MINISTERIAL BRIEFING

Electricity retailer and consumer debt: Protecting consumer outcomes and competition - update, process and timing

Date:	17 April 2020	**Priority:**	High
Security classification:	In Confidence	**Electricity Authority reference number:**	BR-20-0011

Action sought – Note the contents of this briefing.		
	Action	**Deadline**
Hon Dr Megan Woods Minister of Energy and Resources	**note** all indications this week continues to suggest that the retailers will be in a position to meet their settlement requirements on 20 April 2020.	19/04/2020
Appendices included	**None**	

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
James Stevenson-Wallace	Chief Executive	04 460 8842	S 9(2)(a)	✓

Drafter	**Joey Au**	**Position**	**Principal Advisor, Market Performance**

Authorisation for publication on Authority website	☐ Approved	☐ Declined

The following departments/agencies have been consulted
None.

Minister's office to complete:

	☐ Approved	☐ Declined
	☐ Noted	☐ Needs change
	☐ Seen	☐ Overtaken by Events
	☐ See Minister's Notes	☐ Withdrawn

Comments

Purpose

To provide you with an update on:

1. Whether a majority of retailers are still likely to meet their settlement requirements on 20 April 2020
2. Work that the Authority has undertaken in preparation in the event that independent retailers face a material risk of default as a consequence of rising consumer debt.

Recommended action

Hon Dr Megan Woods, Minister of Energy and Resources

It is recommended that you:

<u>Information requests</u>

1. **note** we have expanded our information gathering activity to provide up to date views of retailer's stress.

Noted

2. **note** we are beginning to receive weekly data from retailers on disconnection rates and consumer debt levels on Friday 17 April 2020 and will update you weekly on this information starting Friday 24 April 2020

Noted

<u>Advice and analysis</u>

3. **note** competitive pressure matters for the benefit of consumers not the number of firms or any one firm

Noted

4. **note** we are investigating reports that a few small retailers may not be able to meet their settlement requirement for wholesale market settlement on 20 May 2020 and we will update you by 1 May 2020

Noted

5. **note** all indications this week continue to suggest most retailers will be able to meet their settlement requirements on 20 April 2020

Noted

6. **note** the electricity market has arrangements in place to manage retailer default in an orderly manner that ensures consumers continue to receive electricity supply.

Noted

<u>Advice and possible Code Change: Dealing with conflict between hibernation and retailer default requirements.</u>

7. **note** retailers accessing the debt hibernation scheme may expose them to default under the Code and we are investigating how to best ensure industry arrangements can coexist with the scheme and will provide you an update by 1 May 2020.

Noted

Advice and possible Code Change: regulatory backstop

8. **note** we are developing a backstop urgent Code change to incentivise all lines companies to reach arrangement with retailers to reduce the level of financial stress, which will require two weeks to implement, and will provide you with further information on this option on 1 May 2020.

Noted

9. **note** if we have not observed adequate arrangements by line companies to manage retailer stress by early May 2020 then would seek to implement the backstop urgent Code.

. **Noted**

10. **note** in addition we are investigating other options beyond reliance on lines companies to assist retailer cash-flow

Noted

Ongoing communication and dates

11 **note** the Authority will provide you with the following updates on the dates specified:

- Friday 1 May further update on information received and analysis
- Friday 8 May confirmation of decisions, next steps and implementation path.
- Week beginning 25 May (update after next settlement date for retailers – 20 May).

James Stevenson-Wallace Chief Executive Electricity Authority	**Hon Dr Megan Woods** Minister of Energy and Resources
17/ 04 / 2020	..... / ...... / ......

Problem: How COVID-19 is impacting on consumers & the industry

1. Our statutory objective is to promote competition, reliable supply and the efficient operation of the electricity industry for the long-term benefit of consumers.

2. COVID-19 has the potential to impact on our competition and reliable supply objectives via the following channel:

   Step 1: Reduced income for households and businesses affects their ability to pay power bills.

   Step 2: To the extent power bills cannot be paid we will see increase levels of non-payment and ultimately new bad debt as households and Small Medium Enterprises (SMEs) default.

   Step 3. The degree to which retailers are affected by this new bad debt will vary according to the diversity of each retailer's customer base, market and business financial obligations, and financial strength. Retailers' normal response to bad debt is disconnection, signalled or actual. This normal risk mitigation tool, however, may be constrained by limitations on their ability to disconnect customers currently owing to the increase number of medically dependent and vulnerable consumers.

   Step 4: Depending on the scale of the new bad debt, this may lead to a retailer default.

   Step 5: Depending on the speed and number of retailers exiting the market this could potentially damage competition in the short and medium term.

3. Given the speed and severity with which COVID-19 has impacted economies, labour markets and financial markets there is the concern that the impact on the (independent) retailer segment may not be adequately addressed through the existing regulatory system and market mechanisms. This briefing explores the progress the Authority has made in developing complementary measures which may be called on if needed as the COVID-19 situation evolves.

4. The core service that retailers provide to consumers is to repackage the charges from generation, transmission, and distribution into retail pricing contracts with customers. Retailers take on risk in this process—wholesale price risk, retail quantity risk and the customers' credit risk. Where a customer pays late or fails to pay, the retailer is still obligated to pay for generation, transmission and distribution charges. These risks are built into the retailer's margins, however the degree to which they are accounted for are subject to normal competitive pressures which do not incentivise pricing in once in a lifetime events.

Approach: How the Authority is approaching the issue

5. Our approach to addressing the problem is being driven by prioritising enduring consumer outcomes, which is generally consistent with actual (number and market share of participants) and the potential for (low barriers to entry) competition.

Competitive pressure matters not the number of firms or any one firm

6. Our focus is on protecting critical electricity system attributes and not the survival of individual firms per se. Having a dynamic and vibrant retailer segment is generally beneficial to security, reliability and efficiency as they increase price competition, introduce new innovations, and serve niche consumer segments. Independent retailers have a distinct value in that they serve to highlight potentially undesirable behaviours in vertically integrated businesses that may not be in the long-term interests of consumers. However, the objective is not to seek to preserve each independent retailer. We recognise that as with most industries, defaults are inevitable, particularly in a crisis of this scale, and the costs of preserving what we had is likely to outweigh

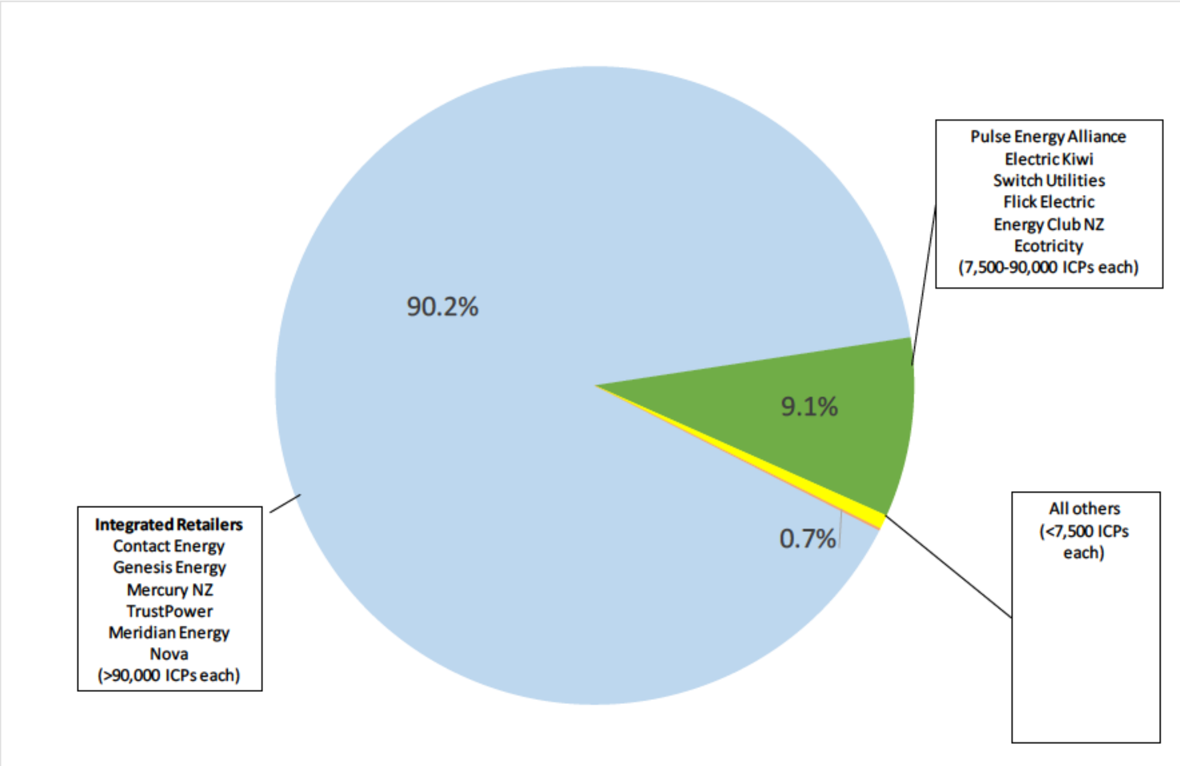
the benefits. High performing markets (that deliver beneficial outcomes for consumers), feature arrangements that manage the efficient entry and exit of firms.

7. We need to ensure there is enough competition within the market to maintain sustained downward pressures on prices to consumers i.e. keeping pressure on all parts of the supply chain, and move away from monopoly-type pricing behaviours that might otherwise occur if you had only a few consolidated participants in the sector.

8. There is no binary measure that would direct how many firms would necessarily be required to secure the intended benefits from competition. Given the context specific to New Zealand's own energy sector (e.g. consumer expectations, geography, income, demand profile, supply profile etc) we consider that consumers can expect to derive pricing benefits from an industry structure that features no fewer than 8-10 retailers, on the assumption that a substantive market share sits outside of that held by the integrated generator-retailers segment of the market. It is important to note that currently the six largest non-integrated retailers hold a market share of 9% by number of customers.

9. We note this number of retailers is larger than in some comparative markets such as petrol retailing or banking. However, a key feature of the New Zealand electricity market is that it is characterised by regional retail markets, delineated by distributors' network areas. This number of retailers should be sufficient to ensure there is adequate competition across all network areas.

Market share trends by retailers as at 29 February 2020



Source: From www.emi.ea.govt.nz provided by the Electricity Authority (New Zealand)

10. Healthy competition among retailers also delivers value to consumers through stimulating greater levels of innovation. At present, the Authority is actively pursuing greater levels of innovation through initiatives such as real time pricing and an expansion of demand response markets, both of which rely on the assumption that New Zealand will continue to attract new firms with new business model to participate in the New Zealand energy sector.

11. Should the financial implications of the COVID-19 crisis result in mass failure of new or recent entrants to the NZ retail market, a concern is that such a collapse may send a strong and negative signal that may reduce the confidence of firms that might have otherwise eyed

commercial opportunities in New Zealand. However, a once in a lifetime disruption such as COVID-19 that cuts across all sectors and all economies is generally unlikely to dissuade investment opportunities in electricity retailing any more than any other markets. The substantive focus, over and above the crude number of firms entering and exiting a market, should be the pursuit of high performing markets that support competition for the long-term benefit of consumers.

12. In terms of the current innovative business models and product offerings that have been introduced by recent entrants to the NZ retail market, a retailer default does not necessarily imply that "innovation" will be lost to the system.

13. We are seeking to ensure uninterrupted supply as an immediate priority, avoid unnecessary defaults where it is cost effective to save them, and ensure the system settings are in place to encourage competition once a recovery begins.

14. Competition is strong in the market, but some independent retailers have been struggling with challenging conditions before COVID-19 - consolidation and exit is likely to occur as a matter of course. Even a hypothetical "worse case" scenario, such as that modelled by The Treasury, competition is likely to remain strong enough for prices to be efficient. One off events like COVID-19 are unlikely to have a major or lasting chilling effect on entry and innovation. This is on the assumption that there continue to be low barriers to entry in the future and prospective investors are not overtly scared away due to the failures of previous independent retailers.

15. The Authority is also focused on avoiding the situation of adjusting market settings in the short term to favour individual firms at the expense of the market and consumers being dogged with carrying the debt of underperforming firms that were otherwise uneconomic regardless of the COVID-19 situation.

What the regulatory system currently provides

16. The wholesale electricity market design incorporates a number of provisions which promote financial stability and responsibility among participants. These includes mandatory stress tests—each quarter participants disclose, and their directors certify, their firm's anticipated performance in relation to shocks to the wholesale market, such as an extended period of high prices.

17. Participants are also required to post prudential security to cover obligations to other market participants. The clearing manager, a market operation service provider to the Authority, is in regular contact with participants and continually monitors each participants payment performance.

18. If a retailer fails to pay on settlement day, an event of default occurs and the clearing manager accesses prudential security to mitigate loss to the rest of the wholesale market. Residual shortfalls, if any, are pro-rated across generators. If a retailer fails to pay a distributor, the distributor has remedies relating to the security it holds.

19. When a retailer fails and exits, its customers are transferred to other retailers under the retailer default process set out in the Code in a manner which is seamless for the consumer.

20. These provisions are generally adequate to protect against most market events and multiple participant failures. If extreme situations occur, the Authority can take drastic steps such as suspending the market.

21. Even though existing provisions protect customer supply and confidence in the market in the event of retailer failure, they may not be sufficient to support robust competition in the retail market if the adverse effects of COVID-19 cause mass failure or withdrawal of independent retailers.

Progress: Steps the Authority is taking

We are meeting with retailers weekly and issued a request for debt and disconnection data

22. The Authority has implemented a priority action plan to actively respond to the risks posed by growing new bad debt. The plan focuses on:

    1. securing information to understand the scope, scale and timing of the new bad debt issue;
    2. informing industry and government stakeholders of the evolving debt landscape;
    3. promoting industry supported solutions to spread risk and
    4. developing implementation-ready regulatory backstops.

23. We are also evaluating alternate options in recognition that the COVID-19 situation is rapidly changing, and the electricity industry is both supporting, and is impacted by, the government and economic response.

We have dramatically increased our monitoring of new bad debt and retailer health and concerns

24. We have pursued direct conversations with retailers and have initiated 'welfare checks' on select independent retailers through the clearing manager. This direct contact with 16 retailers (to date) has identified concern about the impact of COVID-19 but indicates a normal wholesale market settlement on 20 April 2020. A number of retailers have, however, expressed reservations about the settlement on 20 May 2020.

25. We have had additional contact with retailers and other participants though our COVID-19 industry working group. The forum has enabled timely exchange of general information from a range of participants on the impact of COVID-19 response measures and the immediate outlook for the sector.

26. We have exercised our power under section 46 of the Electricity Industry Act 2010 on Thursday 9 April 2020 to obtain information in relation to retailer debt levels and disconnection rates. Retailers are due to provide us with weekly updates. We will be receiving the first set of information on 5pm Friday 17 April and will begin an immediate analysis of the information collected to quantify the impact COVID-19 is having on retailer debt levels. To ensure that the information from the clearing manager regarding any financial distress from retailers is accurate we have reminded retailers of their obligations under the Code to contact the clearing manger.

27. To ensure we are interpreting this financial data properly, and in order to benefit from financial information beyond the scope of our section 46 request, we have retained KPMG to provide us independent expert financial advice on retailer financial stability and insolvency. This will not only assist us in assessing the stability of retailers and the level of new bad debt, but KPMG will also assist us with evaluating the degree of need for retailers who we may consider for targeted assistance. We will be monitoring this information on a weekly basis to track how these debt levels are evolving to help inform the most appropriate policy response from the Authority in real-time. While we do not expect all retailers to have responded to our request by then we will be able to update you on the results of the data we have received by Friday 24 April. We will update you every week in our regular Friday briefing on the latest data.

28. Our rough current estimate is that the quantum of new bad debt which may need to be addressed by targeted measures would be about $5 million per month for the duration of

financial stress. For comparison, $5 million is 1.3% of the total amount owing from payers in January 2020. This estimate is calculated using assumed non-payment rates and the market share of smaller retailers and does not consider new bad debt for the large retailer/generators which we expect they ought to be able to manage within their own balance sheets/funding arrangements. This estimate will evolve with improved visibility on non-payment rates and retailer health. This new bad debt impact on retailers will vary widely with domestic/commercial mix, composition of the customer base and credit standing of customers.

The government guaranteed loans and debt hibernation scheme should help

29. COVID-19 should not be used by independent retailers to cover up failing or marginal business models. The government has introduced a suite of solutions to help all businesses navigate the consequences of COVID-19 i.e. the wage subsidy scheme, debt hibernation, and government guaranteed business loans. These tools are available to any business and at least the last could have a role to pay in addressing the potential problem of retailer default, if indeed it is threatening business viability. We would expect banks (with respect to loan guarantees) and the majority of creditors (in the case of debt hibernation) to use these tools where they see the problems facing the firms are temporal in nature and they offer a better outcome than immediate default.

30. Under the current Code, a retailer accessing the debt hibernation scheme would normally lead to the retailer being in default and trigger a process to exit the retailer and protect the broader market from loss. We are considering what changes are required to retailer default scheme to accommodate participants who may seek to utilise debt hibernation scheme, and the implications of this for the electricity market. The Chief Executive will be seeking in principle decisions from the Electivity Authority Board on 7 May for implementation of any decisions prior to the 20 May 2020.

While pricing is a matter for individual retailers, the Authority expects that retailers will look to pass on COVID-19 related price or payment adjustments to the relevant end users

31. Our view is that the electricity industry is best suited to negotiate ‘pain sharing’ arrangements. We note, however, that given the structure of the industry, coordination may be difficult and natural incentives to reach an agreement may not be especially strong or urgent.

32. As such, we are developing options as a fall-back position if industry is unable or unwilling to reach commercial agreements themselves. The Chief Executive will be seeking in principle decisions from the Electricity Authority Board on 7 May for implementation of any decisions before the 20 May 2020.

Sharing the pain - deferring a portion of retailer payments to distributors under Use of System Agreements and to Transpower

33. While retailers (both independent and vertically integrated) will be the vehicles in which a growing consumer debt problem will manifest in the first instance, ultimately in the event of defaults the costs will fall more widely across the system. In the first instance debt accumulation can be expected to erode retailers' shareholder equity, and once that buffer has gone, ultimately creditors - which will include lines companies, gentailers and the clearing manager.

34. Consequently, there are incentives on lines companies and others to work with the retailers to manage this problem, and potentially agree some arrangement to share the pain. For example, Transpower is offering deferral payment terms to customers impacted by COVID-19, with relief will be offered in proportion to their customers’ level of shut down. Large distributors are offering similar arrangements on their networks. Negotiations between multiple creditors and retailers to arrive at a solution may be complex and time-consuming. Therefore, the Authority is exploring leveraging its Code-making powers to bring major electricity creditors of

independent retailers together to explore offering deferred payment terms to assist retailers in managing large increases in consumer debts that can be attributed to COVID-19.

35. To this end, we are developing a regulatory backstop involving a draft urgent Code change that would require distributors to offer an extended payment period to retailers in financial stress for a temporary period. As with other urgent changes to the Code under the provisions for this in the Act, the provision would last for nine months unless the Authority decided to make a permanent amendment to the Code. This Code change would require two weeks to implement and would not involve consultation. We are fully developing this option in order to provide incentives to distributors to reach accommodation with cash-constrained retailers. We will update you on progress in relation to this action by 1 May 2020.

36. We note that we are not currently developing a further regulatory backstop to also encourage the large retailer/generators to contribute to the sharing of some of the sector impact of new bad debts.

37. We note also that any Code that supported or incentivised sharing arrangements by retailer/generators would likely affect settlement in the wholesale market. Such a change (even if only proposed) could potentially have material flow on effects in terms of offer behaviour in the wholesale market. We are reluctant to risk this type of unintended consequence unless absolutely necessary.

38. Furthermore, actions which alter settlement or affect wholesale market money flows threaten to impact the underlying efficiency of the market. The wholesale spot market is really a balancing market and the amounts that generators receive and retailers pay are not determined there alone, but also through hedge and supply contracts. Affecting settlement flows in the wholesale market will not ensure pain is shared, but may reallocate it in ways that are not intended.

A relief fund may not be beneficial to consumers

39. We are doubtful that a relief fund for retailers will be beneficial for consumers because retail competition is likely to remain in the event of some retailer exit but we are doing further analysis to confirm this. The options we are investigating are establishing a new levy or extend the existing levy to operate as a relief fund, recovered from industry participants over a defined time period. We are exploring the regulatory changes necessary to implement this option and we will update you on progress by 1 May 2020.

40. Another alternative option that we are also exploring is the use of loss and constraint excess, following settlement of financial transmission rights, as a source of funding for a relief fund. Loss and constraint excess are the excess funds arising in the wholesale electricity market because the effect of losses and constraints means wholesale purchases pay more than generators are paid. These surplus funds are used for funding financial transmission rights and then the amount remaining following this is paid by the clearing manager to Transpower, who in turn allocates it to its transmission customers (distributors, generators and industrial consumers connected to the grid.) Implementing this option would involve changing the Code.

41. If implemented such a fund should target the specific cash-flow and value impacts arising from increasing consumer debt attribute to COVID-19. Expected and probable losses from consumer defaults are generally recovered through retailer pricing and therefore should not be recoverable through any relief fund.

We are prepared to be able to have available and use the appropriate instruments when they are needed

42. Should the debt hibernation and loan guarantee schemes be insufficient to mitigate extensive retailer default, we are working to ensure the options discussed in this report can be implemented with urgency.

43. We are expediting conversations with supply chain companies such as distributors and Transpower to explore deferral payment term options, and anticipate these conversations happening over the next few weeks. Once the parameters are agreed we expect it would be very quick to implement.

44. We are considering the design of a possible relief fund and will provide further advice as to whether it may be needed, design parameters and the cost and levy implications. We are advancing this work as a matter of urgency so that if and when it is required, retailers with evidence to show their debt levels are significantly exceeding previous experience could access this scheme, subject to your approval of the scheme. We have scoped out scheme settings and principles and have engaged KPMG (as noted above) to be ready to vet potential fund beneficiaries.