

Arrangements for managing retailer default situations

Consideration of submissions to second discussion paper and possible recommendations to the Board

24 October 2012

1 Recommendation

1.1.1 It is recommended that the Retail Advisory Group (RAG) discuss:

- a) the feedback in submissions to the RAG's second discussion paper on Arrangements for managing retailer default situations; and
- b) the proposed recommendation to the Electricity Authority Board for managing retailer default situations.

2 Background

2.1.1 The RAG has been requested by the Authority to identify arrangements for managing a retailer default situation.

2.1.2 The RAG released a second discussion paper in August 2012 to seek feedback on a detailed proposal for facilitating the transfer of the customers of a retailer that becomes insolvent or otherwise rapidly exits the electricity market to a viable retailer.

2.2 Submissions received

2.2.1 Submissions were received in late September from eighteen stakeholders, with three parties subsequently providing comments on submissions. Table 1 lists submitters. All submissions are available on the Authority's website at <http://www.ea.govt.nz/our-work/consultations/advisory-group/arrangements-for-managing-retailer-default-situations/submissions/>.

Table 1: Submissions to second discussion paper

Group	Submitter
Generator/Retailer (5)	Contact, Genesis, Meridian, Mighty River Power, Trustpower
Retailer (2)	Pulse, Simply Energy
Distributor (10)	Eastland, Marlborough, Orion, Powerco, Powernet, Unison, Vector, Wellington Electricity Electricity Networks Association PricewaterhouseCoopers on behalf of 21 distributors
Other (1)	NZX

Note: Genesis, Simply and Vector provided comment on submissions.

3 Key points in submissions

3.1.1 The key points in the submissions are:

- a) Submitters agree a process to transfer customers in a retailer default event is required.
- b) An event of default should be defined as failure to pay the clearing manager or insolvency (clause 14.55 of the Code). The definition should be expanded to provide recourse to distributors in certain conditions.
- c) There are differing views on the timeframe for resolving an event of default.

- d) Pro-rata allocation of customers of a failed retailer to viable retailers based on their market share at each GXP is supported. Care should be taken to avoid cascade market failure.
- e) Recognition should be given to the financial risks faced by distributors.

3.1.2 These points are described in more detail below. Appendix A provides an overview of the key points in submissions and submitter responses to the questions asked in the discussion paper.

3.2 Submitters agree a process to transfer customers is required

3.2.1 With one exception, submitters agree that the RAG has identified a problem, which is that there is no effective mechanism to stop the financial loss incurred by industry participants should a retailer fail to make payments due to industry participants, or fails to restore ongoing prudential security as required. The industry view is that en masse disconnection of customers who have paid their bills is not a tenable solution.

3.2.2 The one submitter who does not agree, considers that commercial arrangements and insolvency law may be relied upon to transfer customers when a retailer defaults.

3.3 The definition of an event of default

3.3.1 Submitters agreed that the relevant events of default include those matters in clause 14.55 of the Code – failure to pay amounts due to the clearing manager and receivership or liquidation.

3.3.2 The majority of submitters supported including in the definition of an event of default situations where retailers fail to make payments due to distributors. However some submitters think that the definition of an event of default should not incorporate failure to make payments to distributors (or termination of a use of system agreement). Commercial and contractual relationships between retailers and distributors should be sufficient.

3.3.3 Submitters generally agreed that the Authority should not assess whether parties had complied with the terms of a use of system agreement as that is a legal matter.

3.3.4 Unison and the ENA propose a three pronged test which could be adopted:

- a) the retailer is no longer entitled to trade on the network;
- b) there are no unresolved issues between the retailer and the distributor relating to the termination; and
- c) the retailer has not taken timely steps to arrange for consumers to switch to another valid retailer, or its customers have refused to switch.

3.3.5 Meridian agreed that distributors should have the option of prompting the proposed Code prescribed process for transferring customers, provided the Authority can first satisfy itself that the event involves more than minimal risks for the market.

3.4 Only material events should trigger the process

3.4.1 Submitters were supportive of some form of threshold or test to be applied to events of default to ensure that only those posing a material risk to the market were subject to the Authority process. Several submitters commented that a purely monetary threshold was not appropriate as other factors are relevant to the determination of risk, including the size of the retailer and its resources, and multiple smaller events might also constitute a material risk. The specification of a threshold is a key issue for the Group to discuss.

3.5 Timeframe

- 3.5.1 Submitters held differing views on the timeframe proposed. As a generalisation, distributors wanted the process to occur as quickly as possible, while retailers wanted more time for a commercial solution to be sought. A number of submitters comment that the MUoSA upon which the timing is based is not an industry standard. Notwithstanding this, the Authority is expecting standardisation around the model contract over time.
- 3.5.2 Submitters generally agreed that the timeframe should be able to be extended with agreement of the affected parties.

3.6 Allocation of customers

- 3.6.1 The majority of submitters support pro-rata allocation of customers at each GXP based on the market share of other retailers who are currently serving that market segment at that location. Submitters consider a key issue for the allocation process is to ensure that the electricity market is protected from cascade failure:
- a) Several submitters considered that the Authority should evaluate the flow on implications and the sustainability of other retailers prior to transferring customers.
 - b) Two submitters suggested thresholds for the minimum market share of the accepting retailer, or a minimum number of transferring customers.
 - c) Two submitters raised the possibility that the failure of a large retailer might need a different approach.

3.7 Distributor risk

- 3.7.1 Two key points were raised about the level of risk perceived to be facing distributors under the model interposed UoSA for the RAG to be aware of:
- a) many submitters considered that conveyance agreements were not a solution to the level of risk – some submitters indicated that the benefits were limited, others indicated that the transaction costs of switching from interposed agreements were too high for them to consider.
 - b) Some submitters requested that the RAG recognise the financial risks on distributors associated with the level of prudential security available to distributors.

3.8 Other matters

- 3.8.1 Other issues raised by submitters are:
- a) One submitter considered that subrogation should be retained, in order to maintain generators' confidence in the market. Other submitters supported this right being removed.
 - b) Two submitters asked that legal advice received by the RAG be made more widely available.
 - c) The idea of a competitive tender by the EA was generally not supported.
 - d) A technical group to draft Code amendments was suggested.
 - e) It was asked whether investigations into events of default would be recorded and/or reported.
 - f) It was suggested that the Authority should actively work with the relevant parties on whether another plan or process might facilitate trading out.

- g) One party suggested capping wholesale prices if a mandatory transfer occurred.
- h) One submitter suggested that the process and system should be regularly tested.

3.8.2 A number of issues were raised around switching:

- a) switch dates – it was not made clear in the discussion paper whether voluntary switches would be completed in line with normal Code-mandated switching processes, which would suggest that some customers could be switched to their choice of retailer after the mandatory transfer date. Retrospective switch dates were also suggested by a small number of submitters.
- b) obtaining customer details – submitters queried whether a defaulting retailer would comply with an Authority request for its customer list.
- c) privacy concerns – a query was raised about whether privacy laws allow the Authority to access customer lists.
- d) inactive customers – some submitters emphasised that it is important to switch all ICPs even if they appear to be inactive (this was a lesson from the E-gas insolvency).

4 Wholesale advisory group – discussion of implications for WAG prudential and security proposals

- 4.1.1 The Wholesale advisory group (WAG) has requested a face-to-face meeting with the RAG to discuss the retailer default proposal. In particular the WAG is interested in the timeframe for resolving a default and the potential to backdate switches.
- 4.1.2 The RAG and WAG are (separately) scheduled to meet on 28 November 2012. This provides the opportunity for the two groups to meet to discuss matters of common interest (before going their separate ways). The combined meeting also presents an opportunity for the two groups to provide feedback about the review of advisory group terms of reference the Authority will shortly initiate.

5 Proposed recommendation to the Board

- 5.1.1 A proposed recommendation to the Board is outlined below. The recommendation is based on the RAG's proposal outlined in the August 2012 second discussion paper on "Arrangements for managing retailer default situations", and incorporates feedback in submissions to the discussion paper.
- 5.1.2 The proposed approach for managing a retailer default situation is as follows:
 - a) The Code should specify certain situations as events of default. An event of default should be defined as:
 - i) the situations set out in clause 14.55 of the Code (ie failure to pay an invoice to the clearing manager or to restore wholesale prudential security levels, specific events external to the Code such as appointment of a receiver or liquidator)
 - ii) situations where:
 - the retailer is no longer entitled to trade on a distribution network (the retailers use of system agreement has been terminated); and

- there are no unresolved disputes between the retailer and the distributor in relation to the termination; and
- the retailer has not taken timely steps to arrange for consumers to switch to another valid retailer or its consumers have refused to switch.

For discussion – definition of an event of default

The majority of submitters agree that where a retailer has defaulted in terms of its use of system agreement (UoSA) and the only consequence available is the disconnection of customers (refer to cl.20.4 of the model UoSA), then this process should apply. Submitters also agree that the definition of an event of default in relation to the distributor should not capture commercial disputes between parties. Some submitters emphasised that the default should represent more than minimal risk to the market.

Does the test as written satisfy these concerns? Should the first prong state that the termination of the use of system agreement must be as a result of an event of default in terms of the UoSA?

- b) On being advised of an event of default, the Authority will investigate the claimed event of default to determine whether an event of default exists and, if so, whether the event is material.

For discussion – specification of materiality threshold

Submitter comments indicated that the RAG should consider financial or other thresholds to establish the materiality of an event (of default). While an indicative financial threshold was supported, it was not considered to be determinative of a material risk to the market. Factors such as the size of the retailer and the extent of resources available to it to remedy a default were also mentioned. Other submitters consider repeated events, or multiple smaller size events could also pose a material risk to the market. Some submitters commented that the proposed threshold (equivalent to the UoSA test of the greater of \$100,000 or 20% of monthly lines charges) was too high.

How should the threshold be specified? Should the Code list factors to consider? Should there be a 'bright line' financial threshold?

- c) if an event of default is material, the Authority will advise the retailer and its agent (for instance, any receiver appointed to the retailer) that, unless the default had been rectified within eight (8) working days, that the Authority would:
 - i) communicate with all of the failed retailer's customers advising them that their retailer had defaulted, that they should switch to another retailer and that if they did not switch by a specified date, 10 working days hence, the Authority would assign them to another retailer; and
 - ii) proceed to terminate the retailer's rights to trade electricity under the Code.
- d) the eight day period could be extended with the approval of parties representing 75% of the money owed.

For discussion – timeframes

Submitter comments indicate divergent views on the eight day period – too short or too long. Some noted that the model UoSA is not (yet) industry standard. Some considered that the timeframe to rectify the

default should be open-ended where a receiver was involved: the receiver should trigger the next stage of the process by indicating that they are unable to resolve the situation.

The RAG needs to consider whether 8 days with the possibility of extension by agreement represents a reasonable compromise.

- e) if the default is not rectified in the eight day period, the Authority would communicate with each customer, providing information on how to switch retailers and advising that if they had not switched within 10 working days after the date of the letter the Authority would assign the customer to another retailer:
 - i) Retailers in default would be obliged to give their detailed customer list to the Authority. Retailers will be required to have a provision in their contracts with customers allowing their details to be passed to the Authority in an event of default.
- f) retailers will be required to include a provision in their contracts allowing the contract to be terminated on notice from the Authority. In this circumstance the customer would become bound by a contract with another retailer.

For discussion – switching Switch dates

A variety of issues were raised around switch dates. Some submitters recommended a retrospective (fixed) switch date. Some submitters questioned whether those consumers who voluntarily switched should be processed in line with normal Code-mandated rules.

Does the RAG consider it is preferable to switch all consumers on the same date, or to allow voluntary switches to occur in line with usual practice? Does the RAG agree that the switch date for mandatory transfers should be the end of the voluntary switching period?

Customer details

Submitters queried whether a defaulting retailer would comply with an Authority request for its customer list. Does the RAG consider that a Code requirement that the list be provided is sufficient, or should some additional details be recorded in the Registry for all retailers?

- g) retailers in the same network area would be required to enter into contracts with customers of the defaulting retailer whose contracts have been terminated by the Authority (including inactive ICPs). Remaining customers would be pro-rated at each GXP based on:
 - i) the volume of ICPs served by other retailers for non half hour (NHH) customers with a minimum threshold of 100 customers transferring, and
 - ii) the volume of HHR demand served by other retailers where those retailers have at least 10% of the market for HHR customers.
- h) The Authority would evaluate the risk of allocating customers to retailers and would make the allocation to avoid a cascade failure of the receiving retailers.

For discussion – evaluation of risk to other retailers

Many submitters commented on the need to ensure that the allocation of customers to other retailers at a GXP did not result in the failure of those retailers. Two submitters specifically suggested that if a large

retailer defaulted then different allocation criteria might be required; one suggested large be defined as having more than 70% market share at that GXP.

Placing minimum thresholds on the size of the receiving retailer (as suggested above) also contributes to reducing the risk, as well as reducing the cost and complexity of the process.

Is the RAG satisfied that the evaluation process does not need to be tightly defined? We envisage that where there are flow on implications the Authority would discuss alternative options with the affected retailers. These alternatives could include the exclusion of a particular generator from the allocation, or allocation on a different basis (e.g. net generation or hedge position) depending on whether the issues were specific to a retailer or systemic. Specifying the evaluation process, and alternative to be adopted risks reducing the options available in a specific scenario.

We note that one submitter suggested capping the wholesale market price. In general, we consider intervening in the wholesale market is undesirable, and that the evaluation could consider these type of issues. Does the RAG agree?

- i) The retailers receiving the customer would determine the prices and other terms on which they would supply the customer transferred to them.

For discussion – Distributor risk

Many submitters perceived that distributors faced undue risk under the model UoSA.

The discussion paper suggested that moving to a conveyance UoSA might reduce this risk. Many submitters disagreed with this suggestion, either because of the transaction costs involved in changing their contracting and billing arrangements, or because they considered the benefits of conveyance agreements were overstated.

Does the RAG agree that the inclusion of a distributor-related event of default adequately resolves this concern by reducing the impetus to switch to a conveyance agreement?

Some submitters considered that distributors face significant financial risks associated with the level of prudential security available to them. This issue can be considered separately to this process and is not a matter that the Authority has sought the RAG's advice on.

Other matters to note

Legal advice – submitters sought the release of the legal advice provided to the RAG. It is recommended that the RAG forward this request to the Authority for its consideration.

Technical group – a submitter suggested that the Authority establish a technical group to assist it in drafting the Code. It is recommended that the RAG forward this request to the Authority for its consideration, and note that this is considered valuable as the Code changes in simplifying and clarifying Part 14 alone are likely to be significant.

Guidelines – submitters suggested that the Authority develop guidelines and/or flow charts to set out the practicalities of how it will administer the proposed arrangements. It is recommended that the RAG recommend that the Authority prepare this documentation based on, and as part of preparing the final Code amendments. One submitter suggested that the system or process be regularly tested. It is not clear

at this stage whether this would add value as any situation is likely to be quite specific. However, the RAG could consider passing this suggestion on to the Authority for their consideration.

Wider role - One submitter suggested that the Authority take a more active role in developing another plan or process to facilitate the defaulting retailer trading out. This is the role and expertise of the receiver and as such we do not recommend the RAG pursues.

Combined gas and electricity scheme - it was noted by a submitter that because of dual fuel retailers a joint scheme would be preferable. The Gas Industry Company is in the process of introducing a retailer of last resort scheme and a representative has been invited to the meeting to discuss this.

Recording event of default investigations – questions were raised about what reporting and recording of investigations into events of default and actual events of default would be undertaken. Submitters asked whether trends would be monitored through the recording of remedied breaches. While this information could provide an indicator of market health, publication is likely to raise commercial confidentiality concerns (even if the information were made anonymous) and is not recommended.

Appendix A Summary of submissions