

Retail Customers in Retailer Default Situations – Discussion Paper

Submission to Retail Advisory Group of the Electricity Authority



This submission by Contact Energy Limited (**Contact**) responds to Retail Customers in Retailer Default Situations.

For any questions relating to our submission, please contact:

Catherine Thompson | Regulatory Affairs Manager

Contact Energy | DDI: 64-4 462 1130 • Mobile: 0274 399 676

Summary

Contact supports introduction of an effective mechanism for dealing with retailer default however submits that mechanisms to deal with retailer default cannot be considered in isolation of the Wholesale Advisory Group's (**WAG**) work on settlement and prudential security review. The working groups and the Electricity Authority (**EA**) must acknowledge the broader context the issue of retailer default sits in: the generators are effectively providing working capital to the retailers but doing so in an information vacuum. The generators are blind as to the credit quality of the retailers they are effectively funding.

It is in this context that Contact submits that the EA should design the mechanism to deal with retailer default with the following principles paramount:

- ensuring the failing/failed retailer faces the sanction of being forcibly exited from the market expeditiously;
- the ability for any retailer(s) who takes on the customers (forcibly or otherwise) of the failing/failed retailer to fully recover costs from those customers.

Given the purpose of the RAG, it is unsurprising that the Consultation Paper focuses on the implications for consumers but this narrow focus will restrict effective resolution of the issue of retailer default. The RAG must work together with the WAG's settlement and prudential security review. These two work streams cannot be decoupled.

The RAG identifies two aspects of the EA's statutory objective that will be relevant to the EA's decision making on retailer default:

- Promoting competition in the electricity industry for the long term benefit of consumers; and
- Promoting reliable supply in the electricity industry for the long term benefit of consumers.

The proposed solution needs to incentivise efficient risk taking and provide effective signals to new entrant retailers, seeking to challenge on price, to effectively manage their risks. Failure to do this will lead to retailers taking excessive risk and expanding their customer base. Thus compounding the impact of the defaulting retailer.

Of the 3 options presented in the paper Contact submits:

- Retaining the status quo must be ruled out. The current regime provides very limited incentives for retailers to effectively manage risk. Coupled with the inability to

provide a timely transfer of customers to another retailer, the current regime creates a risk of ad-hoc interventions and damage to the reputation of the market;

- Re-establishing mechanisms to allow the Clearing Manager or the EA to appoint a receiver would go some of the way to dealing with the issues that would arise from retailer default. It would improve retailer risk management and reduce the risk of retailer failure however, as it leaves the potential cost of a failed retailer with the generators, it would fail to fully send the correct signals to retailers;
- In addition to being able to forcibly exit a failing/failed retailer from the market the mechanism should include clear procedures to allow transfer of the failing/failed retailer's customer base to retailer(s) of last resort. This would not only ensure the costs of the retailers own risk taking would be borne by the retailer but potentially reduce the cost of risk management and provide certainty to the transferring customers. This process requires further consideration and consultation however Contact would like the EA to note that any such process must include the ability for the retailer(s) which takes on the customers of the failing/failed retailer, to fully recover costs from those customers.

Specific answers to Questions

No.	Question	
1	<p>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?</p>	<p>This is a very narrow question given the range of issues that need to be considered in a retail default situation.</p> <p>No, the paper falls well short of articulating the central problem. The issues in a retail default situation are much broader than just settlement risk allocation.</p> <p>The questions of retailer default regulations are related to issues of settlement, prudential security, and how to efficiently and effectively deal with customers in the event of a failure:</p> <ul style="list-style-type: none"> • the purpose of retailer default regulations is the same as prudential security – to ensure that retailers appropriately manage the risks associated with purchasing from the wholesale electricity market; • the costs and benefits are the same: (i) if arrangements are too weak then retailers will have an incentive to adopt risky business strategies for which they do not bear the cost (i.e. free ride on generator credit); relative to (ii) if arrangements are too strong then the incentive to invest in value adding retailing activity will be below the socially optimal level. <p>The essential problem in Contact's view is that under the prudential security regulations only 7 days of</p>

		<p>average accruals is collected against the possibility of retailer default, while with current retailer default regulations it is extremely unlikely that a defaulting retailer would exit the market in this period.</p> <p>The potential costs and benefits of the current arrangements could be quantified, using the implications for appropriate prudential security. Moreover, the EA has these tools available through its work on prudential security.</p> <p>The paper does not adequately describe the risk that generators currently face. A reader of section 3.3 would likely think that a generator currently only faces low probability – high impact event risks, but this has not been established through any analysis. Given the nature of this issue, that there has not been a significant failure to date should not be taken as an indication of risk.</p> <p>While the paper indicates co-ordination between the two work streams of the RAG and the WAG, Contact sees little evidence of this in the paper. Contact submits that the two issues are not separate, but rather should be considered jointly.</p> <p>Contact submits that the elements of the NZEM methodology which should be considered as part of the design of the new arrangements are:</p> <ul style="list-style-type: none"> • the prudential requirements; • ability to appoint a receiver if collateral not restored; • Mechanism for transferring customers.
2	<p>Do you agree with our summary of the regulatory tools that are available in the case of a failed retailer?</p>	<p>Yes, this is a reasonable summary of current tools.</p>
3	<p>Do you agree or disagree with our summary of possible scenarios that could develop once a retailer begins to fail? Please provide reasons.</p>	<p>Yes, these appear to be the likely scenarios.</p> <p>The paper should have attempted to quantify the likely time period during which non-payment would occur under these scenarios, and where the interim costs fall between default and the default being rectified. For example under scenario A the generators carry the capital costs, and management costs of the default(s) in the first instance for the period of time it takes for the retailer to trade out of default.</p> <p>The essential point of section 4.2 is that the current process creates uncertainties that would bring the electricity industry into disrepute and increase the risk of poorly thought through interventions. It highlights the fact the contractual right to take action maybe outweighed by the dual concerns of public relations risk and practical cost of taking disconnection action.</p>
4	<p>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?</p>	<p>It is most likely that a retailer will default in dry conditions, when spot prices are high increasing prudential security requirements. The short term value of retail customers will decline with increasing spot prices. Moreover, an acquiring retailer will become responsible for customer compensation scheme</p>

	<p>Please provide reasons.</p>	<p>payments. The price at which the customers are transferred will influence the non defaulting retailer's decision to take on the failed retailer's customer base.</p> <p>Retail default regulations should be based on a likely "reasonable worst case". While there is a strong possibility that a willing buyer will be found for a failed retailer's customers, there are good reasons why this may be difficult and, therefore, the rules should allow for a situation where a willing buyer cannot be found. i.e. mandatory transfer provided that the receiving retailer is not prohibited from recovering its full costs from the transferring customers.</p> <p>Note that in a dry year the quantity of generation is likely to be significantly constrained leading to possible demand curtailment initiatives. In this instance, there is likely to be only one generator in a position to take on new load or purchase new customers.</p> <p>Note also that Appendix B is misleading around the potential near term cost to a retailer of taking on an 'average' customer over 60 days. By comparing the retail tariff with the spot price significant other costs borne by the retailer are being ignored. These include network and distribution costs, metering, and cost to serve. As a rule of thumb – network and distribution costs alone account for roughly 35 – 40% of the total retail tariff, or around \$80 – 90 / MWh.</p>
<p>5</p>	<p>Do you think it plausible that customers of a failed retailer would be disconnected from their electrical supply? Please provide reasons.</p>	<p>The disconnection of customers, due to a retailer failure, is very unlikely, given that electricity is an essential service and the likely political response. The settlement and prudential security rules and retailer default rules should, therefore, operate on the basis that disconnection is unlikely. Contact does not believe that most customers are in a realistic position to assess the credit quality of their retailer. Given that customers do not realistically expect to be disconnected – it is rational for them to chase the best price available in the market – particularly on a contract term. If any retailer that takes on these customers in the event of a default is required to maintain their existing terms and conditions – then this situation is somewhat analogous to depositors chasing the highest returns of deposit guaranteed finance companies.</p>
<p>6</p>	<p>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.</p>	<p>Disagree.</p> <p>The central problem, that retailers who do not face the full cost of potential failure will take on excessive risk, is identified. There is also a risk that retailers that do not recognise this cost will expand at the expense of retailers that do, so that the level of risk increases through time. Increasing numbers of customers will be supplied by such retailers which will elevate risk of default.</p> <p>The summary does not identify that the prudential security rules only require 7 days of "excess security" to cover the period between a default and, in a reasonable worst case scenario, the exit of a retailer from the market. It would be possible to estimate the difference between these two periods; and so quantify this risk. Contact submits that even on an optimistic assessment that a reasonable worst case would be 38 days – indicating a very large disjoin that needs to be</p>

		urgently addressed. See also answer to question 5.
7	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.	<p>Yes.</p> <p>The current regime provides very limited incentives for retailers to effectively manage risk. In particular:</p> <ul style="list-style-type: none"> • the retailer is able to default on energy supply payments (which is likely to be their largest supply arrangement) with very limited sanction and the costs of this are largely borne by the generators (especially in the short term given the nature of much of the prudential provided by retailers is non-cash that would require a significant period of time to realise); • there is a substantial disjoin between required levels of prudential security and the time before a retailer would exit the market in a reasonable worst case – so that neither the retailer or its financial backers face the cost of providing security against the possibility of failure. <p>Moreover, the inability to provide a timely transfer of customers to another retailer creates a risk of ad-hoc interventions and damage to the reputation of the market.</p>
8	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?	<p>No.</p> <p>The option should be compared to the status quo or do nothing option. The paper's advantages and disadvantages apply at times to a comparison to both option one and option three. This is very confusing.</p> <p>Contact notes that no disadvantages compared to option one are identified and that, therefore, that option two is clearly better than option one.</p> <p>In section 6.3.2. the paper comments that “the process might be designed to ensure that a receiver would be appointed ... within the period of the existing prudential arrangements”. Contact notes that that the appointment of a receiver does not stop the potential cost to generators, rather this can only be achieved through the transfer of the customers to a solvent retailer. The paper's logic is faulty.</p> <p>The key advantage of this option is that by providing a real sanction in the event of default, retailers would at least face some risk and as a result more effectively manage their risk. This would be efficient, since it improves retailer risk management and reduces the risk of retailer failure. This is in the long term interests of customers, since it would reduce their risk of being exposed to a failed retailer. There would also be a reduced risk of damage to the reputation of the electricity market. Nevertheless, this sanction is limited relative to the risks potentially carried by retailers.</p> <p>Allowing a retailer to be put into receivership would also likely reduce the time necessary to transfer customers to a solvent retailer. By reducing this time, this option would reduce the extent to which the “prudential excess” needs to be increased to appropriately signal the cost of retailer risk, and ensure that retailers appropriately manage that risk. Nevertheless, this option falls well short of fully signalling the extent of retailer risk.</p>

<p>9</p>	<p>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?</p>	<p>No.</p> <p>The paper does not properly identify the advantages, although to a limited extent the key advantages are set out in the disadvantages to option two (which is in itself confusing). The key advantages are that:</p> <ul style="list-style-type: none"> • the costs of a retailers own risk taking would be borne by the retailer and so the retailer would be required to effectively manage these risks; and • by allowing for a relatively quick exit of a failed retailer from the market the need for an extended "prudential excess" to appropriately signal the cost of risk taking by retailers is reduced. On this basis, stronger retailer exit provisions would potentially reduce the cost of risk management. <p>Contact is aware that the Electricity Authority has been made aware of these key advantages, including through discussions with its Australian counterpart. Contact would like to see these discussions reflected in the Authority's work on this issue.</p> <p>A key mechanism for retailers to cover risk is through entering hedge arrangements. If the prudential excess does not equal the reasonable worst case exit period then prudential security arrangements are not reflecting the level of risk created through market exposures – so that retailers have an incentive not to hedge. This may result in these arrangements being under-priced and insufficient reserve cover being purchased for the market. This highlights the need for the retailer default arrangements to be connected to the prudential security arrangements; and that other options exist to reduce the cost of providing security to retailers. In particular, by extending the set of hedge arrangements that can be registered with the clearing manager and allowing net payment the overall cost of prudential security could be reduced. The cost imposed on retailers by these changes should only be considered in the light of other mechanisms to reduce the cost of retailing.</p> <p>Please note 2 further practical considerations to bear in mind in respect of a mechanism to transfer customers. These were highlighted by the E-gas group of companies liquidation:</p> <ul style="list-style-type: none"> • If a retailer default results in stranded customers with no retailer (as happened with some E-gas customers) then the associated consumption becomes unaccounted for electricity allocated to all participants. This in turn impacts remaining retailers via energy settlements and network settlements (where there is GXP pricing or ICP pricing with scaling); • Even with E-gas only having 7000 customers it proved to be quite challenging to set up the transferred customers outside the normal switching process. Sufficient time should be built in to allow switching to take place.
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