollars of default that these businesses will need to absorb in aggregate. This is well in excess of the aggregate level of exposure of distributors due to debt deferral from the scheme under any plausible scenario.

Urgent Code, consultation and precedent

We appreciate you had a strong preference to be consulted about these changes. That is our normal practice, and also our strong preference.

Our objective in making this particular change was to avoid material damage to retail competition should retailers face unmanageable, transient stress immediately prior to their monthly wholesale and distribution settlement obligations. The next relevant wholesale settlement date is 20 May 2020. There was therefore no “wait and see” option, as the time period between observing high levels of customer default and retailers then being at risk of default themselves is potentially short – days, perhaps weeks.

In considering solutions, and noting the variability in how distribution businesses developed responses to COVID-19, we assessed that a timely, pan-industry agreement on how to proceed to protect retail competition was unrealistic. In our view the necessary timeframes also precluded a normal, consultative Code change process. ai

As a result, we elected to develop urgent Code: an urgent measure that aligns with the rapidly changing nature and demands of New Zealand’s COVID-19 environment. This approach is consistent with the urgent Code change principles. The resulting scheme is conservative and tightly targeted, and of limited duration, consistent with the relatively limited scale and scope of relief necessary to achieve our objective.

We note we did have informal discussions with your members, and received documents from ENA, that were useful in helping the Authority to understand your perspectives.

Similarly, some of the alternative options you have suggested had already been raised with us and considered. For most of those alternatives the consistent problem is that, one way or another, they essentially require Cabinet funding approval and we considered it highly unlikely that, if offered at all, this funding would be in place before 20 May.

We acknowledge your concerns about the precedent value of this decision. It is not our intent for this type of decision to occur outside of the most extraordinary of circumstances. We do not

think it would be beneficial to the sector if parties regularly started to advocate for this type of intervention. I would be interested to know what if any specific further assurances regarding precedent you would like from us.

Distributor specific concerns we have heard

Finally, I want to specifically acknowledge two other points you have raised:

- That the Authority's scheme may cause distributors to re-look at specific offers they have made in response to the COVID-19 lockdown to support end customer segments
- That the WACC for price regulated distributors was reduced materially on 1 April (albeit that the COVID-19 pandemic has since had a very material downward effect on the economy-wide cost of debt).

These points provide important context, but do not ultimately change the Authority's view about the appropriate remedy for the retail debt issues facing the sector.

Next steps

The urgent Code change will be in place from Wednesday, 20 May 2020. We will carefully monitor and assess the operation of the Code, including the qualifying regime for retailers. We are open to making further changes if this scheme does not achieve its objectives, including if it impacts distributors more than expected.

I look forward to talking to you soon.

Yours sincerely

James Stevenson-Wallace
Chief Executive