

# Memo

**To**  
Settlement and Prudential  
Security Technical Group

**From**  
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## Summary of Issues Relating to Prudential Security Requirements

1. On 21 November 2012 I gave a presentation to the Settlement and Prudential Security Technical Group (the "**Group**") about some of the issues raised in the context of the prudential security requirements in the Electricity Industry Participation Code 2010 (the "**Code**").
2. The Group asked that I prepare a summary of the points raised in the presentation, and this is that summary. In almost all cases there are some complex arguments that make the position a court would reach a little unclear. I have not explored those issues in detail in this summary but have set out what I think is the most likely outcome. I am happy to provide more detailed advice about anything covered in this summary on request.

### The Issue

3. Under the current model for purchasing electricity, a person that purchases electricity from the Clearing Manager (a "**Purchaser**") pays for that electricity after it has been supplied. This means that the Clearing Manager is taking a credit risk on the Purchaser.
  - 3.1 In my presentation I talked about:
    - (a) the different prudential security requirements;<sup>1</sup>
    - (b) the risk that payments (or security granted as part of the prudential security requirements) could be overturned on the application of a liquidator of a Purchaser;
    - (c) the effect of set-off rights if a Purchaser also supplies electricity to the Clearing Manager.

### Prudential Security Requirements

- 3.2 In the presentation I discussed the following prudential security requirements:

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<sup>1</sup> I did not cover Hedge Agreements in the presentation.

- (a) a requirement that a Purchaser have a high credit rating;
- (b) third party credit support; and
- (c) cash collateral.

#### *Credit ratings*

- 3.3 The issue that the Clearing Manager is looking to manage is credit risk on a Purchaser. A credit rating is an indicator of how great that credit risk is. Consequently, a requirement that a Purchaser's credit rating be at a level that indicates that the risk of the Purchaser defaulting is very low appears to be a legitimate way of managing the Clearing Manager's credit risk.

#### *Third party credit support*

- 3.4 Third party credit support can take a number of forms, but the key characteristic is that a third party agrees to meet the Purchaser's payment obligations if the Purchaser does not. This reduces the Clearing Manager's credit risk because the Clearing Manager will only be out of pocket if both the Purchaser and the third party default – an outcome that is less likely than just the Purchaser defaulting.
- 3.5 For third party credit support to reduce the Clearing Manager's risk to an acceptable level, the third party must be a bank or another entity that is highly creditworthy.

#### *Cash collateral*

- 3.6 Cash collateral involves a Purchaser paying cash into a trust account, with the cash able to be applied to meeting any debt to the Clearing Manager if the Purchaser defaults. This arrangement appears to create a security interest in the cash in favour of the Clearing Manager under the Personal Property Securities Act 1999 (the "**PPSA**").
- 3.7 Cash collateral is effective provided enough cash is held in the trust account to cover any default and no third party is able to lay claim to it and prevent it being paid to the Clearing Manager.
- 3.8 A third party may be able to claim the cash in competition with the Clearing Manager if it has also been granted a security interest in that cash by the Purchaser. For example, the Purchaser may have granted a security interest in all of its property (including the cash) to a bank.
- 3.9 If a third party has a competing claim, the Clearing Manager will only be able to draw on the cash if it has "priority" over the third party. This is likely to depend on whether the Clearing Manager has:
- (a) registered a financing statement on the Personal Property Securities Register (the "**PPSR**"); and

- (b) that financing statement was registered before the third party registered one.
- 3.10 Before the Clearing Manager accepts cash collateral, it could search the PPSR to see whether there was any third party that had a financing statement already registered. It could then refuse to accept the cash collateral as sufficient to meet its requirements unless:
- (a) there was no earlier financing statement; or
  - (b) the person with the earlier financing statement was prepared to enter into an agreement with the Clearing Manager giving the Clearing Manager priority in relation to the cash collateral.

### **Claw-back risk**

#### *Claw-back of payments*

- 3.11 Even if electricity was paid for, there is a risk that a liquidator of a Purchaser could exercise "claw back" rights under section 292 of the Companies Act 1993 (the "**Companies Act**") and require that the amount is paid back to the Purchaser for distribution to other creditors.
- 3.12 Section 292 allows a liquidator to set aside a transaction that was entered into by a company within two years of its liquidation<sup>2</sup> if:
- (a) it was entered into at a time when the company was unable to pay its due debts; and
  - (b) it enabled another person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.
- 3.13 A company is presumed to have been unable to pay its debts at all times within the 6 months prior to its liquidation.
- 3.14 However, there are two defences the Clearing Manager may have if a liquidator tried to claw back a payment.
- 3.15 First, section 292(4B) provides that where:
- (a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company; and
  - (b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship,

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<sup>2</sup> This is a summarised position, but the exact detail of when the transaction must have been entered into to be voidable is not important to the analysis here.

the position is analysed as if all the transactions forming part of the relationship were a single transaction. An individual transaction can then only be set aside if all such transactions, analysed together as a single transaction, meet the conditions set out in paragraph 3.12 above.

- 3.16 In this situation, there would be a good argument that the supply of all electricity and all payments for electricity should be analysed as one transaction. That one transaction would have a net cost to the Clearing Manager. Therefore no claw back would be possible, because there would have been no net payment to the Clearing Manager to claw back.
- 3.17 Secondly, there would potentially be a defence against claw-back for the Clearing Manager under section 296 of the Companies Act if it did not know, and a reasonable person would not have suspected, that the Purchaser was insolvent.

#### *Claw-back of Security*

- 3.18 Section 293 of the Companies Act allows a liquidator to set aside a charge over any property of a company (which would include any cash collateral arrangement) granted by the company within two years of its liquidation<sup>3</sup> if, immediately after the charge was given, the company was unable to pay its due debts.
- 3.19 This power does not affect a charge given to secure future credit, so a cash collateral arrangement would not be able to be challenged to the extent that it secured payment for electricity provided after the cash collateral arrangement was put in place.
- 3.20 A cash collateral arrangement could potentially be challenged under section 292 as well, but again such a challenge would be unlikely to succeed where the arrangement secured payments for electricity supplied after the arrangement was put in place.

#### *Where there is no claw-back risk*

- 3.21 There is no claw-back risk if electricity is paid for in advance.
- 3.22 An arrangement where a third party guarantees payment cannot be challenged by a liquidator of the Purchaser.

#### **Set-off**

- 3.23 If the Purchaser is also a supplier of electricity to the Clearing Manager then, if the Purchaser defaults, the Clearing Manager may be able to set off amounts owing by it to the Purchaser against amounts it owes to the Purchaser. Thus the Clearing Manager would effectively be paid by the reduction of a debt owed by it.

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<sup>3</sup> This is a summarised position, but the exact detail of when the charge must have been granted to be voidable is not important to the analysis here.

- 3.24 The Clearing Manager has a right of set-off under the Code, and a statutory set-off also automatically occurs if a Purchaser goes into liquidation.
- 3.25 However, it is not certain that a set-off will always occur.
- 3.26 In relation to the set-off right in the Code, it may be able to be challenged by a liquidator under section 292 of the Companies Act.
- 3.27 While the automatic set-off that occurs on liquidation cannot be challenged by a liquidator, the inclusion of a transaction in the set-off (ie the inclusion of a supply of electricity that gave rise to a debt from the Purchaser) potentially can. Such a challenge may be possible under section 310(2) of the Companies Act where the transaction was made in the 6 months before liquidation and the Clearing Manager fails to prove that it did not have reason to suspect that the Purchaser was unable to pay its debts as they fell due.