

Retail customers in retailer default situations

Discussion paper

7 February 2011

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Executive summary

1. This discussion paper considers the implications for consumers should an electricity retailer fail to pay amounts due to the Clearing Manager or electricity distribution businesses – referred to as a retailer default situation. Ineffective or inappropriate arrangements for managing a retailer default situation may result in disruption to electricity supply, potentially causing uncertainty and concern for consumers, and potentially damaging the credibility of the market with the consequent potential for ad hoc legislative intervention.
2. Several important changes were made to how the risk of retailer default is allocated in the wholesale market when the former New Zealand Electricity Market (NZEM) rules were replaced with statutory arrangements. The effect of those changes is that there may no longer be an effective mechanism for ensuring a prompt transfer of customers if the failed retailer (or an agent appointed by some other party) does not initiate that transfer, nor is there a mechanism for stemming any financial loss to the Clearing Manager (i.e. generators) or the electricity distribution businesses.
3. The ongoing failure to pay by a retailer risks one or more parties in the supply chain not receiving the funds paid by the consumer with the potential consequential risk of disconnection of the consumer. While a failure of a retailer to pay its bills does not reduce the generation or network capacity available to meet demand, the default may:
 - a) have financial impacts on participants in the supply chain;
 - b) impact on the orderly operation of the market through disruption to information flows;
 - c) affect consumers through the:
 - i) inconvenience in contracting for a new retailer on terms and conditions (including price) that may not be equivalent to those offered by their current (failed) retailer;
 - ii) prospect of having to pay higher prices for supply from the new retailer; and
 - iii) risk of disconnection of electricity supply because one or more parties in the supply chain do not receive the funds paid by the consumer (and the consumer has been unable to contract with a new retailer).
4. This paper begins with an assessment of the risk that the money paid by the consumer is not received by the parties in the supply chain and describes how changes to market regulation have significantly altered this risk.
5. Under the former NZEM rules, settlement risk was borne through three primary risk allocation mechanisms. The NZEM participants agreed (the market at its inception was governed by a multilateral contract) that:
 - a) purchasers would provide collateral sufficient to cover their expected purchases for a period of 57 days, or hold an acceptable credit rating (A- Standard & Poor's or equivalent). Distributors set a similar period of prudential cover;
 - b) the Clearing Manager could appoint a receiver were a retailer to default and not promptly restore its collateral. This provision meant that retailers provided additional security in the form of the market value of their customer base (which is likely to be the largest asset of a retailer available to the receiver). The Clearing Manager could have been reasonably confident that a receiver would achieve a commercial transfer of the customer base to

- another retailer thereby stemming future losses, and might also release funds from the sale of assets to meet unsettled liabilities to the Clearing Manager; and
- c) generators would bear the residual risk (of low-probability, high impact events), as any short-fall in payment by a purchaser (after any recoveries by the receiver) would have been prorated by the Clearing Manager across generators.
6. These arrangements for allocating settlement risk incorporated some strong efficiency enhancing (total cost minimisation) characteristics:
 - a) settlement risk for 'normal' market operation could be priced through a competitive market process via a bank guarantee or equivalent, rather than being set by a bureaucratic process;
 - b) moral hazard issues were mitigated because a retailer placed its assets at risk (not just the prudential collateral) were it to adopt an overly risky practice;
 - c) settlement risk in (low probability) periods of extremely high prices would fall ultimately to the parties best placed to bear that risk – generators; and
 - d) administration costs were minimised because the cost of evaluating and monitoring was allocated to one party with the lowest costs (because of access to information on current liabilities to the market) and a clear agency agreement to do so, the Clearing Manager.
 7. Several important changes have been made to how settlement risk is allocated in the wholesale market since the NZEM rules were replaced with regulations. Importantly, the "right" that had existed under the NZEM rules for the Clearing Manager (subject to approval by the Market Surveillance Committee) to appoint a receiver was not carried over from the NZEM rules to the Electricity Governance Rules and Regulations (EGRs). This right was not reinstated when the EGRs were repealed by the Electricity Industry Act 2010 and replaced by the Code. Similarly, generators are not parties to any agreement with purchasers for the sale and purchase of electricity through the wholesale market that includes a right to appoint a receiver should a purchaser default on payment.
 8. Section 49(3) of the Electricity Industry Act 2010, provides the Authority with the power to suspend a retailer's rights to trade with the Clearing Manager where a purchaser defaults. Suspension of a retailer in default, however, would have limited practical effect as the defaulting retailer would still be a purchaser under the terms of the Code as long as it continues to have valid contracts with its customers and those customers take electricity. This means that the Clearing Manager (and generators) and network companies would continue to incur losses if invoices remain unpaid. The only immediate effect of the suspension provisions is to signal the Authority's belief that the retailer is failing.
 9. Current arrangements therefore risk giving rise to moral hazard in which a retailer may not fully factor in the costs of its potential failure on other participants (both generators and retailers). These incentives could in time lead retailers to adopt riskier business strategies than are economically efficient (strategies that would not be profitable but for the fact that the downside is borne in part by others).
 10. Inefficient risk taking can be expected to lead to more disruption and inconvenience to consumers, with the consequential impact on the reputation of the market. It also creates uncertainty about the level of risk faced by industry participants, particularly for generators who now bear in first instance the risk of electricity used by the defaulting retailer's

customers, and for distributors who bear the risk of lines charges for customers of the defaulting retailer on their network.

11. This paper considers three options. One option would be to make no changes. This option would recognise that market participants who bear the financial costs of a failed retailer face incentives to reach an agreement to curtail the loss – generators for instance may be better off reaching an agreement to acquire the failed retailer’s customers (and therefore the revenues from those customers) than continue to bear the pro-rated share of the shortfall to the Clearing Manager. Making no change would have the advantage of avoiding the costs of amending existing regulatory arrangements or administering any alternative mechanism. The disadvantage of making no change is that the apparent incentives for inefficient risk taking would remain and there would be little or no certainty as to the outcomes or the timeline of events following non-payment by a retailer.
12. Option two is to re-establish a mechanism whereby the Clearing Manager, or the Authority, could appoint a receiver if a retailer in default did not pay any outstanding liabilities and restore its required collateral within the period provided under existing prudential requirements. A receiver would realise assets or management the business for the benefit of creditors, but cannot change the preferential order of claims on the retailer’s assets - preferential claims (such as unpaid wages and amounts owed to Inland Revenue) must be paid before secured creditors and secured creditors must be paid before unsecured creditors.
13. Option three is to implement a modified version of the Draft Code Change that provides the Authority with the means to transfer customers from a retailer. This option would presumably change the preferential order of claims on the retailer’s assets, as the customer base (and associated cash flows) transferred to another retailer would no longer be available to settle preferential claims and secured creditors. Other retailers could be required to take the customers of the failed retailer or, alternatively, some means might be established whereby retailers could elect to take the customers – this arrangement might be implemented in advance (retailers agree to take customers should a retailer fail over some future period) or via some tender process after a retailer fails.
14. Both option two and option three could be designed to provide a high degree of certainty around process following the failure of a retailer to meet payments to the Clearing Manager – that is, the mechanism could be designed to trigger within the period covered by the prudential collateral. The primary advantage of option three over option two is that a mandatory transfer mechanism could also provide a high degree of certainty – to generators, distributors, customers and the Authority – around the timeframe for transferring customers to a new retailer. The certainty provided by a mandatory transfer mechanism would be valuable if the market environment at the time of the retailer default meant that viable retailers were reluctant to accept the customers of the failed retailer.
15. The primary disadvantage of option three relative to option two is that this certainty may come at a cost to other retailers (if other retailers are required to take customers) or to other consumers (if other retailers are compensated for taking customers) and raise the cost of exit and entry to the retail market by altering the preferential order of claims on a retailer’s assets.

1 Introduction and purpose of this paper

1.1 Introduction

1.1.1 The Retail Advisory Group (the Group) provides independent advice to the Electricity Authority (the Authority) on the development of the Electricity Industry Participation Code 2010 (the Code) and market facilitation measures, focusing on the relationships between the retailer/distributor/consumer.

1.2 Role of the Group

1.2.1 The Authority established the Group under section 21 of the Electricity Industry Act 2010 (the Act) to provide independent advice to the Authority on the development of the Code and on market facilitation measures, focusing on:

- a) development of the retail electricity market, including matters relating to the retailer/consumer interface, the retailer/distributor interface and the consumer/distributor interface, the distributor/embedded generation interface and advanced metering infrastructure;
- b) priorities for developing:
 - i) the Code, especially in regard to Parts 6 (Connection of distributed generation), 10 (Metering arrangements), 11 (Registry information management) and 15 (Reconciliation); and
 - ii) market facilitation measures in regard to retail market services.

1.2.2 The Group is charged with recommending Code amendment proposals or market facilitation measures to the Authority that assist the Authority to meet its statutory objective and are consistent with the Code amendment principles specified in section 32(1) of the Act as follows:

- a) competition in the electricity industry;
- b) the reliable supply of electricity to consumers;
- c) the efficient operation of the electricity industry;
- d) the performance by the Authority of its functions; and
- e) any other matter specifically referred to in the Act as a matter for inclusion in the Code.

1.3 Purpose of this paper

1.3.1 This paper considers the implications for consumers should an electricity retailer fail (a retailer default situation). It considers the mechanisms by which the customers of a failed retailer might move to a viable retailer and whether Code amendments should be considered to ensure consumers are not stranded – that is, connected and consuming electricity but with no retailer sending invoices to consumers or making wholesale payments for the electricity consumed – or disconnected.

1.4 Provision of advice and recommendations to the Authority Board

1.4.1 The Authority has statutory responsibility for the Code, and for undertaking market facilitation measures and monitoring the operation and effectiveness of market facilitation measures.

1.4.2 The Group will use feedback from industry participants and consumers on the issues and options presented in this paper to develop advice and recommendations to the Authority Board on arrangements for managing retailer default situations.

1.4.3 Based on the timelines agreed with the Authority Board, the Group expects to provide recommendations to the Authority Board in May 2012.

1.5 Relationship with Wholesale Advisory Group Settlement and Prudential Security Review

1.5.1 The Authority's Wholesale Advisory Group is undertaking a review to ensure that settlement and prudential security arrangements are consistent with the Authority's statutory objective. In particular, prudential security obligations should achieve an appropriate balance between the financial security of the market (the confidence that there will be sufficient money available to pay generators) and the promotion of competition by encouraging new entry into the retail market.

1.5.2 The two Groups have been in dialogue as the consideration of retailer default arrangements influences settlement and prudential security arrangements. In particular, the Wholesale Advisory Group is interested in the timeframes from identification of a retailer default through to the transfer of all customer exposures to another, viable retailer. This is based on the view that the level of prudential security is sensitive to movements in the length of time taken to achieve the transfer of risk.

1.6 Structure of paper

1.6.1 The body of this paper is structured into the following sections:

- a) *background* – this section reviews earlier work undertaken by the Electricity Commission (Commission) as well as practice in other jurisdictions;
- b) *current practice* – this section reviews the evolution of the existing regulatory arrangements governing a situation of a failed retailer, and considers the implications of important changes that have been made to how the risk of retailer default is allocated in the market;
- c) *possible scenarios* – this section considers how the current arrangements might work under alternative scenarios to identify gaps and issues;
- d) *problem definition* – this section brings together the “gaps” and “issues” from experience with the existing arrangements to arrive at a problem definition; and
- e) *review of options* – this section evaluates potential solutions to the identified problems against the Authority's statutory objective and code amendment principles.

1.7 Submissions

1.7.1 The Group's preference is to receive submissions in electronic format. It is not necessary to send hard copies of submissions, unless it is not possible to do so electronically. Submissions in electronic form should be emailed to rag@ea.govt.nz with Discussion Paper—Retail customers in retailer default situations in the subject line.

1.7.2 If submitters do not wish to send their submission electronically, they should post one hard copy of their submission to the address below.

Retail Advisory Group
c/o Electricity Authority
PO Box 10041
Wellington 6143

Retail Advisory Group
c/o Electricity Authority
Level 7, ASB Bank Tower
2 Hunter Street
Wellington

Tel: 0-4-460 8860

Fax: 0-4-460 8879

- 1.7.3 Submissions should be received by 5:00pm on 19 March 2012. Please note that late submissions are unlikely to be considered.
- 1.7.4 Receipt of all submissions will be acknowledged electronically. Please contact the Submissions' Administrator if you do not receive electronic acknowledgement of your submission within two business days.
- 1.7.5 Your submission is likely to be made available to the general public on the Authority's website. Submitters should indicate any documents attached, in support of the submission, in a covering letter and clearly indicate any information that is provided to the Authority on a confidential basis. However, all information provided to the Group is subject to the Official Information Act 1982.

2 Background

2.1 Previous work by the Electricity Commission

- 2.1.1 Issues that may arise if a retailer fails and exits the electricity market have been under consideration for some time in New Zealand. Little firm action resulted from this work, until earlier this year when the Guidelines for Managing Retailer Default Situations were published by the Authority. In this section, we describe some of this earlier work. We also compare the situation in New Zealand to practice internationally.
- 2.1.2 The Commission was required by the 2006 Government Policy Statement (GPS) on Electricity Governance to “establish arrangements to ensure an orderly transition for consumers in the event that a retail company becomes insolvent”. The principle objective of the Commission under the Electricity Act included protection for consumers from unfair treatment in the delivery of electricity.
- 2.1.3 The Commission considered that it was required to implement additional arrangements aimed at ensuring customers of an insolvent retailer did not lose supply and that those consumers did not face higher tariffs than other consumers. Neither of these requirements transitioned to the Authority.
- 2.1.4 The Commission did not publish a description of problems with existing arrangements or assess its draft proposals against a defined problem statement. This lack of a problem definition appears to be because the GPS directed the Commission to intervene in a particular manner.
- 2.1.5 In considering how it might intervene, the Commission explicitly dismissed the potential in the New Zealand electricity retail market for problems arising from moral hazard (where the retailer does not face the full costs of the risks they take) and asymmetric information (where customers do not know the risks taken by the retailer). Concerns have arisen in other markets (and in other industries) where a retailer may under-price, or under-capitalise, risk and attract customers through lower tariffs – these potential problems of moral hazard and asymmetric risk in electricity retail markets are described in appendix A.
- 2.1.6 The Commission noted that a safety net (for example, guaranteed supply and guaranteed average tariffs) may dilute normal precautions that consumers should exercise when choosing a supplier, and possibly encourage overly risky retailers to enter the market with too low prices.¹ However, the Commission did not believe retailers were likely to adopt overly risky practices in New Zealand. It appears this judgment was based on a lack of historical experience of high levels of price-induced switching or aggressive competitor responses.
- 2.1.7 However, recent increased rates of customer switching and the competitive responses by incumbent retailers (for example, increases in prompt payment discounts), illustrates the importance of price competition. Price competition is likely to have been encouraged by the Authority’s What’s My Number campaign which involves the price comparison website: www.whatsmynumber.org.nz that provides a simple calculator for savings, and the more comprehensive, but still largely price-focused www.powerswitch.org.nz. Wholesale prices in New Zealand have also become more volatile over time.

¹ Alternative measures might have other incentive effects, for example measures that provide for the regulator to transfer customers (the major asset of a retailer) might reduce the risk of default and increase the costs to enter the market and minimise the risk of default.

- 2.1.8 The Commission did not complete its work but prepared papers which indicated that its preferred course would have been to regulate to:
- a) amend contracts between retailers and their customers so that these contracts would terminate if the regulator suspended the retailer (this mechanism was intended to circumvent other priority claims under statute to amounts paid by the customer, though the Commission did not resolve whether this could be achieved without change to primary legislation, such as the Companies Act); and
 - b) provide for the regulator to transfer the customers of the suspended retailer to other retailers, with the new retailer required to supply the customer on terms (primarily price) to be determined by the regulator. The Commission did not finalise its thinking on this transfer mechanism but preferred to pro-rata the customers among other retailers on the same local network (the Commission appeared to have in mind that the retailer that failed would have a small number of customers on the network relative to other retailers, rather than being the only or largest retailer on that network).
- 2.1.9 The Commission noted that some other jurisdictions use pre-determined higher tariffs for customers transferred from a failed retailer, to encourage consumers to choose lower risk retailers. However, the Commission considered that New Zealand consumers should have equal tariffs (it interpreted “fair” or “equitable” as “equal”). The Commission’s preliminary view was that a customer transferred from the failed retailer should be placed on the average tariff offered by other retailers in the relevant area (as opposed to say the highest tariff or its existing tariff). Any shortfall between cost of supplying the customer and the average tariff offered by other retailers, and the cost of administering the scheme, would have been met by a levy, the details of which had not been resolved.

2.2 International work on problem definition

- 2.2.1 Internationally, electricity markets typically transfer consumers to a supplier of last resort immediately after a retailer fails. In examining the approaches adopted in comparable markets overseas, we were not able to identify a jurisdiction that has given explicit consideration to the market failure that is being targeted by the interventions. Where policy objectives are identified these centre around ensuring:
- a) continuity of supply to customers; and
 - b) the integrity of the wholesale market, or protecting other industry participants from bad debt or credit risk costs.
- 2.2.2 These are undoubtedly desirable policy objectives and would appear similar to the Authority’s statutory objective. However, these objectives are not descriptive of a problem that would be alleviated by a Code change; for instance they provide no guidance as to whether an arrangement for transferring customers would better achieve the objective of protecting the integrity of the market relative to say an amendment to prudential requirements.²
- 2.2.3 Many of the arrangements elsewhere appear based on a universal supply obligation placed on all retailers, or on an incumbent retailer. These universal supply obligations generally date from

² The Authority’s Wholesale Advisory Group is considering the wholesale prudential requirements.

before the market was opened to competition.³ However, there is no explicit universal supply obligation for electricity in New Zealand, though consumers are likely to have an implicit expectation that they will receive an electricity supply. The competitive market is the primary mechanism for governing the terms on which electrical energy is produced and sold to consumers, with distribution network companies subject to control under Part 4 of the Commerce Act.

- 2.2.4 The following section assesses the supply chain and the evolution of existing New Zealand regulatory arrangements governing a situation of a failed retailer as a basis for identifying gaps or weakness that would warrant further, or amended, intervention in the market by the Authority.

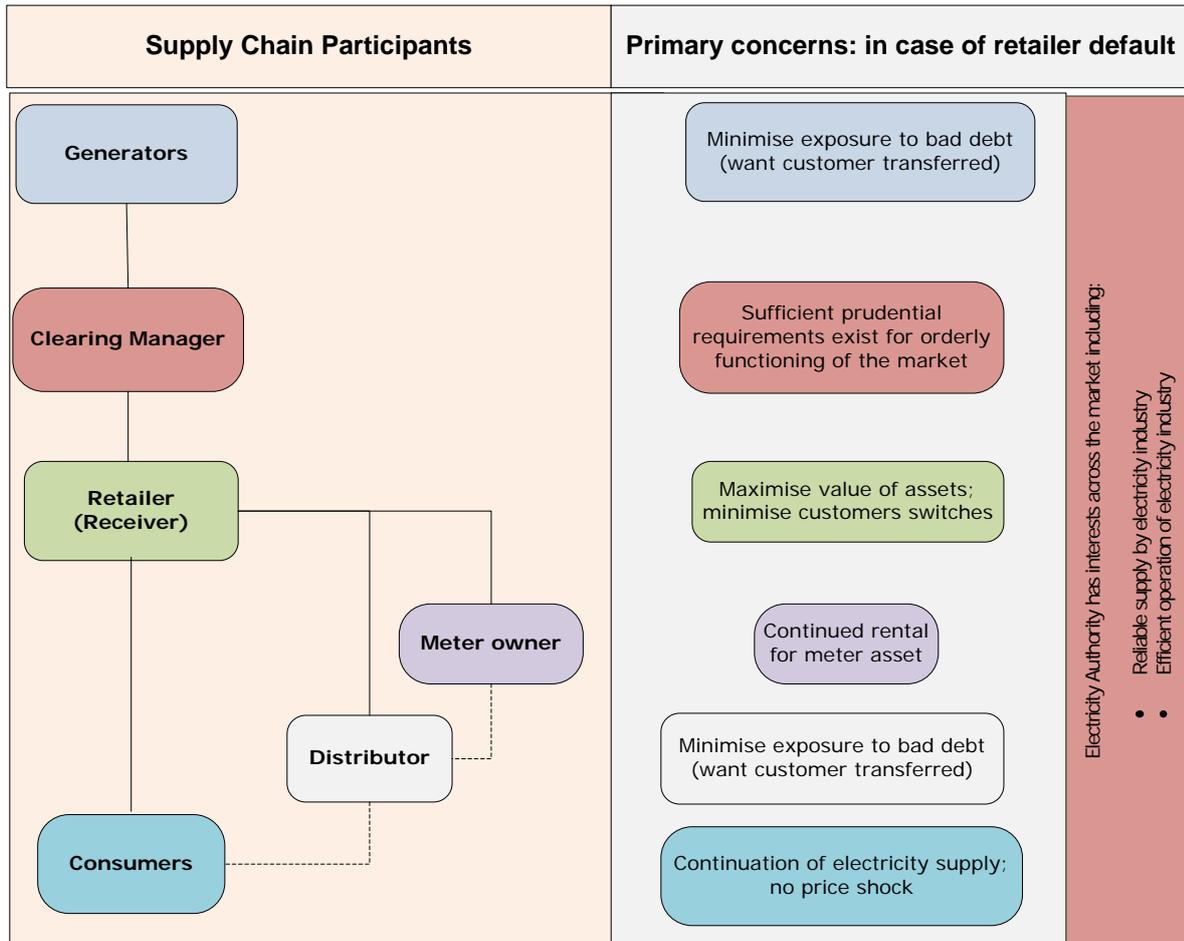
3 Arrangements governing situation of a failed retailer

3.1 Supply chain affects many parties

- 3.1.1 In the New Zealand market, retailers purchase almost all of the electricity they supply to consumers through the Clearing Manager. Major generators sell to the Clearing Manager (very small distributed generators are not required to trade through the Clearing Manager). Retailers, or in some cases consumers, purchase services from lines companies to transport electricity to the final consumer and either provide or purchase metering services. At each step of this chain, there are service obligations to be met and payments that must be made. Retailers (the focus of this paper), pay for energy and (generally) transport and metering in arrears which create default risk for the Clearing Manager and generators and for the transport and metering companies. Most consumers pay retailers in arrears which creates default risk for the retailer.
- 3.1.2 Figure 1 summarises the relationships between the parties in the supply chain and their motivation or incentives should a retailer fail.

³ Utilities with legislative franchise areas are generally obliged to provide a universal service at a standard price, made possible by a system of cross subsidy and cost averaging, which becomes increasingly unsustainable under competitive conditions as prices are driven closer to costs.

Figure 1 Stakeholder interests in the event of a retailer default



3.1.3 A failure by a retailer disrupts this supply chain and may:

- a) have financial impacts on participants in the supply chain;
- b) impact on the orderly operation of the market through disruption to information flows;
- c) potentially affect consumers through the:
 - i) inconvenience in contracting for a new retailer on terms and conditions (including price) that may not be equivalent to those offered by their current (failed) retailer;
 - ii) prospect of having to pay higher prices for supply from the new retailer; and
 - iii) risk of disconnection of electricity supply because one or more parties in the supply chain do not receive the funds paid by the consumer (and the consumer has been unable to contract with a new retailer).

3.1.4 This paper is primarily concerned with bullet (c) - the implications for consumers should an electricity retailer fail. Any risk of disruption to electricity supply is likely to concern consumers,

and may damage the credibility of the market with the consequent potential for ad hoc legislative intervention.

3.2 The potential for supply disruption is because suppliers are not paid

3.2.1 The risk of disruption to electricity supply for consumers following a retailer failure is because one or more parties in the supply chain do not receive the funds paid by the consumer, and hence attempt to withhold services or take actions to stop the consumer taking electricity.⁴ There is no less generation capacity available to meet demand as a retailer exiting the market just removes an intermediary.⁵ An assessment of this risk of supply disruption therefore starts with an assessment of the risk that the money paid by the consumer is not received by the parties in the chain of services making up delivered electricity.

3.2.2 To understand this risk of non-payment for parties in the supply chain, we begin by briefly reviewing the development and changes in the prudential and other relevant governance mechanisms for the wholesale market. This brief review recognises that any regulatory arrangement carries with it a history, including a history of expectations. Retailers, generators, lines companies, and metering providers, have invested in the New Zealand electricity market on the basis of an understanding of the regulatory framework and the settlement cycle forms part of that paradigm. The economic reasoning for the initial arrangements also provides an analytical framework for evaluating how the allocation of risk has changed and implications of this change in risk allocation for the potential for disruption of electricity supply to consumers.

3.3 Settlement (and hence supply disruption) risk under former NZEM rules

3.3.1 The wholesale electricity market called the New Zealand Electricity Market (NZEM) commenced on 1 October 1996. Settlement was (and still is) performed monthly on the 20th day of the following month. The settlement risk therefore covers the period of supply for the relevant month, plus the 20 days until payment is due, plus some period of time for any default to be rectified. Lines companies generally followed the same monthly billing cycle and therefore potentially faced the same period of settlement risk.

3.3.2 Under NZEM this settlement risk was borne through 3 primary risk allocations – collateral, including guarantees; retailer assets available to a receiver; and generators. We outline each of these risk allocation mechanisms briefly below.

3.3.3 The NZEM participants agreed (the market was at its inception governed by a multilateral contract) that purchasers should provide collateral sufficient to cover their expected purchases for a period of 57 days, or hold an acceptable credit rating (A- Standard & Poor's or equivalent). Collateral was in the form of a cash deposit or guarantee or letter of credit or security bond. The amount of collateral required by the purchaser was determined by the Clearing Manager using a formula that referenced the amount payable by the purchaser in an average day in a peak month in summer or winter (as the case may be) multiplied by the 57 days and increased by 10%.⁶

⁴ Non-industry parties might also not receive payment from the retailer, but unless the action of those parties can have a direct impact on the consumers of electricity, the impact on third parties is not considered in this paper.

⁵ It is possible that a retailer gets into difficulty as a result of sustained high prices due to a catastrophic failure of generation capacity. However, any prospect of a sustained mismatch between demand and supply because of a large scale failure of generation plant or fuel sources raise issues beyond the scope of this paper.

⁶ For a history of the development of prudential and settlement arrangements in New Zealand, see appendix B of the draft Wholesale Advisory Discussion Paper: Settlement and Prudential Security Review.

- 3.3.4 The Clearing Manager was required to monitor a purchaser's accrued and unsettled liabilities to the Clearing Manager and report weekly to the purchaser on whether any changes to its collateral requirements were likely within the next week. In concept, this regular monitoring, and the requirement to 'top up' collateral in times of high prices or high demand, should result in the prudential cover adjusting to market circumstances and provide an early signal of difficulty if a retailer struggles to provide additional collateral. In practice, it is difficult to design a formula that fully accounts for the circumstances faced by the retailer and regulators face considerable information disadvantages in assessing the financial position of electricity participants.
- 3.3.5 If a retailer failed to make a payment to the Clearing Manager, then the Clearing Manager could apply the retailer's prudential security to their debt.⁷ The collateral was sufficient to cover the expected debt for electricity purchased by the retailer up to the time of default, and provide security for the electricity that would be supplied while the default was rectified. Because a total of 57 days of collateral was provided, this additional period of cover works out to be between 7 days (if the default occurred on the 20th with respect to a payment that was due) and 37 days (if the retailer completed the payment on the 20th, but then declared itself insolvent). This period of cover for the wholesale market remains unchanged today. Lines companies were in a similar position with respect to payment timeframes, although there was variation in the amount of prudential coverage required.⁸
- 3.3.6 This aspect of the settlement risk was therefore borne by the funders of the retailer, either directly through cash, or debt in the form of a guarantee (which in turn is typically supported by a claim over an asset such as a cash deposit), or by retaining sufficient capital in the business to support the specified credit rating.
- 3.3.7 Were a retailer to default and not promptly restore its collateral with the Clearing Manager, the Clearing Manager could recommend to the Market Surveillance Committee that it make a determination that a receiver and manager be appointed. The Receiverships Act 1993 provides that receivers may be appointed under a deed or agreement (in the nature of a security interest), and as a multilateral agreement the NZEM rules were a form of deed or agreement that provided for the appointment of a receiver.
- 3.3.8 This provision meant that retailers provided additional security in the form of the market value of its customer base (which is likely to be the largest asset of a retailer available to the receiver). Electricity retailers, especially stand-alone retailers without a generation base, are likely to come under the most financial pressure in a winter that is both drier and colder than usual, when demand and spot prices are likely to be high. In these circumstances, a retailer purchasing from the wholesale market to supply retail consumers may experience negative cash flow as wholesale prices may exceed retail prices. However, as shown in Appendix B, the customer base of a (hypothetical) retailer that failed at any time during the past 10 years may still have had a residual positive value – that is, the initial cash-flow loss to a viable retailer of taking on the customers of a failed retailer during any period of high prices over the past 10 years may not have exceeded the

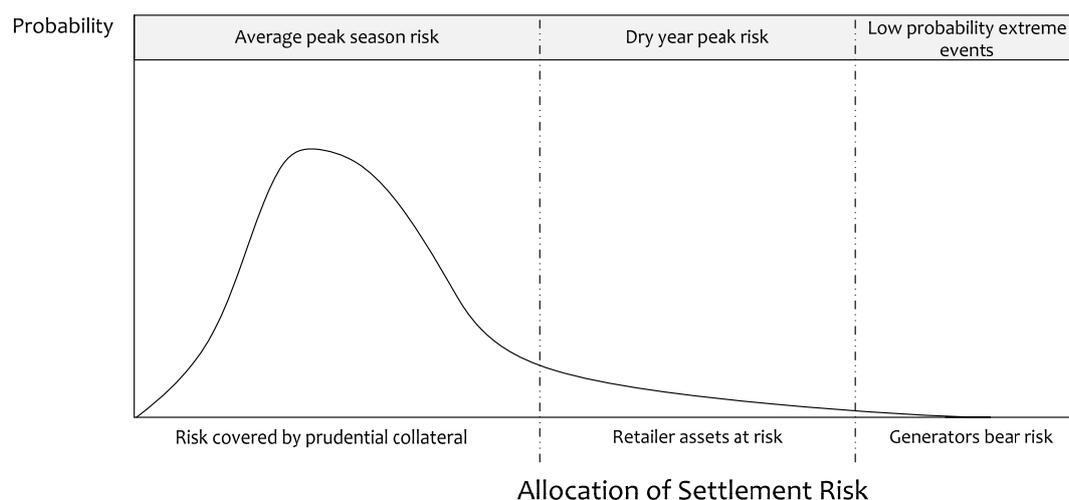
⁷ After offsetting any amounts that the Clearing Manager might owe to the purchaser (e.g., because the purchaser was also a generator).

⁸ The Authority has recently mandated a two week limit on prudential requirements, which can be extended up to 2 months if line companies pay a financing rate for the additional monies collected above the a '2 week' amount. It came into effect for new Use of System Agreements on 1 December 2011 and will apply to existing UoSA from 1 May 2012.

amount retailers have historically been willing to spend to gain (through marketing or acquisition) a customer base.

- 3.3.9 This expected residual value of the customer base (at least during historic market conditions) means that the Clearing Manager could have been reasonably confident that, should a retailer default, a receiver would be successful in achieving a commercial transfer of the customer base to another retailer thereby stemming future losses, and might also release funds from the sale of assets to meet unsettled liabilities to the Clearing Manager. Hence, the ability for the Clearing Manager to appoint a receiver meant that the settlement risk over and above the prudential collateral was borne by the retailer's investors, at least within historic levels of market performance.
- 3.3.10 With an uncapped electricity market price, it was always conceivable that some low-probability, high impact event might occur which meant wholesale prices rose to such high levels that a failed retailer's customer base had no residual value, and therefore no funds would be realised by the receiver to meet unsettled liabilities to the Clearing Manager. Generators bore the risk of these events as any short-fall in payment by a purchaser would have been prorated by the Clearing Manager across generators.
- 3.3.11 Figure 2 illustrates the probability distribution and allocation of settlement risk under NZEM.

Figure 2 Probability distribution for exposure and how risks are managed



- 3.3.12 These arrangements for allocating settlement risk, negotiated by the industry participants in forming NZEM, incorporated some strong efficiency enhancing (total cost minimisation) characteristics:
- settlement risk for 'normal' market operation could be priced through a competitive market process via a bank guarantee or equivalent, rather than being set by a bureaucratic process;
 - moral hazard issues were mitigated because a retailer placed its assets at risk (not just the prudential collateral) were it to adopt an overly risky practice;
 - settlement risk in (low probability) periods of extremely high prices would fall ultimately to the parties best placed to bear that risk – generators; and

- d) administration costs were minimised because the cost of evaluating and monitoring was allocated to one party with the lowest costs (because of access to information on current liabilities to the market) and a clear agency agreement to do so, the Clearing Manager.⁹

3.3.13 Importantly, for the purposes of this paper, the prudential arrangements included a mechanism for organising a transfer of customers from a failed retailer to a viable retailer, in circumstances where the retailer had not itself initiated those actions. If a receiver appointed by the Clearing Manager determined that it could not replenish the collateral, meet the unsettled liabilities and trade back to profitability, it would wish to quickly sell the customer base to maximise the number of customers it could sell. A delay in action by the receiver would risk customers switching away of their own volition as customers became concerned at the prospect of disruption or higher prices.¹⁰

3.3.14 Other efficiency advantages from the potential under the NZEM rules for the Clearing Manager to place a defaulting retailer in receivership included:

- a) the mechanism of receivership is well understood by commercial entities and advisers and contains provisions to protect the interests of all parties (such as not altering the preferential order for payments and security interests in the retailers assets);
- b) allowing for the unwinding of complex commercial arrangements without prejudging the best means of doing so. Over 95% of the retail market is supplied by entities with generation interests or with parent companies with generation interests.¹¹ It is at least conceivable that a default event would arise in circumstances where a transaction that transfers both customers *and* generation (or other assets) is the best solution for resolving the default; and
- c) a retailer's customer base may comprise its largest asset and a process that allowed a failed retailer to maximise the price it achieved for that asset minimises the cost of exit to the retailer; an accepted finding of competition economics is that low exit costs enhance competitive pressure in a market because low exit costs reduce the cost of entry.¹²

3.4 Arrangements seemed to work in practice as well as theory

3.4.1 A number of retailers exited the electricity market in New Zealand in the past decade, with customers successfully transferring to new retailers – no customers were stranded and the Clearing Manager was never left with unsettled liabilities.¹³ Appendix C provides several case studies of retailer failures in New Zealand and overseas. The following table lists retailers that have exited New Zealand subsequent to the flurry of sales and purchases associated with the

⁹ As a retailer was likely to get into difficulty because of its wholesale market transactions, and because the period of prudential cover for lines companies was approximately equivalent to the wholesale market, lines companies could rely on the Clearing Manager to evaluate and monitor rather than replicating its efforts resulting in lower overall costs.

¹⁰ This occurred in the days leading up to the failure of OnEnergy (at the time, New Zealand's largest retailer). As OnEnergy increased tariffs in an effort to mitigate losses, substantial numbers of customers switched to competing retailers.

¹¹ Together the big 5 currently account for 89.5% of the retail market as measured by ICPs. Half of the non-big-5 retailers are owned (wholly or partly) by one of the big 5. Further, Todd Energy owns all of Bay of Plenty Energy and 35% of King Country Energy. Both Todd Energy and King Country have ownership interests in several generation projects.

¹² In theory, a perfectly contestable market would have no barriers to entry or exit. The lower the barrier to exit, the more competitive the market all other things being equal; see William J. Baumol, John C. Panzar, & Robert D. Willig (1982), *Contestable Markets and the Theory of Industry Structure*.

¹³ There has also been 5 retailers exit the gas market, however the regulatory structures governing the gas market are quite different from the electricity market – the gas market does not have a central clearing process nor any entity with the duties and powers of the Electricity Authority.

legislative split of electricity retailers and distribution network businesses were completed in 1999.

Table 1 Retailer exits from the New Zealand electricity market since 2000¹⁴

Sector	Exiting retailer	Acquiring retailer	Date	Reason
Electricity	Empower	Contact Energy	2000	Access to capital
Electricity	Trans Alta	On Energy/NGC	2000	Exiting NZ
Electricity	On Energy/NGC	Genesis Energy (North Island) Meridian Energy (South Island)	2001	Financial distress
Electricity	Energy Online	Genesis Energy	2002	Restructuring
Electricity	Fresh Start	Genesis Energy	2003	Not announced

- 3.4.2 These exits, in which customers were successfully transferred from the exiting retailer to a viable retailer using commercial processes, included the failure of what at the time was New Zealand's largest retailer On Energy. This experience suggests that the size of the retailer is not necessarily in of itself a barrier to successfully transferring customers - a large standalone retailer means there must also be participants with generation capacity that significantly exceeds its retail base.¹⁵
- 3.4.3 Interestingly, the estimates shown in Appendix B indicate the price that Meridian Energy paid for the On Energy consumers it bought during the 2001 crisis. At the height of 2001 energy shortage, NERA report that Meridian paid \$287 for each customer it acquired from On Energy which was exiting the market due to financial distress. At that time, the customers may have imposed a further cost on Meridian of up to \$246 each in negative cash flow. On these estimates, the total initial cost of the customers to Meridian might have been of the order of \$533, before allowing for hedges or lower internal transfer prices for wholesale energy. This amount is broadly in line with the figures presented in Appendix B for the cost of customer acquisition in New Zealand.
- 3.4.4 However, the residual value of customers may be lower now than in the past, including because customers may be less 'sticky' (i.e. more inclined to switch retailers) and electricity wholesale prices are more volatile. Consequently, particularly if a retailer default occurred during an extended period of high spot prices, there is the prospect that retailers might be reluctant to purchase or accept the customers of a failed retailer.

¹⁴ Sourced from the Gas Industry Company's *Recommendation to the Acting Minister of Energy and Resources on arrangements for insolvent retailers*, May 2011.

¹⁵ In 2001, both Meridian and Genesis had sufficient generation capacity to accommodate the On Energy customer base.

Q1. Does our summary of settlement risk allocation under the NZEM capture the main elements, and are there other lessons from experience for the design of current arrangements?

3.5 Important changes to the arrangements

3.5.1 Several important changes have been made to how settlement risk is allocated in the wholesale market since the NZEM rules were replaced with regulations. The effect of these changes is that there may no longer be an effective mechanism for ensuring a commercial transfer of customers if the failed retailer (or an agent appointed by some other party) does not initiate that transfer, nor is there a mechanism for stemming any loss to the Clearing Manager. The key changes are summarised below.

3.6 Now there is no ability to appoint receiver

3.6.1 In 2004 the former Electricity Commission obtained legal advice on whether it had the power to appoint a receiver in the event of default. The advice was emphatic:

“Under no circumstances does the Electricity Commission have the power to appoint a receiver.”^{16, 17}

3.6.2 The Commission’s legal advisers explained that when preparing the Electricity Governance Regulations and Rules (EGRs), which replaced the NZEM rules, officials considered the right of the Clearing Manager to appoint a receiver. The Receiverships Act 1993 provides that receivers may be appointed under a deed or agreement (in the nature of a security interest), and, as a multilateral agreement, the NZEM rules were a form of deed or agreement that provided for the appointment of a receiver. However, the EGRs were not a multilateral agreement. Neither the Rulings Panel nor the Clearing Manager were parties to an agreement with any purchasers that included a term giving the Panel or the Clearing Manager the right to appoint a receiver. Nor did the Electricity Commission have such an agreement with purchasers under the EGRs. The “right” that had existed under the NZEM rules for the Clearing Manager (subject to approval by the Market Surveillance Committee) to appoint a receiver was not carried over from the NZEM rules to the EGRs. This right was not reinstated when the EGRs were repealed by the Electricity Industry Act 2010 and replaced by the Code.

3.6.3 The Authority also sought legal advice in 2011 on whether it or the Clearing Manager could apply to the Court for a receiver to be appointed. The advice received was as follows:

“The clearing manager could apply to the Court for a receiver to be appointed. This process is very unusual in New Zealand because most receivers are appointed under security documents like debentures and mortgages. The Court has a residual “inherent jurisdiction” to appoint a receiver if it is necessary in the interests of justice to do so. It would be necessary to establish why a Court should exercise its discretion in any particular case, and some unusual circumstance would need to be established before a Court could be expected to act.

We do not consider relying on a Court appointed receiver is a viable option for the clearing manager.”¹⁸

¹⁶ Palaret Law, Electricity Commission – Part H Default Issues, 3 August 2004, p 1.

¹⁷ Buddle Findlay advised the Authority that they concurred with the Palaret Law advice, e-mail from Anna Parker to Ross Hill, 20 October 2011.

¹⁸ Palaret Law, Electricity Commission – Part H Default Issues, 3 August 2004, p 1 – 2.

- 3.6.4 Neither the Code nor the service provider contract for the Clearing Manager provide for, or require, the Clearing Manager to apply for a receiver to be appointed in the event of a default, and the Guidelines do not describe the circumstances or timing of any such an action or the process that would be followed.
- 3.6.5 In the event of a default by a retailer, the Code does provide for generators to exercise the rights of the Clearing Manager if the Clearing Manager does not act within specified times.¹⁹ However, as the Clearing Manager has no right to appoint a receiver, this provision does not establish a mechanism for a generator to appoint a receiver. Like the Clearing Manager, generators are not parties to any agreement with purchasers for the sale and purchase of electricity through the wholesale market that includes a term giving them the right to appoint a receiver should a purchaser default on payment.
- 3.6.6 The distributors' use of system agreements do not on their own create a security interest with a right to appoint a receiver, although some distributors have written into their use of system agreements that they have the right to apply to the High Court for a receiver or liquidator to be appointed. Distributors differ from other parties in the supply chain in having the right to disconnect customers of a retailer that is in financial breach of its contract; however mass disconnection of customers - who have been paying their bills - because their retailer failed is unlikely to be a practical remedy.²⁰
- 3.6.7 It is possible, of course, that a party not involved in the electricity industry that holds security over the retailer's assets will place the failed retailer in receivership, or the retailer will voluntarily enter liquidation. But there is no longer any mechanism for the Clearing Manager or the Authority to trigger such an action.

3.7 Suspension and termination

- 3.7.1 Section 49(3) of the Electricity Industry Act 2010, provides the Authority with the power to suspend a retailer's rights to trade with the Clearing Manager where a purchaser:
- a) is unable to pay its debts; or
 - b) calls a meeting for the purpose of Part 14 of the Companies Act 1993; or
 - c) is adjudicated bankrupt; or
 - d) in the case of a company, society, or partnership, has a receiver or statutory manager or similar person appointed in respect of it or of all or any of its assets; or
 - e) is put into liquidation.
- 3.7.2 In assisting the work of the Group, the Authority sought advice from Buddle Findlay on the practical effect of the Authority's power to suspend a retailer. Buddle Findlay advised:²¹

The effect of suspension under the Act is that a participant's right to make bids or offers is suspended. Despite the suspension, the participant is still a participant and obliged to comply

¹⁹ Code, Part 14.53-63.

²⁰ The Electricity Governance Rules removed an earlier requirement for purchasers to have a signed power of attorney in favour of the Clearing Manager to allow the Clearing Manager, on default by the purchaser, to instruct the network company to disconnect the purchaser's customers, apparently in recognition that disconnection of a retailer's customers was unlikely to be practical.

²¹ E-mail from Anna Parker, Solicitor, Buddle Findlay, to Craig Evans, Electricity Authority, 27 October 2011.

with the Code. Part 14 of the Code, relating to clearing and settlement, and Part 15, relating to reconciliation, do not contain modified obligations for suspended participants.

Rather than viewing the suspension as suspending the ability of the participant to purchase from the clearing manager, we think that the better interpretation is that the participant continues to purchase electricity as long as it has customers (despite the fact that it is not able to make bids or offers) and continues to do so until, for example, its customers are transferred to another retailer. The reason for this view is that clause 14.33 of the Code provides that:

- Each purchaser must purchase from the clearing manager the electricity taken by the purchaser during a trading period through a point of connection with the grid and reconciled in accordance with this Code. The clearing manager must sell the electricity as set out in this Code.
- The obligation on the clearing manager to issue invoices and on the participant to pay the invoices continues despite suspension, and we think that such invoicing and the requirement to pay is what constitutes the purchase.
- Therefore, we think the best interpretation is that the retailer is still purchasing electricity, even though it is not able to make bids or offers. It may be worth considering whether a Code amendment could be made to make a suspended participant's obligations clearer.

- 3.7.3 Suspension of a retailer in default would therefore have limited practical effect as the defaulting retailer would still be a purchaser under the terms of the Code as long as it continues to have valid contracts with its customers and those customers take electricity. This means that the Clearing Manager (and generators) would continue to incur losses if invoices remain unpaid. The only immediate effect of the suspension provisions is to signal the Authority's belief that the retailer is failing.
- 3.7.4 The Authority could apply to the Rulings Panel to terminate the rights of the retailer as an industry participant. Similarly, since the defaulting retailer would be in breach of the Code, the generators or other participants owed money by the retailer could take a formal complaint to the Authority. Like a suspension, a complaint to the Authority (assuming it is unresolved) would ultimately lead to the Rulings Panel. The procedures that the Rulings Panel must follow in considering a complaint are prescribed under the Act, the Electricity Industry (Enforcement) Regulations 2010, and the Code. These procedures are intended to provide for due process and include requirements to provide each party to the complaint at least 20 working days to make submissions on the complaint and task the Rulings Panel to try its best to reach a final decision within 40 working days.²² The time periods involved will therefore likely exceed, possibly by weeks, the cover currently provided by the prudential requirements.
- 3.7.5 Even if the timelines to be followed by the Rulings Panel were appropriate to resolving a default by a retailer, the Rulings Panel has no means of addressing a default or stemming the loss to the Clearing Manager were a retailer not to comply with the orders of the Panel. Ultimately the Panel can terminate the retailer's rights, if it considers the failure by the retailer has "seriously prejudiced the operational or financial security of the wholesale market or the transmission system" (section 58(a) of the Act). However, terminating the rights of the retailer would seem to leave the Clearing Manager (and generators and other retailers) in no better position than suspension discussed above.

²² <http://www.ea.govt.nz/act-code-regs/rulings-panel/>.

3.8 No power to obtain information to switch customers

3.8.1 Consumers of a failing retailer may seek to improve their position by switching to a viable retailer. It is conceivable that an insolvent retailer may attempt to delay customer transfers to maintain its cash-flow. The Authority sought legal advice on whether it currently (absent the Code amendments attached to its Guidelines being implemented) has scope to intervene to obtain information needed to switch customers to a new retailer. The Authority was advised:²³

We do not think that the Authority currently has scope to intervene to obtain information needed to switch customers to a new retailer.

We have considered whether the Authority's general information gathering powers under section 46 of the Act could be used (e.g. to require a participant to provide information). However, the powers in section 46 may only be used for a purpose described in section 45 of the Act. The purposes for which the powers may be exercised are carrying out the Authority's monitoring functions, or carrying out the Authority's function of investigating breaches/possible breaches and enforcing compliance with Parts 2 and 4 of the Act, the regulations, and the Code. We consider that the purpose of obtaining the information to switch customers would be to reallocate customers, and do not think that such a purpose is one of the purposes set out in section 45 of the Act.

3.8.2 A Code amendment (such as the draft Code amendments attached to the Authority's guidelines for managing retailer default situations) would be needed to enable the Authority to obtain information from participants if it wished to assist customers switch retailers when the original retailer proves uncooperative.

3.9 Retailer contracts mostly provide for assignment

3.9.1 In its work, the Electricity Commission expressed concern that the contracts between a retailer and its customers might not provide for the customers to be assigned to another retailer, meaning that a commercial transfer (or a transfer mandated by the Authority under the Code²⁴) might not be feasible. However, there are strong commercial reasons for retailers to include assignment provisions in their contracts as without the provision the retail base is potentially less valuable.²⁵

3.9.2 From reviewing the terms and conditions of retailers, it would seem most retailer contracts currently allow the retailer to assign the contract.²⁶ The contracts by all of the big 5 – Contact, Genesis, Mercury (Mighty River Power), Meridian, and Trustpower - provide for assignment, as do the contracts for Pulse, King Country Energy, Powershop, Energy Online, Just Energy, Tiny Mighty, and Bosco Limited. The contracts for Energy Direct and Nova Energy do not appear to provide for assignment, but do provide for the contract to be amended by the retailers following a 30 day notice period. The contract for Bay of Plenty Energy (a Todd subsidiary) does not provide for assignment and also does not include provision for the retailer to unilaterally amend the contract.

²³ E-mail from Anna Parker, Solicitor, Buddle Findlay, to Craig Evans, Electricity Authority, 27 October 2011.

²⁴ The Authority may place requirements on market participants under the Code. The majority of electricity consumers are not market participants and therefore the Authority cannot require a customer to transfer between retailers. However, the Authority could (if the Code were amended) require a retailer to exercise its contractual rights to assign a customer.

²⁵ In economic terms, an assignment clause means the major asset of a retailer is not “sunk” as it valuable in part or in whole to another retailer.

²⁶ This is a requirement of the Authority's minimum terms and conditions for domestic contracts for delivered electricity – a voluntary market facilitation arrangement.

- 3.9.3 It would appear therefore that in most cases there is no insurmountable contractual impediment to achieving a commercial (or mandated) transfer of the customers of a failed retailer to a viable retailer.
- 3.10 Backstop Code provisions**
- 3.10.1 As part of its *Guidelines for Managing Retailer Default Situations*, the Authority has developed backstop Code amendments that could be enacted urgently. These Guidelines are an interim measure while more permanent arrangements are developed through the Advisory Group process, and as such were not consulted on. The purpose of these provisions is to give the Authority the power to disconnect or transfer customers. The amendments to the Code would give the Authority the power to require a retailer to transfer its customer contracts to another retailer (provided the contracts contain an assignment clause), and require that the recipient retailer accept the defaulting retailer's customers.
- 3.10.2 The urgent amendments would expire 9 months after they were enacted. The *Guidelines* acknowledge that identifying recipient retailers, and allocating customers to them, is a potentially fraught task, given the possible effects on the recipients' business. Three possible allocation methods are discussed, but the selection is left to be determined by the specifics of the situation. These *Guidelines* are considered further in the discussion of alternative solutions.
- 3.10.3 The *Guidelines* also summarise the regulatory provisions governing a situation of a failed retailer. These regulatory provisions, and relevant contractual provisions, are shown in table form in Appendix E.
- 3.10.4 The *Guidelines* also outline the range of indicators the Authority has developed which might warn of an increased likelihood of an event of default occurring. This range of indicators is reproduced as Appendix F. The Clearing Manager also has an obligation to inform the Authority should it have reasonable grounds to believe that an event of default is likely to occur and seek instruction of an appropriate course of action to minimise the risk of default occurring. Clause 14.55 of the Code defines an event of default to include:
- a) a retailer fails to provide security;
 - b) a retailer fails to meet its settlement obligations (that is, pay its invoice) on settlement date; and
 - c) an event happens outside of the electricity market that indicates that the retailer is in financial difficulty (for example, the retailer cannot meet its debt or is placed into receivership or liquidation).

Q2. Do you agree with our summary of the regulatory tools that are available in the case of a failed retailer?

4 Possible scenarios when there is a risk of a retailer failing

4.1 Possible outcomes

- 4.1.1 There appear to be broadly four possible outcomes under current arrangements were a retailer to default:

- a) the retailer could continue to trade and return to profitability, sustaining its status as a participant. In this case, the consumers are supplied on their existing terms, and prudential requirements protect the wholesale market and distribution companies;
- b) the retailer's customer base could be sold or switched to another, viable retailer. The retailer itself or a receiver/liquidator appointed by some third party (but not the Clearing Manager, Authority, or generators) with a security interest in an asset held by the retailer could undertake a sale process;
- c) the retailer exits the market, or fails to function, without transferring its customers, the Authority identifies that the customer contracts include a clause allowing them to be assigned to another party. The Authority enacts backstop Code provisions from the Guidelines and allocates the customer contracts to other retailers on some basis; and
- d) the retailer exits the market, or fails to function, without transferring its customers, and the Authority identifies that the customer contracts do not include an assignment clause. Customers are advised that they must switch, and any customers who do not are disconnected.

4.1.2 The Code does not stipulate any deadlines or time-periods for these scenarios.

4.2 Unlikely that customers would be disconnected in mass

4.2.1 Line companies have the contractual right to disconnect customers when they terminate the UoSA with the retailer, even if the customers have paid their bills and otherwise comply with their contractual terms.²⁷ The process for terminating a UoSA is described in Appendix G. Under the draft MUoSA the retailer, in its contract with its customers, must grant the distributor the authority to "temporarily disconnect" the customer should the retailer default or if the agreement between the retailer and the distributor is terminated. The distributor must give each consumer:

- a) At least [9] Working Days' notice in writing warning of disconnection and include a general notice on its website; and
- b) A final warning not less than 48 hours or more than [8] days before the disconnection, providing the timeframes for disconnection.

4.2.2 However, a distribution company is unlikely to be willing to carry out large scale disconnection of customers, who have been paying their bills, but whose retailer has not passed on the money to the distributor, because:

- a) the public relations cost to the distributor is likely to be untenable, especially for community owned or publically listed lines companies;
- b) the transaction cost associated with disconnecting and reconnecting a mass of customers would likely be unrecoverable for the lines company; for instance,
 - i) the vulnerable consumer guidelines state that the distribution company must ascertain whether a consumer is vulnerable if they face disconnection for the first time²⁸ and medically dependent consumers should not be disconnected;²⁹

²⁷ Some retailers have written broader disconnection powers into their customer supply agreements, where continued supply would be uneconomic, e.g. Energy Direct.

²⁸ Electricity Authority, Guideline on arrangements to assist vulnerable consumers Version 2.1, May 2011.

²⁹ Electricity Authority, Guideline on arrangements to assist medically dependent consumers Version 2.1, May 2011.

- ii) where a smart meter is not in place, a contactor would need to attend the premises to make the disconnection; and
- c) the Authority, in its Guidelines, has indicated that it would ask lines businesses not to disconnect retail customers within a specified period, to give the customers an opportunity to switch retailers.

4.2.3 While disconnecting consumers in response to an event of default by a retailer could occur, it would seem to be a remote possibility. The more likely scenario is the customers would received communication from the lines company, or some other party (perhaps the Authority or competing retailers) advising them that their retailer was in default of its obligations and that they should find a new retailer. Such notices would likely cause uncertainty and possibly anxiety for a number of consumers and may attract media and political comment if issued to a large number of customers.

- Q3.** Do you agree or disagree with our summary of possible scenarios that could develop once a retailer begins to fail? Please provide reasons.
- Q4.** How likely, and in what situations, do you think that efforts to secure a transfer of a failed retailer's customer base would prove unsuccessful? Please provide reasons.
- Q5.** Do you think it plausible that customers of a failed retailer would be disconnected from their electrical supply? Please provide reasons.

5 Problem definition – incentives for inefficient risk taking and unnecessary disruption for consumers

5.1.1 The previous section summarised existing regulatory arrangements governing a situation of a failed retailer. In the context of the New Zealand electricity market, the existing regulatory arrangements suggest the following potential issues:

- a) the Authority, the Clearing Manager, and generators do not appear to have the power to appoint a receiver, nor an effective remedy of ceasing supply, should a retailer default on payments due to the Clearing Manager; hence the well established mechanism for governing a creditor in default do not appear available to the parties with a vested interest in an orderly functioning wholesale market;
- b) if the retailer is in financial breach a distributor may have a right to appoint a receiver depending on the terms of its contract. However, if the agreement is terminated for a non-financial breach, the distributor is limited in its response to disconnecting all the retailer's customers, a remedy that is likely to be impractical and unpalatable;
- c) although the Act grants the Authority powers to suspend an insolvent retailer, such a suspension has no immediate effect as the retailer can continue incurring wholesale debts that it may have no realistic prospect of meeting in full;
- d) it is also possible that a number of factors could be present in any given case that limit the ability of a failed retailer to transfer its customer base, thereby creating a scenario where customers are 'stranded', these factors include:
 - i) although a failed retailer may have a strong commercial incentive to transfer its customer base, a small number of customer contracts currently do not include a right of

assignment to allow for the transfer of customers to another retailer. If a retailer failed without having rights of assignment written into its customer contracts (or was unable to unilaterally amend the terms of such contracts in the timeframe required to effect a transfer) customers would have to switch individually;

- ii) for whatever reason, a retailer may refuse, or may be unable, to switch customers prior to exiting the market (e.g. loss of data). If such a situation was to arise there may be insufficient information in the registry about the retailer's customers to enable another party to take over the customer base;
- iii) there is a possibility of customers emerging who no retailer wants to supply, particularly in regions in which the availability of pre-pay meters is limited. This potential problem is not tied to the prospect of retailer failure, but may exist in regions in which all retailers are viable though refuse to supply credit to a customer, or small group of customers, who do not pay their bills; and
- iv) it is possible that the customers of a failed retailer are on long-term contract terms which are well below market rates so that no retailer could profitably supply the customer or some extraordinary event has occurred (such as never occurred in the past 10 years) which means the cash flow loss associated with taking on the customer exceed the value of the customer.

- 5.1.2 Current arrangements therefore risk giving rise to moral hazard in which a retailer may not fully factor in the costs of its potential failure on other participants (both generators and retailers). Shareholders of a retailer need take less care to monitor whether the hedging strategy adopted by management is unduly risky as the risk (beyond the prudential collateral) is shifted to generators in the first instance. In a gross pool market, generators cannot charge a higher price to riskier retailers, and therefore generators need to cover that risk by charging a higher price to reflect the average probability of not being paid, shifting the risk back onto the less risky retailers. These incentives would in time lead retailers to adopt riskier business strategies than are economically efficient (strategies that would not be profitable but for the fact that the downside is borne in part by others).
- 5.1.3 Inefficient risk taking can be expected to lead to more disruption and inconvenience to consumers, with the consequential impact on the reputation of the market. It also creates uncertainty about the level of risk faced by industry participants, particularly for generators who now bear in first instance the risk of electricity used by the defaulting retailer's customers, and for distributors who bear the risk of lines charges for customers of the defaulting retailer on their network.
- 5.1.4 Wholesale prudential security levels are being examined by the Wholesale Advisory Group, with a key consideration being the timeframe for resolving a retailer default. With the new 2 week limit on prudential security levels (or up to two months with compensation payments), a distributor that invoices in arrears may be exposed to up to 37 days of unpaid lines charges were the default to occur on the 20th of the month.³⁰

³⁰ Calculated as a month's supply, plus 20 days to payment date, less 14 days security. The exposure to risk is mitigated by the provision in the regulated weighted average cost of capital that incorporates a factor accounting for a level of bad debt.

Q6. Do you agree or disagree that this summary identifies correctly the problems with the current arrangements for governing a retailer failure; are there additional problems that we have not identified? Please provide reasons.

6 Options for additional intervention

6.1 Relevant criteria from the Authority's statutory objective

- 6.1.1 Any regulatory intervention by the Authority must further its statutory objective (Section 15 of the Act) which provides that the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.
- 6.1.2 Two aspects of this objective seem especially important when evaluating possible solutions to the problems identified above.
- 6.1.3 First, the Authority interprets the phrase *promoting competition in the electricity industry for the long-term benefit of consumers* to mean:
- Exercising its functions in ways that facilitate or encourage increased competition in the markets for electricity and electricity-related services, taking into account long-term opportunities and incentives for efficient entry, exit, investment and innovation in those markets.³¹
- 6.1.4 This aspect of the Authority's objective is important because the analysis of the current arrangements show that these arrangements create incentives for retailers to adopt riskier business strategies than are economically efficient (strategies that would not be profitable but for the fact that the downside is borne in part by others). Changes to the Code may also increase or decrease the costs to a retailer from exiting the market and low exit costs enhance competitive pressure in a market.
- 6.1.5 Second, the Authority interprets the phrase *reliable supply for the long-term benefit of consumers* to mean:
- “efficient levels of reliable supply, where efficiency includes dynamic efficiency gains from adopting time-consistent arrangements – that is, arrangements that are robust to adverse events over the long term. In regard to minimising total costs, the Authority believes the potential costs of regulatory uncertainty and ad-hoc interventions should be taken into account in determining minimum total costs.”³²
- 6.1.6 This aspect of the Authority's objective is important because it suggests that market arrangement should be durable in the face of high impact, low probability events, or the impending prospect of those events occurring.
- 6.1.7 The following sections consider three options, or possible responses, to the problems identified above against the Authority's statutory objective.

³¹ Electricity Authority, *Interpretation of the Authority's statutory objective*, 14 February 2011, para A.30.

³² Electricity Authority, *Interpretation of the Authority's statutory objective*, 14 February 2011, para A.45.

6.2 Option one: Do nothing

- 6.2.1 One option would be to make no changes. This option should be favoured if the potential costs of the problems identified above were thought to be small or at least less than the cost of any action to try and correct the problems.
- 6.2.2 A no change option would recognise that market participants who bear the financial costs of a failed retailer face incentives to reach an agreement to curtail the loss – generators for instance may be better off reaching an agreement to acquire the failed retailer’s customers (and therefore the cash paid by those customers) than continue to bear the pro-rated share of the short-fall to the Clearing Manager. Making no change would have the advantage of avoiding the costs of code change and the costs of administering any alternative mechanism.
- 6.2.3 The disadvantage of making no change is that the apparent incentives for inefficient risk taking would remain. These adverse incentives might be exacerbated by the Code providing the failed retailer with a point of leverage over a viable generator-retailer – a generator faced with the prospect of sharing in the ongoing shortfall of payments to the Clearing Manager might be prepared to pay above market value for the failed retailer’s customer base to curtail further losses. In addition, there would be little or no certainty as to the outcomes or the timeline of events following non-payment by a retailer.

Q7. Do you consider the problems with the current arrangements for governing a retailer failure are of sufficient magnitude to rule out doing nothing to address the identified problems? Please provide reasons.

6.3 Option two: Amend the Code or implement alternative instruments to provide for the Clearing Manager or Electricity Authority to appoint a receiver if a retailer is in default

Advantages

- 6.3.1 A second option could be to re-establish a legal basis for the Clearing Manager to appoint a receiver should a retailer default on payments due to the Clearing Manager, if this can be achieved. As the Act now places responsibility on the Authority for monitoring and enforcing compliance with the Code, consideration might be given to whether the Clearing Manager, as a service provider, would be the right entity to make the judgement call on when to appoint a receiver in an event of default. This may particularly be the case if the commercial structure of the entity defaulting is more complex than a standalone retailer. A process could be established whereby the Authority made the decision on recommendation by the Clearing Manager, for example.
- 6.3.2 The process of appointing a receiver could be structured to have very clear deadlines for resolving any shortfall in payment by a retailer. For example, the process might be designed to ensure that a receiver would be appointed if a retailer did not pay any outstanding liabilities and restore its required collateral within the period provided under existing prudential requirements.
- 6.3.3 As discussed in paragraph 3.3.14, the efficiency advantages of a receiver would include:
- a) The mechanism of receivership is well understood by commercial entities and advisers, reducing costs to new entrants and investors in understanding the financial risks in market;
 - b) The process contains provisions to protect the interests of other lenders (such as not altering the preferential order for payments and security interests in the retailers assets);

- c) Allowing for the unwinding of complex commercial arrangements without prejudging the best means of doing so; and
- d) Allowing a failed retailer to maximise the price it achieved for its primary asset (its customer base) and therefore minimise the cost of exit to the retailer and hence lower barriers to entry.

Disadvantages

- 6.3.4 The disadvantage of a mechanism to appoint a receiver (relative to option 3 below, of providing the Authority with powers to transfer customers) is that there is not complete certainty that all customers in all circumstances would be transferred smoothly to a viable retailer.
- 6.3.5 This uncertainty in part arises because the value of customer base to another retailer is uncertain. The residual value may be lower now than in the past for several reasons, including:
 - a) retail customers may be less 'sticky' (that is, tend to be more inclined than in the past to change suppliers); and
 - b) electricity wholesale prices are now more volatile than during the initial years of the wholesale market.
- 6.3.6 However, on the available data it seems unlikely that the retailer customers of a failed retailer would, as a group, have a negative value and hence a market solution (sale of the customer base to one or more retailers) seems an achievable outcome.
- 6.3.7 There appear to be at least two possibilities which might not result in an orderly transfer of all customers to a viable retailer on existing terms through a commercial process following an appointment of a receiver by the Clearing Manager. Each possibility is discussed in turn.
- 6.3.8 Among the customers of the failed retailer there may be a group of customers which are less commercially attractive (that is, those who are less likely to pay their bills). It is possible that a failed retailer has a higher than usual proportion of customers that fail to pay their bills and that the sale process may allow viable retailers to sift these customers from those they are willing to acquire. Conceptually, viable retailers typically do not refuse to serve customers; rather they refuse to provide credit to people with a track record of not paying. One solution is prepay meters. However, the availability of prepay metering in New Zealand is not comprehensive. This issue is not tied to the prospect of retailer failure. This problem may exist in regions in which all retailers are viable, but refuse credit to a customer or group of customers.
- 6.3.9 Second, it is possible that the cash flow loss to a viable retailer from taking on the customers of a failed retailer exceeds the value of the customer to the alternative retailer. This situation might arise, for example, where a failed retailer had entered into long-term contracts to supply customers on terms which are well below market rates so that no retailer could profitably supply the customer. Another example is where the market is experiencing an ongoing period of high spot prices.
- 6.3.10 In these circumstances, the contracts between the retailer and its customers would be a liability (rather than an asset) and the defaulting retailer would likely go into liquidation. A liquidator may be able to *disclaim onerous property* under s.269 of the Companies Act 1993. An unprofitable contract is defined as onerous property (s.269(2)(a)(i)). A liquidator would therefore have the option of disclaiming the retail contracts, in circumstances where the wholesale cost exceeds the

contracted retail price, in order to limit future losses, if it thought that the sale of the contracts would not offset these costs.

- 6.3.11 If a contract is disclaimed, the customers of the failed retailer would likely be notified by the liquidator that their contracts were terminated and that they would be disconnected unless they obtained supply from another retailer. At this point, the failed retailer's customer lists become a marketable asset which the liquidator could readily sell because the customer list would no longer be attached to the uneconomic terms of supply. The customers could therefore expect to receive alternative offers of supply from a viable retailer, but not on the same terms (i.e. higher prices) they had previously agreed with the failed retailer.

Q8. Have we identified the relevant advantages and disadvantages of a mechanism to allow the Clearing Manager to appoint a receiver if a retailer is in default for a period that exceeds its prudential cover?

6.4 Option three: Provide for the Authority to allocate customers

- 6.4.1 Option three could be viewed as a 'safety net' option and would involve Code changes to provide the Authority with the power to mandate the transfer consumers in a narrow range of circumstances. These changes might be considered in addition to option two, or as a substitute.
- 6.4.2 As with option two (appointment of a receiver), the process for triggering a mandatory transfer of the retailers customers could be structured to have very clear deadlines for resolving any retailer default. For example, the process might be designed to ensure that the retailer's customers would be transferred if it did not pay any outstanding liabilities and restore its required collateral within the period provided under existing prudential requirements.
- 6.4.3 The most effective means of implementation a regulated customer transfer mechanism (without the need for primary legislation) would likely be the approach set out in the attachment to the Authority's Guidelines "Draft changes to Part 11 to provide the power to the Authority to allocate stranded customers" ('the Draft Code Changes). A variant of this option would be to retain the Draft Code Changes as a back stop that could be implemented by the Authority with urgency if required (for instance, in a situation that was unprecedented in some way).
- 6.4.4 The key aspects of the Authority's Draft Code Changes include:
- a) the Authority requires all customer contracts to provide for customer assignment;
 - b) where there is a serious event of default by a retailer (or an event of default is imminent), the Authority can direct the retailer to exercise its powers under customer contracts to transfers its rights and obligations to other specified retailers;
 - c) the Authority can direct specified retailers to accept a defaulting retailer's customers and to take other actions to facilitate the transfers;
 - d) the Authority can direct the defaulting and recipient retailers to make payments to each other; and
 - e) the Authority can direct the defaulting retailer, or a relevant distributor, to provide information to the Authority about the defaulting retailer's customers.
- 6.4.5 A variant of this option is that some means might be established whereby retailers could elect in to take customers of a failed retailer. This arrangement might be implemented in advance, where

retailers tender periodically a price (positive or negative) at which they would be willing to accept customers should a retailer fail within a defined period of time. Alternatively, some form of tender process might be managed by the Authority should a retailer fail.

Advantages

- 6.4.6 The primary advantage of this approach is that it could be designed to provide a high degree of certainty – to generators, distributors, customers and the Authority – around the process and timeframe after an event of default.

Disadvantages

- 6.4.7 The primary disadvantage is that this certainty may come at a cost to other retailers (if other retailers are compensated for taking customers).
- 6.4.8 The existence of such a scheme may also influence the entry and exit strategies of retailers:
- a) a regulatory regime that enables the regulator to transfer a retailer's customers could be seen as imposing an additional cost that potential new entrants would need to consider before entering the market, for instance, the security of other debtors would be reduced presumably raising the cost of finance for retailers;
 - b) a failing retailer may attempt to voluntarily exit the market through such a model – effectively removing any liability for having to continue to supply its customers. At the extreme this latter scenario could result in retailers voluntarily exiting the market during a period of high wholesale prices and perhaps attempting to re-establish themselves as another entity when market conditions are favourable. This has been dealt with overseas by requiring failed retailers to make payments to the recipient retailer (which requires solvency) or by considering such past behaviour when issuing licences (not applicable in New Zealand);
 - c) the scheme may undermine possibilities for a commercial sale – a party that might otherwise have entered negotiations to acquire the retail base of a failing retailer may hold-off in anticipation of a better deal under an Authority mandated transfer; and
 - d) a mandated transfer would be terminal for the business concerned, whereas a receiver leaves open the possibility that the firm may trade back to solvency.
- 6.4.9 To provide the certainty which is the advantage of the transfer scheme, a retailer of last resort model typically includes the ability of the regulator to override the concerns of a recipient retailer and direct them to accept customers from a failed retailer. As with a commercially agreed transfer, customers would be transferred on existing terms as the mechanism for transfer is the assignment of an existing contract. A regulatory requirement to accept (rather than negotiate for) the transfer of customers has implications for the business of a recipient retailer that may not be readily apparent to the regulator.³³ At the extreme, the impact on the receiving firm could create the possibility of a cascading failure of other retailers, particularly if the reason for the retailer failing is due to external factors such as high wholesale prices.
- 6.4.10 One possibility to reduce this risk is for the transfer scheme to include the regulator holding a contestable tender whereby retailers bid for the right to receive the customers of the failed

³³ These costs might include increased exposure to wholesale market volatility, requirements to serve customers on terms and tariffs not currently offered, implications for changes in prudential cover, and potentially internal disruption with business process issues from merging customer bases

network. An alternative approach, adopted in South Australia and the UK, is to provide for the recipient retailer to be compensated through a levy that is imposed on all electricity consumers.

Q9. Have we identified the relevant advantages and disadvantages of a mechanism to allow the Clearing Manager to transfer a retailer's customers if a retailer is in default for a period that exceeds its prudential cover?

7 Conclusions

7.1.1 Several important changes have been made to how settlement risk is allocated in the wholesale market since the NZEM rules were replaced with regulations. The effect of these changes is that there is no longer a mechanism for ensuring a commercial transfer of customers if the failed retailer (or an agent appointed by some other party) does not initiate that transfer, nor is there a mechanism for stemming any loss to the Clearing Manager.

7.1.2 This paper outlines three broad options:

- a) one option would be to make no change and rely on the incentives on market participants who bear the financial costs of a failed retailer to reach an agreement to curtail the loss;
- b) re-establish a mechanism whereby the Clearing Manager, or the Authority, could appoint a receiver if a retailer in default did not pay any outstanding liabilities and restore its required collateral within the period provided under existing prudential requirements; and
- c) implement a modified version of the Draft Code Change that would provide the Authority with the means of transferring customers from a retailer and either require other retailers to take those customers or establish a method for identifying retailers willing to take those customers.

Appendix A Moral hazard and asymmetric information

- A.1.1 When a retailer makes an offer in the market to consumers, it generally provides information on terms and conditions, and a tariff or tariffs. Consumers decide whether to accept this offer or stay with their existing retailer. It seems likely that consumers largely base their decision, for what is generally perceived as a homogeneous service, on price.³⁴
- A.1.2 If a retailer were to enter the market with a very low tariff, consumers would be encouraged to switch to it. If this low tariff was based on a risk management strategy that involved low rates of hedging, the retailer may have difficulty sustaining it during all market conditions. A retailer with a more moderate risk management strategy, but a low level of capital, may also find it difficult to sustain its business through a period of high spot prices (for instance in a dry year) because of high levels of outward cash flow. A retailer with a stronger capital base can sustain a period of loss to be recouped later when market conditions change, and a retailer with high levels of hedge cover would have less exposure to high prices; however, the costs of hedge cover and or a higher capital base would need to be recovered through higher prices.
- A.1.3 In economic terms, these situations can be considered a moral hazard problem, to the extent that such practices contribute to insolvency risk and the resulting costs are not borne fully by the risk taker, but are 'socialised' in some form. A consumer choosing a retailer may not have information about either the hedging strategy or the capital backing of the retailer. That is, they may have no information about the risk of the retailer being able to honour its contracts as market conditions change. This is an asymmetric information problem.

³⁴ Recent reviews of electricity retail competition in Australia by the AEMC concluded that electricity retailers rated reputation for customer service, brand recognition, provision of green energy products, and good corporate citizenship as important factors in obtaining/retaining electricity customers. However, almost all retailers viewed price as the single biggest factor in its pitch to a new customer. The AEMC reviews are available at: <http://www.aemc.gov.au/Market-Reviews/Completed.html>

Appendix B Estimating the residual value of a retailer customer of failed retailer

- B.1.1 Electricity retailers, especially stand-alone retailers without a generation base, are likely to come under the most financial pressure in a winter that is both drier and colder than usual, when demand and spot prices are likely to be high. In these circumstances, a retailer purchasing from the wholesale market to supply retail consumers may experience negative cash flow as wholesale prices may exceed retail prices. For another retailer to be willing to take on the customers of a failed retailer in these circumstances it would need:
- sufficient hedging (either contracted or through its own generation capacity) or sufficient capital to sustain the negative cash flow; and
 - a reasonable belief that the consumers will have a positive net value over their life cycle with the acquiring retailer.
- B.1.2 Absent a major disruption to generation supply (which raises matters beyond the scope of a retailer failure) the first criterion is satisfied, for the market as a whole, because a retailer exiting the market just removes an intermediary; there is no less generation capacity available to meet demand. Hence, the quantity of hedges – contract and generation – available in the market should still be sufficient to cover the retail base.
- B.1.3 Establishing whether the customers of a failed retailer would have a positive net value over their life cycle with the acquiring retailer is more complex. Estimates of the value of a customer rely on information which is difficult to obtain, including:
- average retail margin (long-term);
 - average retention of an acquired customer; and
 - un-hedged liability of electricity purchases of customer.
- B.1.4 Because there is information we do not know on the value side of a customer, it makes more sense to consider the liability side – that is to ask the question, what is the short-term liability that an acquiring retailer might take on and is that amount likely to outweigh the future value of that customer?
- B.1.5 We have reviewed electricity price data for the past 10 years to estimate the upper range of the cash flow deficit that might be acquired with the retail customer of a failed retailer. We made the following assumptions in this analysis:
- all electricity would be purchased from the wholesale spot market for a period of 2 months – that is, the customer base would be entirely un-hedged;
 - average household consumption per customer of 8,400kWh/annum, with a higher proportion of consumption in winter;
 - historic retail tariffs from Ministry of Economic Development data, with an allowance for a weighted within-day average; and
 - historic distribution network charges from Ministry of Economic Development data.
- B.1.6 The following table shows the net effect on the cash-flow of the acquiring retailer over the worst 60 day period in each year for the 10 years from 2000 to 2010. This estimate assumed that the customer paid the average retail tariff prevailing at the time and that the retailer purchased

generation at HAY2201 (this node is often used as a benchmark for 'North Island' wholesale prices):

Table B1 Lowest 60 day value of average customer purchases (retail less spot price)

Year	60 day unhedged value
2000	\$36.43
2001	-\$246.54
2002	\$8.22
2003	-\$172.44
2004	\$67.40
2005	\$0.55
2006	-\$60.54
2007	\$20.78
2008	-\$287.03
2009	\$95.80
2010	\$53.88

B.1.7 These results show that the maximum short-term cost associated with an un-hedged customer historically would have been \$287. This amount is significantly less than the amount retailers have historically been willing to spend to acquire customers.

B.1.8 A study by NERA Economic Consulting in 2006 looked into the direct purchase price of electricity customers in a number of countries.³⁵ The estimates of acquisition prices in New Zealand are shown in table below.

Table B2 Estimated acquisition price for NZ retail base

Company/Year	Estimated Acquisition Price (per customer)
Meridian (2001 – NGC)	\$287
Contact (1999)	\$400
Meridian (1999)	\$410

³⁵ "Approach to Estimating the Retail Margin and Retail Costs for a Mass Market New Entrant – for Integral Energy", 5 September 2006.

Company/Year	Estimated Acquisition Price (per customer)
Trans Alta (1999)	\$630
Genesis (1999)	\$820
NGC (1999)	\$1,020
Mighty River Power (1999)	\$1,410

- B.1.9 Interestingly, the estimates indicate the price that Meridian Energy paid for the On Energy consumers it bought during the 2001 crisis. At the height of 2001 energy shortage, NERA report that Meridian paid \$287 for each customer it acquired from On Energy which was exiting the market due to financial distress. At that time the customers may have imposed a further cost on Meridian of up to \$246 each in negative cash flow. The total initial cost of the customers therefore was approximately \$533. This amount is broadly in line with the figures presented in table B2.
- B.1.10 The residual value of customers may be lower now than in the past for several reasons, including:
- a) retail customers may be less 'sticky' (that is, tend to be more inclined than in the past to change suppliers). Some estimates are that the average retention of a consumer was previously 10-16 years. However, as the amount of switching in New Zealand has more than doubled since 2006 the average retention period is likely to have decreased.³⁶ If the insolvent retailer is a new entrant, then its customers are likely to have already switched once (depending on whether it bought a customer base or built it up) and therefore may be considered less 'sticky' by potential purchasers; and
 - b) electricity wholesale prices are now more volatile than during the initial years of the wholesale market.

³⁶ Based on the average proportion of ICPs that switched each month in the last 12 months (1.6%) it would take a minimum of more than five years for all ICPs to switch (this assumes that each ICP switches only once, this is unlikely as some consumers are highly immobile).

Appendix C Case studies

C.1 E-gas – New Zealand

- C.1.1 On 18 October 2010 the E-gas group of companies went into voluntary liquidation. E-gas had approximately 3% of gas customers and 9% by volume of allocated gas. About one quarter of their customers were residential, the rest were small commercial businesses.
- C.1.2 E-gas was in financial distress as a result of historical under-reporting of its gas consumption volumes. This had been discovered and admitted to by E-gas in 2009 as a result of audits performed under the Gas (Downstream Reconciliation) Rules 2008.
- C.1.3 As a result of this under-reporting, E-gas was facing penalties and compensation payments to other retailers. The other retailers had been paying for the under-reported volumes through the unaccounted for gas process. It was also facing payments for wash-ups of volumes and transmission charges. Other parties in the gas supply chain had asked E-gas to make prudential payments to reduce their exposure. E-gas was also involved in litigation with Nova Gas over 100 customers that Nova had signed-up. E-gas considered the customers were not free to switch under the terms of their contracts with it.
- C.1.4 BDO New Zealand was the liquidator and tried to sell the E-gas customer base. It entered into short term arrangements with the relevant suppliers in order to enable it to keep trading while it sought to do this. This process took approximately six weeks to complete.
- C.1.5 The industry body (the Gas Industry Co) was concerned that if the liquidator was unable to sell the customers they would become unaccounted for gas and other retailers would have to pay for their consumption. Distributors would have been concerned that the retailers would try to recover these costs from them unless they disconnected the customers and may have managed this risk by disconnection. The Gas Industry Co wanted to ensure that the customers remained contracted to a supplier.
- C.1.6 The Gas Act provides that transition arrangements for insolvent retailers may be made under urgency and the consultation requirements do not apply. The Minister of Energy and Resources requested that the Gas Industry Co assist the Ministry of Economic Development and Parliamentary Counsel Office to prepare the Gas Governance (Insolvent Retailers) Regulations 2010.
- C.1.7 These were made under urgency to provide a mechanism to transfer the contracts of E-gas to another retailer. Apportionment was to be random, but in proportion with market share, to those retailers with greater than 10% market share (or which opted in). The regulations were revoked 6 months after they came into effect.
- C.1.8 The Regulations were not invoked as BDO sold the customer base to Nova. There is anecdotal evidence that the regulations may have helped BDO to finalise the sale.³⁷
- C.1.9 The Gas Industry Co considered that the regulations were a suitable mechanism for the specific situation surrounding E-gas:
- the volumes were marginal and could easily be accommodated by the other retailers; and
 - it was summer, so the total volume was low.

³⁷ Gas Industry Company *Gas Governance (Insolvent Retailers) Regulations 2010* – Statement of Proposal March 2011

- C.1.10 In the assessment of the regulations after the event, the Gas Industry Co concluded that the regulations were not suitable for all situations because they were tailored to the specific circumstances and size of the E-gas situation.
- C.1.11 The Gas Industry Co has not yet undertaken further work to determine what if any long-term solution is required.
- C.2 Electricity4Business (E4B) – UK**
- C.2.1 E4B provided electricity to about 40,000 small and medium sized businesses before it went into administration. E4B was a small stand alone retailer predominantly operating in regional areas such the Midlands.
- C.2.2 In a statement released on the day of the company’s collapse on October 22, the appointed administrator PricewaterhouseCoopers said the decision was taken “as a result of volatility in the energy market”, where small suppliers have been hit by the soaring wholesale price.
- C.2.3 On 20 October 2008, Ofgem was informed that E4B was trading at a loss and required an injection of funds to remain solvent. E4B told Ofgem that it was holding preliminary talks with administrator but was also hoping to achieve a trade sale for part if not the whole all of its business in the next few days.
- C.2.4 By 21 October, while Ofgem recognised that a trade sale would have been preferable, it took the view that this option was looking unlikely and that insolvency was increasingly likely. As a first step, Ofgem informed a number of industry participants that a process for RoLR situation may arise due to a potential insolvency situation.
- C.2.5 On the afternoon of 21 October, E4B informed Ofgem that a trade sale could not be achieved and that it would be going into administration. Ofgem took the view that the appointment of RoLR was the only regulatory route available to protect consumers by reducing the level of potential costs to be smeared across the industry.
- C.2.6 On 22 October, the regulator revoked the E4B’s licence.
- C.2.7 In accordance with the 2003 Guidance in place at the time, Ofgem immediately issued formal information requests of relevant industry participants including E4B and 10 retailers (potential RoLRs). The information requested from the retailers included:
- a) their willingness to act as the RoLR;
 - b) their capability to supply E4B’s customers and the;
 - c) the terms of the deemed contracts;
 - d) their ability to source electricity;
 - e) how they manage the transfer of customers;
 - f) how they would maintain increased credit cover; and
 - g) customer services.
- C.2.8 Ofgem established a Panel to assess the information provided by the 10 retailers of which six indicated that they were volunteering to act as the RoLR. The six volunteering retailers were willing to waive their right to the last resort payment levy. This avoids the RoLR seeking to

recouped costs from the industry as a whole and had a large bearing on Ofgem's assessment of the retailer information. The Panel made its assessment against the criteria in the 2003 Guidance.

- C.2.9 Following an assessment of the information, Ofgem decided that British Gas offered the most favourable offer to E4B customers and could comply with a last resort supply direction without significantly prejudicing its ability to continue to supply its customers.
- C.2.10 As such British Gas was directed to supply electricity to the customers of E4B.
- C.2.11 In 2008 Ofgem conducted a review of the 2003 Guidance and it commented that since that document was published there had been a number of developments that had allowed testing and refining of procedures.
- C.2.12 These developments included the failure of five smaller suppliers during winter 2005/06 and E4B in October 2008. In each case the retailer was unable to secure a trade sale and Ofgem was required to revoke their supply licence and appoint a RoLR.
- C.2.13 Ofgem reported that participants in these RoLR events had commented that some form of early contact from Ofgem would have been useful as it would give potential RoLRs more time to consider their position, and, if possible, attempt a trade sale, and enable them to respond quicker to a formal information request.
- C.2.14 In preparing the 2008 Guidance, Ofgem said that it would endeavour to give potential RoLRs early warning that a RoLR situation may be imminent. Such warning may include the total number of domestic and non-domestic electricity supply points and the likely energy volume commitments required.

C.3 Jackgreen – Australia

- C.3.1 Jackgreen Limited (Jackgreen) was a renewable energy retailer or "greentailer". In its five years of operation it had grown to supply 75,000 customers.
- C.3.2 Jackgreen was suspended from trading in the National Electricity Market on 18 December 2009 from the National Electricity Market by the Australian Energy Market Operator (AEMO).
- C.3.3 The next day, 19 December 2009, all of Jackgreen's customers in NSW, Queensland, South Australia and Victoria were transferred to the relevant default retailer under the retailer of last resort (RoLR) scheme in their State.
- C.3.4 On 30 November 2009, Jackgreen's Annual General Meeting was held and a trading halt called. In a statement released to the stock exchange, Jackgreen stated that it had experienced considerable volatility in wholesale electricity markets during the hottest November on record. Trading results for November were impacted by the extreme weather conditions in New South Wales. While the company said that it was adequately hedged, the volatility had required the company to post substantial additional cash backed credit support with the market operator, AEMO, in order to meet the market operator's prudential requirements.
- C.3.5 On 7 December 2009, Integral Energy served a winding up notice on Jackgreen on the basis of an alleged failure to pay an amount of \$808,983.10 identified in a statutory demand by Integral of 3 November 2009. Apparently the money was owed due to the on-the-spot purchase of energy during NSW's November heat wave, when Jackgreen was forced to buy electricity at higher prices Jackgreen responded that it had paid the amounts sought in the statutory demand in full.
- C.3.6 The next day, Integral's winding up application was adjourned until 18 December 2009.

- C.3.7 On 14 December 2009, Jackgreen requested that its shares be placed in an immediate trading halt until 10am on 16 December 2009. On 16 December, Jackgreen's securities were suspended from quotation.
- C.3.8 On 18 December, AEMO suspended Jackgreen from the NEM effective at midnight under the National Electricity Rules.
- C.3.9 At midnight on 18 December, Jackgreen's customers were transferred to the relevant retailer of last resort under the applicable RoLR scheme in their State. On Monday 21 December, Jackgreen announced that voluntary administrators had been appointed to it and its subsidiaries.
- C.3.10 The NSW Minister for Energy has designated EnergyAustralia, Integral Energy and Country Energy to be the ROLRs in NSW. Each of these retailers is the ROLR for a specific geographic area that matches their distribution network.
- C.3.11 In Queensland Origin Energy became the ROLR (the default electricity retailer) for all Jackgreen customers in the Energex network area. For Jackgreen customers in Country Energy's small retail area in the south of Queensland, they were transferred to Country Energy.
- C.3.12 In Victoria, the State Government designated three retailers - TRUenergy, Origin Energy and AGL as Retailers of Last Resort. As a part of the transfer, the RoLRs were entitled to charge ex-Jackgreen customers a one-off \$65 administrative fee to cover the cost of the transfer, which would appear on their next bill. This fee was been set by the Essential Services Commission of Victoria.
- C.3.13 In general the options available to customers of the failed Jackgreen regarding their ongoing supply of electricity included:
- a) remaining with RoLR on a standard contract with regulated prices and conditions;
 - b) arranging supply under a negotiated customer supply contract from the RoLR ; or
 - c) arranging supply with a different retailer.
- C.3.14 The process for transferring customers was administered by AEMO in accordance with the published RoLR procedures. AEMO coordinated the RoLR event in conjunction with jurisdictional regulators, government agencies, RoLRs and distributors.

Appendix D Provisions of current consumer contracts

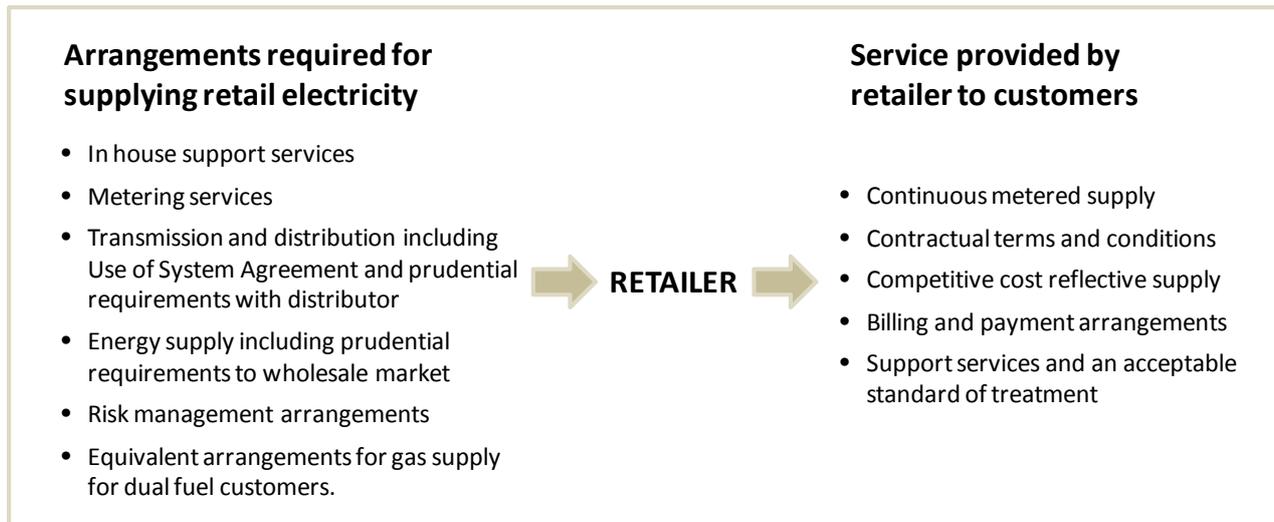
- D.1.1 Most electricity consumers have a single contract with their retailer that covers both the supply of electricity and the use of the lines company's network to physically deliver that electricity to the consumer's premises. This contractual approach is known as the 'interposed' model. It reflects the way the retailer assumes the relationship with the lines companies on the consumers' behalf.
- D.1.2 In three areas in New Zealand, consumers have one contract with a retailer and another contract with the lines company. In one of those three areas, the lines company actually invoices the consumer separately from the retailer so that consumers receive two bills for their overall electricity supply. This contracting approach is generally termed a 'conveyance' model.
- D.1.3 The Authority has developed a set of voluntary minimum terms and conditions for retail contracts underpinned by a set of good contracting principles.³⁸ Work is ongoing around developing these so that they can be used by lines companies under the conveyance model.
- D.1.4 It is important to note that the minimum terms are voluntary; retailers can choose whether to align their standard contracts with the minimum terms or not.
- D.1.5 This document forms a useful description of the services consumers buy from their retailer. It frames the service as including:
- a) an ability to freely sign up with or switch away from the retailer;
 - b) a supply of electricity that is safe, reliable and 'fit for purpose';
 - c) access to a good standard of information in a supply interruption situations and restoration of supply within a reasonable timeframe;
 - d) metering and in house support services;
 - e) contractual arrangements that are transparent and fair;
 - f) tariffs that reflect the costs of supply;
 - g) timely and accurate billing and payment information for electricity and associated services;
 - h) access to appropriate mechanisms for making payment that take account of consumer circumstances;
 - i) access to suitable arrangements for dealing with any complaints; and
 - j) access to consumer's consumption and payment information.

D.2 Retailer arrangements

- D.2.1 For consumers relying on the interposed model an electricity retailer sits between a contractual relationship with a consumer for a domestic electricity supply service as described above and a series of arrangements that enable them to provide the service. This back to back arrangement is shown in the figure below.

³⁸ 'Final Principles and Minimum Terms and Conditions for Domestic Contracts for Delivered Electricity (Interposed) May 2010 See: <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/domestic-electricity-retail-contracts/>

Figure 3 The retailer provides customer service through a series of arrangements



Appendix E Existing regulatory arrangements for retailer default

E.1.1 A list of the regulatory arrangements is shown in table E1 below, in approximate order of regulatory hierarchy.

Table E 1 Regulatory arrangements governing failed retailer and its customers

Hierarchy	Instrument	Provision	Governs
Primary legislation	Electricity Industry Act	Sec 49(3)	Authority may suspend retailer right to bid if insolvent
	Companies Act	Part 14	Any compromise by retailer with creditors on debt
		Part 15	Voluntary and Court appointed administration of insolvent retailer or retailer that may become insolvent
		Part 16	Mechanism and process for liquidator appointed to retailer
	Receivership Act 1993	Act	Role of receiver, including personal liabilities for new debt ³⁹
Regulation	Electricity Industry Participation Code	Part 14.5	Retailers must maintain acceptable security (e.g, cash deposit, letter of credit, 3 rd party guarantee) ⁴⁰
		Part 14.18-22	Security covers about 57 days: 28-31 days of trading month ~20 days till settlement day 7 days post settlement
		Part 14.47	Any short-fall in payment by retailer (after security taken) pro-rated across generators
		Part 14.56	Clearing Manager refers any anticipated default to Authority
		Part 14.53-63	In event of default, Clearing Manager to call securities etc and apply against debt; generators may exercise Clearing Manager rights if Clearing Manager does not act within specified times
		Part 14.9	Receiver/liquidator not entitled to be paid back deposit unless all retailer debt to Clearing Manager paid
		Part 14.63	Statutory right of Clearing Manager to apply to court to appoint receiver or

³⁹ A receiver is personally liable for new contracts entered into by the receiver in exercising its powers and is not personally liable for payments due under an agreement subsisting at the date of the receiver's appointment; it is doubtful that the purchase of electricity under the Code would constitute a new contract for each trading period (or day).

⁴⁰ An entity maintaining an A- credit rating (Standard and Poors) or higher is deemed to provide acceptable security; only Transpower maintains a sufficiently high credit rating to avoid having to provide acceptable security.

Hierarchy	Instrument	Provision	Governs
			liquidator not limited by Code ⁴¹
		Part 15	Unaccounted for electricity is allocated to other retailers / consumers in the local area
Contract	Use of systems	Prudential	If a distributor requires prudential security the retailer can meet requirements by having an Standard & Poors credit rating of BBB- (or equivalent) or providing two weeks of lines charges as security. A distributor may require additional security up to two months lines charges if it pays the retailer interest on the additional security above the two week level.
		Temporary disconnection	Currently, the model use of system agreement provides for distributors to disconnect an ICP in event of retailer default of insolvency event; the Authority proposes to add a requirement that the distributor provides at least 9 working days notice.
	Retail contract	Assignment	Existing contracts generally provide for retailer to assign its rights and obligations
		Receivership / liquidation etc	Some contracts explicitly provide for retailer to take all reasonable steps to ensure continued energy supply if receiver / liquidator etc appointed
		Terminate (other than for non-payment)	Contracts typically provide for retailer to terminate agreement if retailer agreement with lines company terminates
Guidelines	Managing Retailer Default Situations	Identifies different types of events of default; and Sets out processes the Authority will follow if any event of default occurs	

⁴¹ For the reasons discussed further below, it would not appear that neither the Clearing Manager nor the Authority have an effective remedy of applying to the Court to appoint a receiver or liquidator.

Appendix F Electricity Authority warning signs of an event of default

F.1 Guidelines for Managing Retailer Default Situations (page 13)

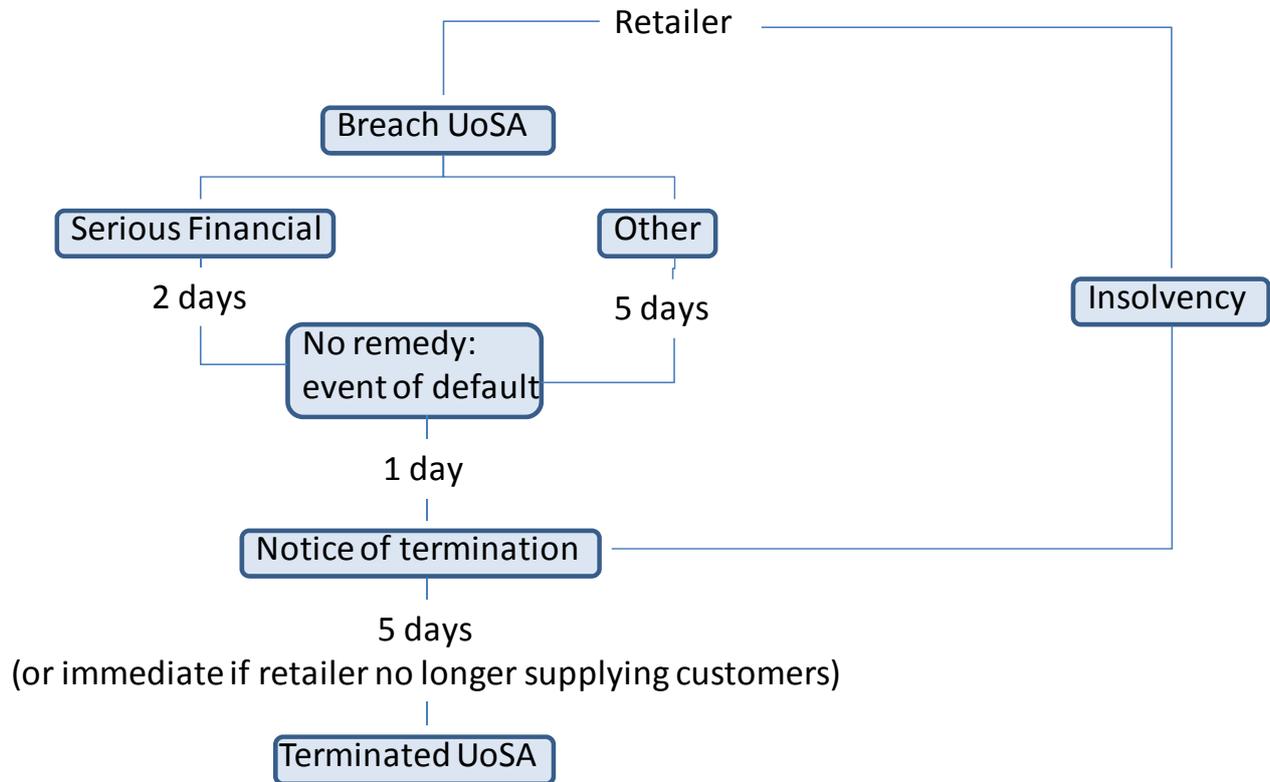
- F.1.1 There are a number of situations that may indicate there is an increased likelihood of an event of default occurring.
- a) Those situations include:
 - b) a retailer or generator's hedge cover is insufficient when taking into account the retailer's or generator's actual electricity sales and purchases (information not necessarily available to the Authority);
 - c) a retailer or generator has defaulted on the payment of hedges that are not settled by the clearing manager (information not necessarily available to the Authority);
 - d) the market is producing high electricity spot prices for a prolonged period, or there is a significant variation in final spot prices particularly if any given NSP is significantly
 - e) above the time-weighted market average price for a period exceeding four hours;
 - f) a retailer experiences high customer influx. This information is available from the registry manager but it is currently required only monthly although daily updates may be requested. A rate of change of >10% per month or 3% per day may indicate a future prudential exposure or invoice payment issue;
 - g) a retailer has high levels of net spot market exposure. There are two situations in which net spot market exposure can occur:
 - h) net spot volume exposure – this can be determined from information received monthly from the reconciliation manager. If a participant's exposure exceeds 50% of the participant's purchases, the participant may be at risk during adverse price times;
 - i) net spot financial exposure – this can be determined from information received monthly from the clearing manager but, because of the way the reconciliation process operates, it is only available monthly. If a participant's financial exposure exceeds 50% of the participant's purchases, the participant may be at risk during prolonged periods of adverse prices;
 - j) there has been a transmission or generator failure that has temporary but serious impacts on spot prices;
 - k) a service provider to a retailer withdraws service from a retailer (e.g.; a meter reading company or a metering equipment owner); or
 - l) the quality of a retailer's meter reading statistics and reconciliation submissions deteriorates over time, indicating a drop in compliant business activity. This information is currently required from participants but is only available monthly;
 - m) prudential calls where a participant has the net spot market exposure identified in 6. above, and the relevant market price exceeds \$200/MWh.
 - n) Situations 1 and 2: Situation 1 is probably the best of any KPI for the benchmarking of a retailer's risk exposure. However, amendments to the Code would be required to require participants to provide the information in situations 1 and 2.

- o) Situation 3 could be a KPI that is calculated on a daily basis by the Market Performance Team and provided to the Operations Development Team when the threshold is exceeded, and could then be a trigger for more detailed monitoring of situations 4 to 8.
- p) Situations 4 to 9 are monitored by the Operations Development team.
- q) If the Authority considers that the occurrence of a situation places a retailer at risk, the Operations Development team will examine all available information to ascertain the possibility of an event of default occurring, and assess the risk level.
- r) It must be noted that any information relating to a retailer's default may be commercially sensitive and publication may cause significant damage to the retailer.

Appendix G Termination of the Use of System Agreement

- G.1.1 Retailer invoices for most consumers contain two distinct components. One component covers the cost of supplying energy to the consumer including associated activities such as metering and data administration. The other component is the lines charge. The exceptions to this are some direct relationships between retailers and large consumers and one network company that bills all consumers directly.
- G.1.2 In most other cases the arrangement between retailer, lines company and consumers is an interposed arrangement where the retailer is liable for the lines charges and collection from consumers is at their risk. Where a retailer on an interposed arrangement defaults the lines company is a creditor in the same way as other suppliers.
- G.1.3 Some lines companies maintain a direct contractual relationship with consumers and the lines charge is collected on the lines company's behalf by the retailer as an agent. This relationship is referred to as a conveyance arrangement. In this case, where a retailer goes into default the retailer is liable to pay the lines companies ahead of other creditors.
- G.1.4 The model use of system agreement (UoSA), promulgated by the Electricity Commission and recently revised by the Authority, provides three reasons whereby a lines company could terminate the agreement:
- a) A serious financial breach (defined as a failure by the retailer to pay the greater of \$100,000 or 20% of the lines charges or a material breach of prudential requirements).
 - b) A material breach by the retailer of its obligations under the agreement.
 - c) Any breach where there have been at least two other breaches in the last 12 months and the cumulative effect is material.
- G.1.5 The most likely reason a retailer would default is because of a financial breach (that is, failure to pay its bill, or failure to pay on time). A distributor that invoices after the service has been delivered would be exposed to up to 37 days of unpaid lines charges were the default to occur on the 20th of the month.
- G.1.6 There are other factors that might result in a breach such as:
- a) Failure to provide accurate information, or consistently poor consumption data;
 - b) Systematic failure to put consumers on the correct distribution tariff; or
 - c) Non-compliance with the network connection standards, or failure to enforce these with customers, including a failure to maintain metering installation standards (for example, load ripple receivers).
- G.1.7 The model use of system agreement (UoSA) provides for the process for termination for breach of the agreement as outlined in the diagram below.

Figure 4 Flow diagram showing process for lines company to terminate retailer contract



- G.1.8 The timeframes indicated in the diagram are minimum periods, which the distributor has discretion to extend.
- G.1.9 Should a distributor proceed to terminate a UoSA, it appears the following situation could eventuate:
- The retailer's customers may still be connected and consuming electricity.
 - The customer may still have a contract with the defaulting retailer; retailer contracts typically provide for the retailer to terminate the agreement with the customer if the lines company terminates the retailer's agreement (time frames and process are discussed below).
 - The retailer may still purchase electricity from the wholesale market and would be obliged to provide reconciliation information.
- G.1.10 The model agreement provides the distributor with discretion in disconnecting consumers where it has terminated an agreement with the retailer. The retailer is liable for all lines charges, irrespective of the fact that its agreement has been terminated, unless it directs the distributor to disconnect the customers and the distributor has not done so. The process for disconnecting a consumer is discussed below.
- G.1.11 Prior to 1 May 2008, the Electricity Governance Rules contained a provision in Part G, section VI, rule 2.4 that before notifying the reconciliation manager of an intention to purchase electricity at a grid exit point, the purchaser must have all necessary conveyance arrangements in place. On 1

May 2008, Part J, the reconciliation rules, came into force. This provision does not appear in Part J, nor in its equivalent Part 15 of the Code.⁴²

- G.1.12 As a consequence of this change there is no specific requirement in the Code that a purchaser have a use of system agreement prior to commencing trade. It would appear possible that the retailer could trade without a use of system agreement whether because it has not entered one, or because the distributor has terminated the agreement due to an event of default. If the retailer is in financial breach the distributor may have a right to appoint a receiver, depending on the terms of its contract, and the discussion in the preceding section about the likelihood of completing a sale process would apply.
- G.1.13 However, it would appear that if the agreement were terminated for a non-financial breach (there is no debt owed by the retailer to the distributor), the distributor is limited in its response to disconnecting all the retailer's customers.
- G.1.14 Under the draft MUoSA the retailer, in its contract with its customers, must grant the distributor the authority to "temporarily disconnect" the customer should the retailer default or if the agreement between the retailer and the distributor is terminated. The distributor must give each consumer:
- a) at least [9] Working Days' notice in writing warning of disconnection and include a general notice on its website; and
 - b) a final warning not less than 48 hours or more than [8] days before the disconnection, providing the timeframes for disconnection. However, it would appear that if the agreement were terminated for a non-financial breach (there is no debt owed by the retailer to the distributor), the distributor is limited in its response to disconnecting all the retailer's customers.

⁴² The relevant place is with the provision of trading information clause in 15.3. This provision, which is intended to require that a purchaser give notice of its intention to trade at a connection point, is not clearly worded at present.

List of Discussion Questions:

- Q10.** Question one: Does our summary of settlement risk allocation under the former NZEM capture the main elements; are there other lessons from experience for the design of current arrangements?
- Q11.** Question two: Do you agree with our summary of the regulatory tools that are available in the case of a failed retailer?
- Q12.** Question three: Do you agree with our summary of possible scenarios that could develop once a retailer begins to fail?
- Q13.** Question four: How likely, and in what situations, do you think that efforts to secure a transfer of a failed retailer's customer base would prove unsuccessful?
- Q14.** Question five: Do you think it plausible that customers of a failed retailer would be disconnected from their electrical supply?
- Q15.** Question six: Do you agree that this summary identifies correctly the problems with the current arrangements for governing a retailer failure; are there additional problems that we have not identified?
- Q16.** Question seven: Do you consider the problems with the current arrangements for governing a retailer failure of sufficient magnitude to warrant investigation into options for resolving these problems?
- Q17.** Question eight: Do you consider the problems with the current arrangements for governing a retailer failure of sufficient magnitude to rule out doing nothing to address the identified problems?
- Q18.** Question nine: Have we identified the relevant costs and benefits of a mechanism to allow the Clearing Manager to appoint a receiver if a retailer is in default for a period that exceeds its prudential cover?
- Q19.** Question ten: Have we identified the relevant costs and benefits of a mechanism to allow the Clearing Manager to transfer a retailer's customers if a retailer is in default for a period that exceeds its prudential cover?