19 March 2012

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

by email: rag@ea.govt.nz

SUBMISSION ON RETAILER DEFAULT SITUATIONS

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the "Retail customers in retailer default situations" discussion paper (the **paper**) released by the Retail Advisory Group (**RAG**) in February 2012.

2 We consider that the paper is a very good summary of the issues, although we consider that it could usefully have proposed a preferred option for a way forward. That aside, the body of our submission comments on only a few areas.

3 We have provided responses to the paper's specific questions as an appendix.

General comments

4 Orion considers that history has shown that retailer default in the New Zealand market is a real and extremely important issue. We agree with the paper that:

> *"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."*

5 Having said that we consider that disconnection of electricity supply to customers, because one or more parties in the supply chain do not receive the funds paid by customers (and the customer has not been able to contract with a new retailer) is not a realistic or practical option. Unfortunately we believe that the Authority has exacerbated the possibility of disconnection in the event of retailer default with its recent changes to the prudential requirements that

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distributors can require of retailers.

6 While we acknowledge the paper's observation that there is no explicit universal supply obligation for electricity in New Zealand we also concur with the observation that consumers are likely to have an implicit expectation that they will receive an electricity supply.

Information to switch customers

7 Regarding the possibility (discussed in section 3.8 of the paper) that an insolvent retailer may seek to delay switching, we think this is a very minor risk. We believe that by far the most likely cause of retailer insolvency is high spot prices where the retailer has inadequate hedge cover and fixed price retail obligations. In this situation every kWh that the retailer sells to a consumer will be at a loss and can only worsen the (net) cash flow situation. The incentive will be to exit customers as soon as possible. There is also the possibility that a business delaying switching when insolvent could expose itself to criminal prosecution?

Existing prudential requirements

8 Section 4.1 a) refers to "existing terms [that] protect … distribution companies." Given the recent Participation Code changes, Orion does not believe that we (or distributors in general) will be so protected in future. In fact the changes have very specifically been made to socialise such costs and risks. We do not agree that socialisation is appropriate, but the RAG, or perhaps more appropriately the Authority, needs to explain why the distributor approach does not apply to generators?

"**Stranded" customers**

9 It is probably true that all retailers, at any point in time, have a group of customers whose payment characteristics make them undesirable acquisitions. However we doubt this is a significant consideration in dealing with a retailer default situation, as we see no reason why a defaulting retailer's book would be much different to the average of other retailers. In any case the problem is really only an issue if there is a compulsory element to the customer transfer.

10 Incidentally the paper continues a confusion which frequently muddies the waters. Prepay *metering* is not required to deliver prepayment solutions.

Risk of cascade failure

11 The point made in para 6.3.9 is a very important one. The nature of the New Zealand wholesale market is that spot prices can go very high for a long time. Furthermore all retailers (or at least all prudent ones), be they closely aligned

with a generator or not, carefully manage their risk positions. Any process which can *compulsorily* require retailers to take on more customers in the event of another retailer's default potentially changes the game significantly and, other things equal, could quite conceivably cause a default by one or more of the recipient retailers. This suggests that the Authority should be very cautious in establishing a compulsory regime, and careful about how it structures the terms of that regime. For example if the acquiring retailer is required to honour the terms and conditions, and in particular the prices, of the defaulting retailer (which may not have been appropriate to start with) the risk of cascade failure is that much higher.

12 We would also note that, in an environment of high spot prices, the sensitivity of the risk positions of the non defaulting retailers to (proportional) changes in their retail positions will not be the same. Put more bluntly, a predominantly hydro generator will be less financially able to absorb additional customers when storage is low than will a predominantly thermal generator.

13 The risk of retailer default causing significant problems for other participants (retailers and distributors) and consumers is one reason why prudential requirements need to be robust.

Suspension and termination

14 We note that the paper uses terminology somewhat loosely and appears to assume that the defined terms **purchaser** and **retailer** can be used interchangeably, we disagree.

15 We believe that the paper has incorrectly interpreted s49(3) of the Electricity Industry Act 2010 in relation to the Authority's power to suspend a retailer's right to trade. S49(3) refers to generators and purchasers: retailers are not mentioned in this section.

16 To further confuse the issue we note that generator, purchaser, retailer and trader are defined in the Code in a different way to in the Act.

17 We note that the Authority has recently proposed a change to the definition of retailer[1] as they have recognised that not all retailers do purchase electricity from the Clearing Manager. However we do not believe that the proposed change to the definition of retailer in the Code will resolve the issue we have raised in relation to s49(3).

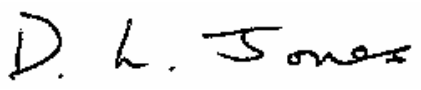
[1] Miscellaneous Code Amendments Consultation paper 9 March 2012

18 However we would agree that even if the Act could be interpreted (or was changed) so that s49(3) applies to a retailer, then suspension of a retailer in default would have limited practical effect.

Concluding remarks

19 Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely



Dennis Jones
Industry Developments Manager

Appendix: Responses to specific questions

Question	Response
Q1: 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?	Yes it captures the main elements. We note that the only example of retailer exit that really informs discussion about the consequences of default is the On energy exit in 2001. It is also interesting in that it was a very significant portion of the market, showing that this is not just about small entrant retailers at the margin: any mechanism needs to accommodate possibly large scale events. We note in this regard that with the On energy exit the transfer of financial responsibility for wholesale and other (eg distributor) payment obligations happened many months in advance of the actual operational switch of the (several hundred thousand) connections/customers, which was itself a major project. This depended on the seller maintaining operational capability and cooperating fully. It is conceivable that future circumstances could be quite different.
Q2: Do you agree with our summary of the regulatory tools that are available in the case of a failed retailer?	Not entirely. s49(3) of the electricity Act provides that the Authority has the right to suspend generators and purchasers; retailers are not mentioned in this section. The paper appears to assume the terms purchaser and retailer can be used interchangeably - we disagree. To further confuse the issue we note that generator, purchaser, retailer and trader are defined in the Code in a different way to in the Act. However we would agree that if the Act could be interpreted as applying to a retailer that suspension of a retailer in default would have limited practical effect.
Q3: Do you agree with our summary of possible scenarios that could develop once a retailer begins to fail?	Yes. Given the reduction in the prudential security available to distributors, it seems likely that they will act earlier than they would have previously, and this may take the Clearing Manager by surprise.
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?	We consider that there probably is a price at which a voluntary transfer would be achieved. We are not sure this will always be on terms that leave generators with no residual exposure, and nor that the terms and conditions offered to customers would be able to be maintained.

Q5: Do you think it plausible that customers of a failed retailer would be disconnected from their electrical supply?	It is important to distinguish between practical and principled reasons for not disconnecting. It is probably *impractical* to disconnect large numbers of customers. However practicality problems may well be overcome by the capabilities of smart metering. Of more importance is whether it is fair and reasonable to disconnect the customers of a failing retailer. We would agree that in nearly all circumstances it is not, because we do not consider that customers are well placed to assess the solvency of a retailer. On the other hand this reinforces the need for robust prudential requirements so that retailers with socially inefficient business models cannot enter in the first place. Unfortunately we believe that the Authority has exacerbated the possibility of disconnection in the event of retailer default with its recent changes to the prudential requirements that distributors can require of retailers. Moreover there are circumstances where it may be both practical and reasonable to disconnect larger customers (for example, direct connect customers) as part of an arrangement with the Clearing Manager.
Q6: 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?	We agree that the summary identifies the problems with the current arrangements, noting our comments on the ability of the Authority to suspend retailers and that there is significant risk of socialisation of cost and risk with the existing arrangements, and therefore inefficient outcomes. Whatever default-retailer arrangements are put in place should seek to minimise such inefficiencies.
Q7: 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?	We agree that the current arrangements for governing retail failure are of sufficient magnitude to rule out doing nothing. There is a significant cross over here with prudential requirements. If these are sufficiently robust (which we do not believe they currently are for distributors) for there to be virtually no chance of the residual risk bearers being out of pocket, and / or customers being disconnected/stranded, then “do nothing” (or more accurately leaving the outcome to voluntary arrangements) might be an option. At a minimum the Authority would have to review and significantly increase the current minimum distributor prudential requirements to make this practical, however if there is a strong presumption as to outcome and timeliness built into prudentials, then at least a backstop arrangement is probably necessary.
Q8: Have we identified the relevant costs and benefits of a mechanism to allow the Clearing Manager to	Perhaps more importantly, how under NZ law can the Clearing Manager be made able to appoint a receiver? Having the ability as an option must be an advantage. In addition as the paper indicates

appoint a receiver if a retailer is in default for a period that exceeds its prudential cover?	the retailer's main asset may be its customer base which may have very little residual value, in which case it is unlikely that creditors such as generators and distributors will be ultimately paid.
Q9: 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?	We are not sure that the options discussed in section 6 are exclusive options. Depending on the overall timeframe available it might be possible to allow a voluntary process to proceed for some period. We also generally support approaches that provide choice where these are possible, for example having some sort of tender (pre or post default) to determine the parties most appropriate (and willing) to take on the customers. Both this and the idea of compensation of the recipient retailer raise the issue of *how* this is to be funded. We would argue that this should either be funded from all consumers (on the argument that they are the ultimate beneficiaries) or funded by those that create the risk.