Arrangements to manage a retailer default situation

Decision and Reasons

8 November 2013

Introduction

1 The Electricity Authority (Authority) is an independent Crown entity charged with promoting competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.[1]

2 Electricity is a somewhat unique product because supply cannot easily be ceased if a party in the contractual chain (other than the consumer) fails to meet financial commitments. This means that an on-going failure by a retailer to pay for electricity or distribution services can lead to increasing financial losses by generators and distributors (a retailer default situation).

3 The potential for an unresolved retailer default situation has been a long-standing concern for the electricity industry and policy-makers. For example, the December 2000 Government Policy Statement requested the development of arrangements to ensure an orderly transition for end users in the event that a retail company becomes insolvent.[2]

4 The Authority requested the Retail Advisory Group (RAG) in August 2011 to consider options to manage a retailer default situation. The RAG presented the Authority with a recommended approach for managing a retailer default situation in December 2012 after concluding that participants could not rely on the usual insolvency processes for managing a retailer default.[3] The RAG also considered that disconnecting the customers of the failed retailer was not a practicable option for stopping the financial loss; nor would disconnection (of customers who had paid their bills) be consistent with maintaining consumer confidence in a reliable electricity supply.

5 The Authority consulted during June to August 2013 on proposed amendments to the Code to give effect to arrangements to manage a retailer default situation. The proposal was based on the RAG approach.

6 The Authority received 16 submissions on the retailer default proposal. A summary of submissions is available on the Authority's website at http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/.

7 This paper sets out the Authority's decision to introduce arrangements to manage a retailer default situation, and provides the Authority's response to issues raised in submissions.

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1 Refer to the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.

2 Government Policy Statement (revoked) Further Development of New Zealand's Electricity Industry, December 2000, page 4, available at http://www.med.govt.nz/sectors-industries/energy/pdf-docs-library/electricity-market/electricity-industry/specific-legislation/revoked-gps/gps-publicly-released-dec-00.pdf

3 Retail Advisory Group, December 2012, Establishing a process to manage retailer default situations, available at http://www.ea.govt.nz/dmsdocument/14205.

Decision to introduce arrangements to manage a retailer default situation

8 The Authority has decided to introduce arrangements to manage a retailer default situation. The key elements of the arrangements are:

(a) a regulated process for resolving a retailer default is initiated when a retailer does not fulfil financial obligations to the clearing manager, becomes insolvent, or the retailer's use-of-system agreement (UoSA) with a distributor is terminated because of a serious financial breach by the retailer (and certain other conditions are met)

(b) the defaulting retailer would have seven days to resolve the default situation (phase one)

(c) if the default situation is not resolved, the Authority would advise the customers of the defaulting retailer that they have seven days to switch to another retailer (phase two)

(d) the Authority would have three days to arrange to assign all remaining customers to a new retailer: first by running a two-stage tender process; and then by mandatory allocation process (phase three)

(e) all customers of the defaulting retailer are to be assigned to a new retailer 18 days from the process being initiated.

9 The Authority has decided to amend Parts 1, 11 and 14 of the Code to establish a process for managing a retailer default situation, and to publish a guideline explaining the process and actions of the Authority and participants to manage a retailer default situation.

10 The Authority is finalising a plan for implementation of the new arrangements. The Authority considers that the key implementation actions will be:

(a) develop a process manual to specify the step-by-step actions the Authority will take if there is a retailer default situation

(b) finalise the guideline for managing a retailer default situation by including further detail identified during development of the process manual

(c) undertake a desktop exercise involving the Authority, the clearing manager, registry and participants to test the effectiveness of the arrangements and the preparedness of each party.

11 The amendments to the Code are to be gazetted as soon as practicable. The Authority's target is to complete implementation by April 2014.

Key issues raised and response

12 There was considerable support from submitters for the proposed arrangements, with submissions indicating that there is a consensus view amongst all submitters recognising the importance and need for a formal process for managing retailer default situations. However, some submitters indicated broad support while suggesting changes to specific aspects of the proposal. No submitter identified developments or provided new information that might warrant the Authority making fundamental changes to the proposed arrangements. The key issues raised in the submissions were:

(a) **Trigger for the retailer default process**. Submitters mostly agreed with the criteria for triggering the retailer default process, but some submitters suggested changes or clarifications to the conditions for the new category of event of default (the conditional ability of a distributor to initiate the process)

(b) **Period for resolving a default**. There was no consensus between submitters about the appropriate period for resolving a retailer default. Some submitters suggested less time, some considered the 17-day period was, on balance, appropriate, and some suggested that 17 days was not long enough

(c) **Ability to require and release information**. Most submitters supported the Authority having the ability to require information and to communicate with the market and customers of the failed retailer

(d) **Approach to allocating remaining customers of the failed retailer**. There was mixed support for the process for allocating remaining customers of the failed retailer, with a number of submitters noting that the two-stage tender process would be overly complex and time-consuming

(e) **All ICPs should be allocated**. A submitter requested that the Authority clarify the draft Code to confirm that where there is no customer for an ICP for which the failed retailer is responsible, there should be a process to transfer the ICP to the recipient retailer. This would include vacant properties or those where electricity was not connected

(f) **Recipient retailer responsibility for advising customers**. Submitters agreed that the recipient retailer should be responsible for advising new customers of contractual terms and conditions

(g) **Period for retailers to update their customer contracts**. The period for retailers to amend their customer contracts should be longer.

Trigger for the retailer default process

13 Submitters mostly agreed with the categories of event of default that would trigger the retailer default process, but some submitters suggested changes or clarifications to the conditions for the new category of event of default (the conditional ability of a distributor to initiate the process). In particular, submitters suggested several amendments to the new category of event of default, which are discussed further below:

(a) requirement to terminate UoSA

(b) definition of serious financial breach

(c) no unresolved disputes

(d) event of default should apply not only to the network on which default occurred.

Requirement to terminate UoSA

14 Eleven submitters supported the proposed new event of default which enables distributors to initiate the retailer default process. Three submitters either did not oppose on balance (Genesis) or did not comment specifically on this issue (Pioneer and Simply Energy).

15 One submitter, Pulse, was opposed to distributors being able to initiate the retailer default process on the basis the ability is unnecessary because distributors have alternative mechanisms for managing the failure of a retailer to meet financial obligations. The concerns raised by Pulse were considered at length by the RAG and informed the specification of the conditions for distributors to initiate the retailer default process. As such, the Authority does not consider that removing the new category of default is warranted.

16 WEL, PwC and WELL observed that terminating a UoSA would not be taken lightly and could take significantly longer than the minimum 12 days and that this time is incurred before the 17 days for the Authority process. PwC raised the following additional concerns:

(a) the distributor will be in breach of section 77 of the Electricity Industry Act 2010 (Act), which requires distributors to have written UoSAs with each connected retailer (where that retailer retails more than 5GWh per annum)

(b) there is the potential for legal and compliance issues and ambiguity if the retailer continues to trade after the UoSA is terminated

(c) terminating the UoSA may affect a distributor's legal rights to recoup costs, for instance if a receiver is appointed.

17 The purpose of enabling distributors to initiate the retailer default process, but on a conditional basis, is twofold: to remove the incentives for distributors to adopt ad hoc alternative mechanisms to limit financial losses; but to avoid retailers being exposed to additional leverage from distributors over commercial disputes. The Authority does not consider that submitters have provided any relevant new information to suggest that their proposed change to the new category of event of default is efficient.

18 PwC noted that if a distributor terminates a UoSA it could breach section 77 of the Act. Although that is correct, the real basis of the new event of default called "serious financial breach" is not the termination of an agreement but rather the failure by the retailer to pay money owing to the distributor.

Definition of serious financial breach

19 The consultation proposal as consulted on enables a distributor to initiate the retailer default process when a UoSA is terminated because of a serious financial breach as defined in the UoSA. The expectation is the definition of a serious financial breach used by each distributor would be consistent with the definition in the Authority's model use-of-system agreement (MUoSA).

20 Contact, Pioneer, Meridian, Mighty River Power and Pulse noted in their submissions that many distributors do not use the Authority's MUoSA and that the definition of a serious financial breach varies across UoSAs. The submitters considered that this undermines the Authority's objective by enabling distributors to establish a lower threshold for initiating the retailer default process.

21 The Authority considers that the ability of distributors to choose their own definition of a serious financial breach would enable distributors to lower the threshold for initiating the retailer default process, thereby altering the balance of commercial risk between retailers and distributors. This is likely to increase barriers to retail entry and expansion into a region, particularly for small retailers.

22 Consequently, the Authority revised the draft Code to include the definition of serious financial breach contained in the MUoSA in the Code, rather than simply referencing the definition in the MUoSA.[4] This clarifies the Authority's policy intent and does not represent a material change to the proposal.

23 WEL submitted that the threshold of "serious financial breach" is too high, and that five or 45 per cent of the 11 retailers trading on its networks would not meet this threshold in the event of missing a monthly invoice payment. WEL expressed concern that the absence of a similar threshold on payments to the clearing manager would mean a retailer would favour paying the clearing manager over electricity distribution businesses.

24 The Authority notes that the RAG recognised that the conditions of the new category of event of default establish a higher threshold than applies to non-payment to the clearing manager. The RAG formed the view that this higher threshold was necessary to balance the interests of distributors and retailers. The balance struck by the RAG has gained widespread support, and the submissions by WEL, PwC and WELL have not provided new information to support an alternative definition of serious financial breach.

No unresolved disputes between distributor and retailer

25 Several submitters considered that the draft Code should clearly connect the "no unresolved dispute" condition with the serious financial breach – that is, there are no unresolved disputes in relation to the serious financial breach that triggered the termination. Disputes may, or may not, exist between the parties on other matters, but that is not relevant to whether the condition has been met.

[4] Serious financial breach is defined in the interposed MUoSA as a) the failure by a retailer to pay an amount due that exceeds the greater of $100,000 or 20 per cent of the payable charges for the previous month, or b) a material breach of clause 12, which details the requirements on retailers to pay prudential security to the distributor.

26 Vector proposed that the threshold should be “no bona fide unresolved disputes”, allowing the default provisions to be trigged in the case of a ‘bona fide’ dispute. PwC (on behalf of 21 EDBs) submitted that distributors should have the discretion to trigger the default process even where dispute exists, as retailers might have an incentive to raise contractual issues to delay the process.

27 The conditions applying before a distributor can initiate the retailer default process are designed to provide confidence to retailers that the new category event of default would not be used as a point of commercial leverage, and to avoid the Authority from being placed in a position of determining which party was at fault in a dispute. The submissions by Vector and PwC did not raise any new factors not considered by the RAG in arriving at balance of interests reflected in the four conditions.

28 The Authority revised the draft Code to clarify that there must be no unresolved disputes between the retailer and distributor in relation to the serious financial breach before the termination of a UoSA will initiate the retailer default process.

Event of default should apply not only to the network on which default occurred

29 The proposed process for managing a retailer default would capture all customers of the failed retailer, even if the event of default were initiated due to a failure to meet financial obligations to a single distributor. The reason for adopting this position is to remove the incentive for struggling retailers to ‘cherry pick’ the process and attempt to shift uneconomic customers into the regulated retailer default process while retaining profitable customers.

30 Genesis and Pulse opposed this aspect of the proposal submitting that the risk of ‘cherry picking’ was overstated. However, the approach was supported by nine submitters, with a further four submitters not commenting explicitly on the provision. In addition to supporting the reasoning in the retailer default consultation paper, submitters noted that a default on one network may simply be a matter of timing and would work against efforts to create standard terms or a single contract across networks (eg where the networks are owned by the same entity).

31 No evidence or new arguments were presented by the two submitters opposed to the approach recommended by the RAG and supported by the vast majority of submissions. As such, the Authority did not change to this aspect of the proposal.

Period for resolving a default

32 The time required to resolve a retailer default has been the most contentious aspect of the proposal, with some parties (mainly generators) wanting less time and some parties (mainly retailers) wanting more time. The RAG considered the period of time required to resolve a retailer default at length, taking into account the views of participants, consumers and the Wholesale Advisory Group.

33 The Authority accepted the RAG proposal for a 17-elapsed-day period to resolve a retailer default situation.

34 Eight submitters supported the 17-day period, although some encouraged the Authority to try to achieve a shorter period where possible. Four submitters considered the period too long and a shorter period should be set. Genesis and PwC believed the period may be too short to be achievable in some circumstances and there should be scope to extend the period. One submitter did not comment on this issue.

35 The submissions on the time period for managing an event of default did not raise any new information on a matter that has been the subject of considerable discussion. The vast majority of submitters supported the judgment reached by the RAG. Furthermore, a number of submissions on the Settlement and Prudential review commented on the 17-day period and its appropriate length. However, those comments too did not raise any new information on a matter which had been a matter of considerable discussion by RAG and at the subsequent working group session convened by the Authority. As such, the Authority has not changed the timeframe for resolving a retailer default situation.

Ability to require and release information

36 The proposal enables the Authority to require information from participants and to release information to undertake the tasks required in managing a retailer default situation.

Ability to request information

37 There was strong support for the Authority having power to require distributors and the registry to provide information about the defaulting retailer's customers to the Authority, if the Authority cannot obtain that information for the retailer in default. However, some distributors asked that the request for information be subject to a "within a reasonable timeframe" requirement, given the potential difficulties in extracting the information. Submitters also suggested some form of "reasonable cost" standard, after pointing out that in some circumstances distributors may have the information but would not be able to extract the data without making system changes.

38 The Code does not need to explicitly state that the Authority will be reasonable because this is required under administrative law. Consequently, any request for information by the Authority must allow parties time to respond that is reasonable in the circumstances.

39 However, submitter comments about reasonable timeframe and reasonable cost raise a further question – how prepared will parties be to respond if there is a retailer default situation? The retailer default process involves a very compressed period which does not leave much time for debate about availability of information or costs. Parties will need to be ready to respond to requests or contribute if the process is to be successful. This suggests that the Authority's implementation process will need to focus on the preparedness of parties, including the Authority, to respond in a retailer default situation. The Authority intends testing the preparedness of all parties during the implementation process.

Ability to keep the market and consumers informed

40 With one exception, submitters supported the Authority having powers to keep the market informed in an event of default and advising the retailer's customers to switch to another retailer if the default is not resolved. Contact and Nova emphasised that the Authority should contact the retailer's customers only after the end of the seven-day period – this is consistent with the proposal. Code amendments dealing with the publication of information about an event of default are also being proposed as part of the review of settlement and prudential security arrangements.

41 Pulse opposed the provision that would allow the Authority to communicate directly with the customers of the retailer in default on the basis that it would destroy the value of the customer base. The step in which the Authority advises customers that their retailer is in default and that they should switch to another retailer was considered by the RAG. The alternative is to increase the role of the Authority in allocating customers, which the great majority of submitters wish to minimise to a 'last resort' or fall-back.

Approach to allocating remaining customers of the failed retailer

42 The Authority proposed allocating remaining customers of the failed retailer through a three-stage process:

(a) first, inviting retailers to tender for the remaining customers of the failed retailer. Customers/volumes would be assigned randomly to the retailer(s) bidding the lowest price (tariff)

(b) second, if not all customers are assigned to another retailer, the Authority would invite retailers to tender for the remaining customers. Customers would be assigned randomly to the retailer(s) bidding the lowest price (tariff) weighted by the length of the term

(c) third, if not all customers are assigned through the tender processes, customers would be assigned randomly to retailers according to their market share.

43 Contact, TrustPower and Powerco opposed the tender process using an allocation approach due to the added complexity and added time. Vector cautioned against the approach for the same reasons.

44 Genesis, MEUG, WEL and Mighty River Power supported the allocation approach. Meridian supported the approach for domestic customers, but considered that further thought is required about how the tender aspect could apply to commercial customers. PwC appeared to support tender arrangements (but may have misread the proposal as precluding a commercial sale between the defaulting retailer and other retailers).

45 Nova and Pulse supported the tender process, but on the basis that it sought to achieve the highest value for the customer base.

46 Simply Energy and Pioneer did not comment specifically on this issue.

47 The primary objection of the submitters opposed to the tender aspect of the allocation approach was the potential risks associated with a more complex and time-consuming approach. The retailer default consultation paper discussed how the tender process provides a mechanism that:

(a) enables retailers to define the terms and conditions on which they will accept customers of the failed retailer – this is likely to result in a more commercially acceptable outcome for the recipient retailer

(b) causes the customers of the failed retailer to be transferred to a retailer that has made a conscious decision to take on those customers – this is likely to result in the customer being offered terms and conditions (including price) that are acceptable to the customer

(c) reduces the risks associated with an arbitrary mandatory allocation of customers, such as the potential for further retailer failure due to assignment of customers to a retailer not in a position to manage those additional customers.

48 No submitter provided information showing that the complexity of the tender process would result in additional costs that outweigh the benefits of giving retailers flexibility to determine the terms and conditions of the customers they are assigned. Accordingly, the Authority does not consider that change to the allocation approach is warranted.

Specifying the allocation approach and tender process in the Code

49 Genesis supported the allocation approach, but considered that the requirements of the approach should be specified in the Code. The proposal contained in the retailer default consultation paper gives the Authority considerable discretion to define the allocation approach by establishing a head of power in the Code for the Authority to assign contracts and describing the allocation arrangements in the guideline.

50 The Authority considers that keeping the detail of the allocation approach in the guideline would give the Authority and participants more flexibility if the process is ever used. For example, the Authority may want to refine the approach very quickly if the particular circumstances of a default show that some aspect will not work. Amending a guideline is a simpler exercise than amending the Code under urgency. Further, changing the allocation approach by amending a guideline potentially reduces the risk of successful court action by a receiver or other creditor of the failed retailer.

Awarding the tender on the basis of the best price to consumers

51 Nova and Pulse considered that the tender aspect of the allocation approach should be on the basis that the Authority extracts the highest value from the customer base for creditors.

52 The retailer default consultation paper discounted the potential for the Authority to seek a cash payment for the defaulting retailer's customer base. The key reason is that the owners of the retailer and any receiver or liquidator would likely argue that any money received belongs to the retailer and should be returned to meet the claims of secured creditors and other claims against the failed retailer. Returning the funds to the

receiver may create an incentive for the receiver not to attempt a commercial sale of the customer base (if the customer contracts are uneconomic) as the Authority may achieve a higher value in tendering the customers on the terms of the recipient retailer.

53 The tender aspect of the allocation approach is intended to efficiently allocate the remaining customers of the failed retailer to new retailers, thereby maintaining the confidence and integrity of the electricity market by resolving retailer default. The intention is not to sell the customers. This is the purpose of the initial seven days of the retailer default process during which the failed retailer has the opportunity to achieve a commercial solution.

Further detail on allocation approach

54 Meridian encouraged the Authority to develop further detail on how it would evaluate the tenders, especially given the variation in terms offered by retailers. Comparing retailer customer terms is far from straightforward and may become more difficult with the introduction of AMI. Given the very limited time available for the tender, two options might be feasible:

(a) require retailers to submit tenders on the basis that they would comply with some specified customer terms (so that meaningful comparisons of prices could be made quickly)

(b) tender be awarded to the entity that offers the biggest discount to their own posted terms.

55 The first option would require retailers to develop a contract for the transferred customers which may be different from the contracts they offer to their existing customers. This approach would risk deterring retailers from participating in the tender.

56 The second approach would accept that an evaluation of different terms is difficult. Presuming the market is workably competitive, then the mix of terms currently offered by retailers will have been determined by the competitive process and reflect different preferences of consumers and suppliers. A comparison of discounts may therefore be a reasonable indication of the competitiveness of the tender, relative to other retailers. The approach may involve anomalies, but given the circumstances, all approaches will involve anomalies.

57 Meridian also proposed that tenders should be submitted at the GXP level so that retailers are not allocated customers on GXPs not currently served by the acquiring retailer. The intent of the arrangements is that customers would be allocated to retailers operating in the same network area.

58 The Authority intends updating the guideline for managing a retailer default situation be revised once the Code amendments have been finalised to include further detail on the operation of the allocation process and evaluation of tenders and to clarify that retailers would not be allocated customers on GXPs not currently served by the acquiring retailer.

De-minimus threshold for mandatory allocation

59 The final stage of the allocation approach would involve the mandatory assignment of remaining customers to retailers based on market share in a region.

60 Eight submitters (Contact Energy, Genesis, MEUG, Meridian, Nova, Orion, Powerco and Pulse) agreed that the mandatory allocation should be on the basis of market share in the relevant networks without using a de minimus threshold.

61 WEL Networks also agreed with this aspect of the Authority's proposal, but suggested this would be a fair method only after all processes have been exhausted.[5]

[5] WEL Networks, p. 5

62 Four submitters (Mighty River Power, Pioneer, TrustPower and Vector) considered a de minimus threshold should be used when determining customer allocations. Generally it was considered that a de minimus threshold is needed because very small retailers may not be in a position to absorb additional customers in short timeframes, but that flexibility should be retained for altering what the threshold is.

63 Vector suggested the threshold should be 5 per cent, whilst TrustPower and Mighty River Power proposed it should be 10 per cent.

64 The retailer default consultation paper proposed that retailers concerned about the risks of accepting customers could object to the allocation on the basis that the assignment would seriously threaten their financial viability. This approach removes the need for a de minimus threshold.

All ICPs to be allocated

65 Contact identified that the draft Code that provides for the Authority to assign contracts does not appear to deal with allocating those ICPs that are the responsibility of the failed retailer but where there is no customer. This would include vacant properties and those where electricity is not connected.

66 The proposal is intended to ensure that all ICPs that are the responsibility of the failed retailer at day 17 of the process are allocated to another retailer. This deals with concerns arising from the failure of E-Gas where inactive ICPs of E-Gas were not transferred to any retailer and were left orphaned.

67 The relevant clause of the draft Code referred to "customer contracts". The Authority revised the draft Code to provide for the allocation of all ICPs, as appropriate to the NHH and HHR market segments.

Recipient retailer responsibility for advising customers

68 Submitters agreed that the recipient retailer should be responsible for advising its new customers of their new contractual terms and conditions. However, some submitters suggested that the obligation should be to take "reasonable steps", as the recipient retailers may only have partial information (if the Authority has not been able to obtain information on the customers transferred).

69 The Authority revised the draft Code to reflect that retailers should be obliged to take all reasonable steps to advise customers assigned to them of their contractual terms and conditions. This does not represent a material change to the proposal.

Time period provided for making changes to customer contracts

70 Contact submitted that the time period provided of six months for retailers to amend every customer contract to provide for the assignment terms etc. (clause 11.5B process) was impractical and unreasonable. Contact suggested that a period of 12 months should be provided and noted that it has negotiated a 12-month period in all of its UoSAs.

71 The Authority considers that the six-month timeframe gives retailers enough time to update customer contracts while enabling the timely implementation of the regime. Ensuring that retailers update customer contracts in a timely manner is critical to the regime operating as intended by enabling the Authority to assign ICPs during the last phase of a retailer default situation on terms and conditions (including price) offered by the recipient retailer through the allocation process. No other submitter provided information that making specific amendments to customer contracts required more than six months.

Implementation and next steps

72 The amended Code was gazetted on 7 November 2013 and comes into force on 16 December 2013. The arrangements will be operating from 16 June 2014 after retailers make the necessary amendments to their customer contracts.

73 The Authority will develop a temporary process to be used from mid-December until a permanent process has been implemented as:

(a) retailers have six months to update customer contracts to allow the Authority the ability to assign ICPs

(b) the registry service provider will need to effect system changes.

74 The Authority will develop and implement a detailed process that the Authority, relevant service providers and market participants will follow in the event of a retailer default situation.

75 The development of the retailer default situation process will require input and review from relevant service providers and market participants. The Authority will gain this input and review by liaising directly with affected parties and ensuring that the retailer default process is achievable by all affected parties.

76 The Authority, relevant service providers and market participants will undergo a retailer default preparedness exercise (anticipated in April 2014) whereby a test system will be set up to simulate a retailer default situation. A regular retailer default preparedness exercise may be scheduled, for example annually or biennially.