meridian

19 March 2012

Retail Advisory Group
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RAG Discussion Paper on Retail Customers in Retailer Default Situations

Meridian is pleased to provide feedback on the above paper noting the importance of market arrangements which will:

- provide confidence to electricity users that the supply of an essential service will not be disrupted by the insolvency of their electricity retailer; and
- protect industry participants, who, unlike participants in most other industries, have limited ability to cease supplying services, from significant losses in the event a market participant becomes insolvent.

This submission is made on behalf of Meridian and its subsidiary Powershop.

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

Meridian considers that the consultation paper captures the main elements of the settlement risk allocation under NZEM. In particular Meridian recalls that:

- the prudential arrangements were intended to provide sufficient cover to sellers in a blind market to give them confidence in the settlement process; and
- the right to appoint a receiver was designed to stem the losses which would otherwise accrue in the event a retailer became insolvent.

It should be noted that at the time the NZEM rules were developed, there was a strong expectation that a customer book would always have positive value. It followed that supply continuity was not considered to be an issue. Meridian agrees with the RAG's comments in paragraph 3.4.4. that greater volatility in electricity prices and a greater tendency amongst consumers to switch suppliers may have lowered the residual value of customers relative to the past.

Meridian observes that energy companies are now much more likely to have a closer balance between their generation and retail interests. This means that there is a real prospect that retailers might be reluctant to purchase some customers of a failed retailer particularly during an extended dry period.

In addition, there is now also much wider variety of contract offers available to consumers. Some of a defaulting retailer's contracts may not be attractive to other retailers, particularly taking into account the fixed costs of each new customer.

The insolvent retailer might be in default because of its poor knowledge of the profitability of various customer groups. In order for a sales agent to effect a timely sale of a defaulting retailer's customers, good information would need to be made available to the market on the nature of the defaulting retailer's customer contracts.

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

It is clear that the transition from a contract-based to a legislated market has increased the risk for market participants with respect to a failed retailer.

The inability of the clearing manager to appoint a receiver under the Code means that generators have no protection from incurring ongoing losses even when the insolvency of a market participant is well known. This is because consumers are likely to continue to take electricity from the grid irrespective of the solvency status of their market intermediary (the defaulting retailer).

Lines companies will also face ongoing losses under their bilateral contracts with the defaulting retailer. This is most unusual as trading with an insolvent company would normally only occur on a voluntary basis with additional surety such as a receiver's personal guarantee.

Meridian agrees the Authority has the power to pass urgent regulations to address a retailer default. However the current "backstop Code amendments" are of considerable concern to Meridian as they provide no clarity for industry participants as to how the defaulting retailer customer base would be allocated or transfer fees established, and no cap to the liabilities potentially transferred to the acquiring retailer under the existing contracts.

Q3. Do you agree or disagree with our summary of possible scenarios that could develop once a retailer begins to fail? Please provide reasons.

Meridian considers that **in relation to each block of customers** held by a defaulting retailer the possible scenarios include retention of customers and return to profitability, transfer to another retailer by either a voluntary customer-initiated switch or a commercial sales process, mandatory transfer to other retailers or disconnection of customers. The mandatory transfer could occur by either urgent regulations made by the Authority if the defaulting retailer's customer contracts permitted assignment or under a separate piece of legislation passed by central government.

However within these scenarios Meridian notes there is room for a number of outcomes which would undermine industry and/or consumer confidence in the market. For example if there was a long period of uncertainty in the outcome for a group of customers, or extensive losses to industry participants (including net generators, lines companies, Transpower, service providers and the Authority in terms of levies and ongoing tax liability) whilst new arrangements were being put in place.

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.

Efforts to secure a transfer of a failed retailer's customer base might prove unsuccessful if:

- The process relied on the power of a receiver or liquidator to sell and there were competing priorities or challenges to those rights resulting in a drawn out legal process;
- The sales agent had difficulties getting the information required by the market about the customer base;
- Cherry-picking of customers occurred resulting in a block of unattractive customers which no retailer wanted;
- Contract terms meant that there were no offers acceptable to the sales agent;
- A prolonged dry period or other supply event meant there was little interest amongst remaining generator-retailers in expanding their current retail base; or
- The purchase price sought for each customer was higher than the cost retailers consider they can acquire customers for.

Meridian is not qualified to comment definitively on the likelihood that efforts to secure a transfer of a failed retailer's customer base on a voluntary basis would fail but considers that it is likely in at least some circumstances. However Meridian's view is that providing for mandatory transfer of customers in the Code will increase the likelihood of a failure to secure a voluntary transfer of customers. This is because other retailers are likely to view the prospect of paying for customers as commercially undesirable when, if the retailer fails, it will secure a share of them for nothing.

Q5. Do you think it plausible that customers of a failed retailer would be disconnected from their electrical supply? Please provide reasons.

A number of Meridian's current use of system agreements give lines companies the power to disconnect retail customers in the event of Meridian's failure to comply with the provisions of its use of system agreement.

Meridian assumes other retailers have similar clauses. Disconnection rights are also preserved in the MUoSA (albeit with improved notification requirements). On this basis Meridian considers that a number of lines companies would have the contractual right to withdraw lines services from customers if their charges were not paid on the due date.

Lines companies regardless of whether they are in public or private ownership are likely to be very sensitive to the public relations issues associated with disconnection so would only exercise these rights when the default was considered sufficient to affect their own solvency requirements. Meridian therefore considers it unlikely that customers of a failed retailer would be disconnected from their electrical supply.

However, directors of lines companies have duties to maintain the solvency of their organisation. Recent Code changes have limited the amount of prudential security lines companies are able to seek from retailers to reduce their credit risk. This means that lines companies are likely to have significant concerns if network services continued to be used by a defaulting retailer without guarantee of payment.

In Meridian's view it is unlikely that lines companies' own governance processes would permit them to sit back quietly as their debts grow. Instead, the inequity of continuing supply to a defaulting retailer would trigger sustained lobbying of Government and/or media campaigns to improve lines companies' position. Generators would be in a similar position particularly if they saw customer electricity payments to an insolvent retailer being siphoned off to meet other debts of the insolvent retailer.

The resulting publicity would raise concerns amongst consumers, particularly consumers who might not consider themselves an attractive supply proposition, and inevitably lead to some kind of ad hoc government intervention.

Q6-7. Do you agree or disagree that this summary identifies correctly the problems with the current arrangements for governing a retailer failure; are there any additional problems we have not identified? Please provide reasons. Do you consider the problems with the current arrangements for governing retailer failure are of sufficient magnitude to rule out doing nothing to address the identified problem? Please provide reasons.

The summary correctly identifies the problems with the current arrangements which provide limited redress to market participants locked into a supply chain with a defaulting retailer, with the most likely outcome being adverse publicity undermining consumer confidence and ad hoc legislative intervention.

Meridian believes a solution is required which will provide confidence to market participants that any losses will be capped and manageable whilst maintaining continuity of supply to consumers. However, the probability of an insolvency event is low which means great care needs to be taken to design a solution which is efficient, well-understood, intrudes on retailer's rights only to the extent absolutely necessary, and has a low ongoing cost to the market and consumers.

Q8. Have we identified the 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 prudential cover?

The paper correctly identifies the advantages of the appointment of a receiver. Meridian assumes that if receivership clauses were reinserted into the Code, the Authority would also include provisions requiring all customer contracts to permit assignment to another retailer.

In terms of the disadvantages, one issue is the fact that it is an incomplete solution as this mechanism relies on the market supplying a willing purchaser for each block of customers. For the reasons noted previously this may not occur in all circumstances.

Another issue is the impact of a Code power to appoint a receiver on the existing financial arrangements of industry participants, and in particular their ability to secure funding. We anticipate that a number of industry participants will, as part of their financial arrangements, be subject to negative pledge arrangements requiring them not to create or subsist or permit to subsist any security interest over their assets (subject to some exceptions). Some may also be subject to existing financial arrangements giving their banks or others the power to appoint a receiver over their assets (including customer debts and contracts). Meridian would like further information about the Electricity Authority's proposals so it can assess whether these proposals:

- would arguably amount to a security interest over assets; and/or
- alternatively, are within the common exceptions to negative pledge arrangements.

Meridian would also like to understand more about the legal position if there were competing rights to appoint a receiver, for example between the Clearing Manager and a participant's existing creditor (such as a bank) and/or a lines company. Would the Clearing Manager as part of its process ensure it has first priority to sell a defaulting retailers' customer base within timeframes acceptable to the relevant stakeholders? What would occur if an existing creditor had already appointed a receiver? Would that receiver take appointment subject to the deed between it and the appointer without reference to the industry and mean that the claims of generators and distributors would rank as unsecured debts, leaving the industry no better off? In the absence of that information Meridian is unable to offer firm support for the proposal.

Q.9 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?

The paper correctly notes there is a trade-off to be made between providing absolute certainty to consumers and costs to acquiring retailers. There is also a cost to the failing retailer in that they (or their receiver) lose the value of, and control over, a major asset (namely their customer base). There is also a middle ground between those two options.

Consumers are used to the consequences of insolvency and will want but not necessarily expect an acquiring retailer to supply electricity on the same terms as the insolvent retailer's contracts[1].

Taking this into account, Meridian's preference would be for a transfer mechanism with the following core features:

- Allocation of the insolvent retailers customer base to be undertaken by the Authority on the basis of market share for each GXP[2];

[1] For instance, consumers experienced the situation recently where their Borders/Whitcoulls gift vouchers were redeemed on different terms and conditions by administrators.

- Able to be used for up to 5% of total customers, or alternatively, those customers with qualifying meters under the Customer Compensation Scheme;
- Customers to be free to switch to an alternative supplier at all times in the transfer process (unless a short period of suspension is required for administrative reasons); and
- Acquiring retailers would be permitted to transfer assigned customers to the most appropriate of their existing product offerings within a specified period of transfer e.g. three months (this would need to be a regulated term for each customer contract).

This proposal would mitigate the costs imposed on the acquiring retailers of a mandatory scheme and have lower overall administrative costs than some of the alternatives, whilst targeting those most at risk of “stranding” (small, domestic customers).

It is preferable to the current "backstop" amendments as it provides more certainty to generator-retailers as to the potential scale of their liability in the event of retailer insolvency.

A possible effect, however, is that the proposal (as could the Authority’s proposal for backstop Code amendments) could lead to difficulties in securing bank financing and increased financing costs for small retailers whose customer debts make up a significant proportion of their balance sheet, and whose assets are largely comprised of its customer contracts. We note that proposals for a mandatory transfer of customers on retailer default could therefore effectively act as a barrier to new entrant retailers.

Another issue that may need to be addressed is that the Authority would need to have access to sufficient information to enable it to ensure that only customers of the defaulting retailer, and not those whose services are provided under the contract of a third party, would be eligible for mandatory transfer.

Concluding Comments

Meridian believes that there is a need for the Authority to introduce measures to address retailer insolvency because of the high impact of such an event on the market.

Meridian is not yet in a position to offer firm support for the mechanisms proposed by the RAG on the basis of information provided to-date and, in particular, would welcome further information on what would happen in the event of competing rights of appointment amongst receivers and to inform assessments of the compatibility of these changes with negative pledge agreements.

Meridian’s current preference would be for a two pronged approach, whereby:

1. Subject to:
    - compatibility with existing agreements with creditors; and
    - the Authority first satisfying itself that it would be entitled to a first charge over assets,

[2] Many retailers do not retail on all GXP’s within a network. Retailers should not be forced to take customers where they do not currently trade, given that they will have made decisions about where to trade based on transmission and other risks.

the receivership provisions are reinserted along with Code amendments which require customer contracts to permit sale or assignment by a receiver; and

2. A simple transfer mechanism for the insolvent retailers' customers most at risk of stranding is included in the Code along with Code amendments which would ensure that in the event the mandatory transfer provisions were triggered by the Authority the acquiring retailer, after following an appropriate process, could transfer the customers to one of its own product offerings.

At each stage in the process, customers should be free to select their own alternative retailer.

Such an arrangement would appear to offer advantages of maintaining the credibility of the market, mitigating the losses flowing to generators and lines companies and reducing the risk of ad hoc government intervention to protect the interests of consumers, particularly those likely to be seen as less attractive in a market sales process.

Meridian is pleased to note the RAG has been engaging on the review of the settlement and prudential security arrangements currently being progressed by the EA's WAG. It is critical that this integrally linked review continues to be informed by the RAG's work and that no code amendments are pursued until such a time as there is reasonable clarity on the nature of any changes arising from the WAG's review.

Yours sincerely

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