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Submission on retailer default situations

1. Vector welcomes the opportunity to respond to the Retail Advisory Group's consultation paper entitled *Retail customers in retailer default situations: Discussion paper* (the "consultation paper").
2. Vector's contact person for this submission is:
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Overall comments

The paper contains useful analysis of an important issue...

3. Vector welcomes the Advisory Group's focus on potential retailer default. This is a live issue within the electricity market today in which one retailer in particular is experiencing some difficulties in meeting its payment obligations.
4. The experience faced in the gas sector during the E-gas liquidation (discussed further below) also highlights the negative impacts such an event can have on consumers and other industry participants.
5. Vector strongly supports initiatives to ensure an orderly management of retailer default, which minimises impacts on consumers and other industry participants. Vector would support Code provisions that ensure continuity of supply and appropriate payment to suppliers (distributors, meter owners, etc).

6. In our view, the options presented in the paper represent a reasonable range of options for consideration and there is some valuable analysis.

... but is unbalanced and one-sided in its consideration of the issues...

7. However, Vector is concerned by the unbalanced nature of the consultation paper. The paper has an excessive focus on the potential failure of a retailer to make payments to the Clearing Manager. While we recognise that earlier drafts were even more focused on the Clearing Manager and there have been some attempts to insert material regarding other market participants, the overall impression from the paper is still that the Clearing Manager is the only participant for whom default really matters. This may simply be a drafting issue¹ but it is nevertheless concerning to Vector.

8. Vector is very concerned, for example, by comments such as this:

“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**”² [emphasis added]

9. This analysis does not address any situation where a retailer continues to pay the Clearing Manager but fails to pay other industry participants. That is still a case of a retailer defaulting on its payment obligations but would seem unable to trigger the mechanisms being considered.

... because it seems primarily (if not only) to be concerned with non-payment to the Clearing Manager, ignoring the risks faced by other participants...

10. Large sections of discussion focus only on payments to the Clearing Manager and the specific questions that have been asked appear to ignore other types of retailer default. While we do not dispute that a retailer defaulting on payments to the Clearing Manager is an important issue, it is by no means the only method by which a retailer default could have a negative impact on consumers and the electricity market. Vector **recommends** the focus of the Advisory Group and any recommendations it makes to the Electricity Authority (“Authority”) is broad based and addresses the risks that the entire industry faces, rather than just a part of it.
11. We note that the Authority’s interpretation of its objective does not focus excessively on the wholesale market and recognises that other parts of the

¹ For example, we note that the questions regarding options 2 and 3 refer only to the Clearing Manager, while the discussions of the options indicate that they would most likely apply more broadly. This could indicate that the questions were prepared earlier and not changed with the later drafting amendments.

² Consultation paper, paragraph 14.

market are of importance.³ Vector **recommends** the Advisory Group take a similar approach.

...and does not recognise that the Clearing Manager is already better protected from non-payment than other market participants.

12. Vector would be concerned if the retailer default arrangements were set in such a way as to encourage retailers to continue paying one market participant at the expense of others – such an approach is inequitable and unjustified.
13. We note that there are already heavier penalties in place (and larger prudentials at risk) for failure to pay the Clearing Manager. It is already the case that the Clearing Manager is generally the last creditor to be defaulted, so we do not see why they, in particular, need greater protection. Any arrangement that exacerbates this situation will simply make it even less likely that other participants will be paid by the retailer. We would be interested to see any quantified analysis that justifies such an outcome or that justifies the focus on the Clearing Manager payments rather than payments to other industry participants.

Discussion of the options

Vector does not support option 1...

14. Given the likely impacts of retailer defaults on the industry and the market, we do not consider that option 1, doing nothing, is a viable option.

... and considers that option 2 and 3 are potentially complementary...

15. Vector considers that options 2 and 3 are not mutually exclusive. If implemented, option 2 (the ability to appoint the receiver) should **not** be restricted to the Clearing Manager. The Authority should have this right in clearly defined circumstances. Those circumstances must not be limited to a retailer's failure to make payments into the wholesale market. This is a whole-of-industry issue and requires a broad focus.

... and strongly supports option 3 as the optimal solution, provided it is not limited to the needs of the Clearing Manager.

16. Vector strongly supports option 3. The need for option 3 is not materially reduced even if option 2 is implemented.
17. Permanent regulations would ensure the complete and timely transfer of an insolvent retailer's customers to other retailers, without which market participants face significant financial risks while the transfer is not completed.

³ Electricity Authority, *Interpretation of the Authority's Statutory Objective*, 14 February 2011.

The inability to transfer customers efficiently is a case of market failure that requires regulatory intervention.

18. Having Code provisions in place in advance will make it more likely that insolvency events can be properly managed and financial impacts on other industry participants minimised, reducing the risk of customer disruption.

Regulations to govern the transfer of customers should be developed in advance

19. While the Authority can make urgent Code amendments if required, by necessity these would be made without consultation and at speed. Such a process is not conducive to the development of robust regulation, even if any urgent amendment would expire within nine months of coming into force, nor will it promote certainty within the industry.
20. It would be preferable for the Authority to have pre-developed Code provisions in place that have been through a full consultative process. This would provide certainty to the market about how retailer insolvency events would be managed and provide greater assurance that the regulations are fit for purpose.

Co-ordinated approach

The electricity and gas regulators should ensure their work is complementary...

21. The Gas Industry Company ("GIC") developed urgent regulations to allow for the transfer of customers during the E-gas liquidation,⁴ although ultimately the regulations were not used. The GIC's workplan includes a workstream to consider developing permanent regulations, which are strongly supported across the gas industry.
22. Vector **recommends** the Authority and the GIC work together to develop regulations that transfer customers of retailers that default. Retailers that default may well be both gas and electricity retailers and a combined process for transferring their customers would improve certainty within the market and mitigate risks of customer and industry confusion. For example, if a retailer that supplies both gas and electricity fails, then customers who purchase both gas and electricity from that retailer may prefer to be transferred to another retailer who can provide them with both gas and electricity.

... and retailer default should be considered in the context of related issues

23. Ultimately, when a retailer fails it imposes costs on consumers and other market participants. Vector is concerned that the Authority's previous work on distributors' prudential requirements was separate from this retailer default project. Also, there appears to be no consideration of whether there

⁴ Gas (Insolvent Retailers) Regulations 2010.

should be more stringent requirements on parties seeking to become retailers (e.g. have systems and processes in place to meet legal requirements of retailers, not have a director who was a director of a previously failed business). All of these issues are linked and Vector **recommends** they are considered in a comprehensive manner. The current piecemeal approach is not desirable.

Distributors will be exposed to more than 37 days line charges

24. The consultation paper states that, allowing for 14 days of prudentials, “a distributor that invoices in arrears may be exposed to **up to** 37 days of unpaid line charges were the default to occur on the 20th of the month” [emphasis added].⁵ This is simply incorrect and reveals a key misunderstanding of the nature of the credit risk faced by distributors.
25. The 37 days of line charges only covers the period up to the point of default. A retailer is highly unlikely to enter into liquidation immediately as of that date. As set out in pages 46-47 of the consultation paper, industry standard practice is to provide at least 8 working days to serve a notice of default and allow time for the retailer to rectify the situation. Then at least 11 working days are needed to notify customers and ask them to transfer to a new retailer. Even at that point, as the consultation paper recognises, it is very difficult for a distributor to disconnect a customer.
26. In practice, distributors will spend considerable time and effort persuading customers of failed retailers to move, which can involve requirements to physically visit each customer, at considerable cost to the distributor. It should be recognised that, due to the difficulties faced in disconnecting customers, the incentives on customers to switch are very limited. This point further emphasises the need for clear regulations to govern the transfer of customers from defaulting retailers.
27. The distributor will therefore face at least an additional month of lost revenues beyond the 37 days, and most likely will lose more from the customers that are difficult to switch. Vector **recommends** the final advice to the Authority from the Advisory Group provides correct information in this regard. We are happy to provide more details to the Advisory Group if that would be helpful.
28. Further, where retailers self-report their billing Vector has experienced situations where retailers attempt to delay or hide components of debt that they owe. Therefore the amount of arrears may be greater than is recognised on the day of default.

⁵ Consultation paper, paragraph 5.14. A similar comment is made in paragraph G.1.5.

Key lessons from the E-gas liquidation

29. As a gas distribution business, Vector has had first-hand experience of the impact of a recent retailer liquidation. A regulatory mechanism to ensure the orderly transfer of customers is vital to avoid the difficulties experienced during the E-gas liquidation. In our view, the discussion in Appendix C of the consultation paper regarding the E-gas liquidation is incomplete as it implies that all customers were transferred to Nova.⁶ As we discuss below, this is not what occurred.
30. Firstly, there were customers on the Vector network that were not purchased by Nova as they were viewed as being unprofitable. Vector was then required to enter into a lengthy process of personally contacting and visiting each one to persuade them to change retailers. This took time, during which the customers continued to use gas.
31. Further, Vector originally believed all customers switched to the purchaser after 42 days, except those that Nova considered unprofitable. Later, after conducting a spot check, we discovered that further customers were actively consuming gas but had been considered inactive by E-gas. It took Vector several months to follow-up with a further 167 customers and ensure all of these customers were switched to a new retailer or had stopped using gas. This type of situation is relatively more likely to arise with insolvent retailers as they are the retailers most likely to have inefficient systems which allow customers to use energy without being billed.
32. Based on our experience, the E-gas liquidation has demonstrated that retailer liquidations have negative impacts for both customers and other industry participants:
 - a) E-gas customers suffered as, without any notice, they received a letter (from the liquidator) effectively stating they would be disconnected in four days if they did not find a new retailer. Some of the larger customers in particular felt they were being given little choice in their gas supplier. Overall, the situation came as a real and unpleasant shock to customers.
 - b) Distributors such as Vector experienced difficulties as substantial resources were required to contact the affected customers, explain their options and persuade them to change retailers; in some cases site visits were necessary.

Other points

33. Paragraph 3.1.3 identifies various negative impacts possibly due to retailer default. We note that financial impacts on participants in the supply chain

⁶ Consultation paper, paragraph C.1.8.

are also likely to have affects on consumers as the increased costs caused will eventually be felt by consumers.

34. Further, we do not consider that the risk that customers may have to pay higher prices should necessarily be seen as a problem – the customers’ prices may have been lower than was sustainable by the market and hence caused the failure of the retailer. In such circumstances, higher prices from the new (and surviving) retailer may still be competitive.

Responses to questions

35. Appendix A of this submission contains Vector’s responses to the specific questions asked in the consultation paper.

Code drafting recommendations

36. Appendix B of this submission contains some recommendations for new Code requirements to transfer customers of retailers that enter into liquidation. These recommendations are based on the emergency regulations developed by the GIC and the Authority’s Guidelines for Managing Retailer Default Situations.

Yours sincerely,



Bruce Girdwood
Manager Regulatory Affairs

APPENDIX A: ANSWERS TO SPECIFIC QUESTIONS

<p>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?</p>	<p>The summary is no doubt accurate as it reflects the Clearing Manager arrangements. However, it is a fairly distorted discussion as it ignores other industry payment requirements.</p> <p>The key omission from our perspective is that the summary does not mention that retailers and distributors were still integrated entities when the NZEM was established. Thus there was no need to establish market rules for failures by retailers to pay line charges to distributors.</p> <p>After the split of retail and distribution, prudential requirements were established by which distributors could manage their risk of non-payment by retailers. These arrangements have recently been eroded by the Authority. The discussion in the consultation paper does not cover the impact of these points adequately.</p>
<p>Question two: Do you agree with our summary of the regulatory tools that are available in the case of a failed retailer?</p>	<p>This summary, while not inaccurate, is also distorted by an excessive focus on Clearing Manager arrangements at the expense of consideration of other parts of the industry.</p> <p>We recommend this is re-written taking a more balanced view of the New Zealand electricity industry.</p>
<p>Question three: Do you agree with our summary of possible scenarios that could develop once a retailer begins to fail?</p>	<p>The summary is accurate as regards current industry arrangements.</p>
<p>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?</p>	<p>Provided suitable Code provisions are in place to manage customer transfers from failed retailers to other retailers, we see no reason why a transfer of customers should be unsuccessful.</p>
<p>Question five: Do you think it plausible that customers of a failed retailer would be disconnected from their electrical supply?</p>	<p>As discussed in the consultation paper, it is unlikely that distributors would disconnect customers due to the impact that would have and, in particular, the risks to those that are vulnerable and medically dependent.</p> <p>However, this should not reduce the imperative for meaningful customer transfer Code provisions to be put in place. As a matter of principle, distributors should not face incentives that encourage them to disconnect customers when</p>

	alternative arrangements are feasible.
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?	<p>Yes. We consider that the summary is well thought-through and clearly identifies the deficiencies with the current market arrangements.</p> <p>We note that more market participants than are discussed here may suffer from retailer non-payment. For example, metering companies also rely on payments from retailers and Vector is aware of at least one retailer that has recently experienced some difficulties with meeting its payment obligations to a metering company.</p>
Question seven: 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?	Yes. Doing nothing is not a credible option.
Question eight: 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?	<p>The title of option 2 refers to both the Authority and the Clearing Manager having the right to appoint a receiver. However, the wording of the question refers only to the Clearing Manager having this right. This makes it unclear what the option is proposing.</p> <p>The discussion of option 2 is further distorted as it focuses on the situation of non-payment to the Clearing Manager. The ability of the Authority to appoint a receiver appears to be limited to situations where the Clearing Manager recommends that the Authority appoint a receiver.</p> <p>We see no discussion of how option 2 may benefit consumers in situations where retailers fail to pay <u>other</u> market participants and the default exceeds any prudential cover.</p> <p>This is especially surprising as paragraph 5.1.1(b) of the consultation paper recognises that distributors may not have the right to appoint a receiver in cases of default.</p> <p>Vector recommends this option makes it clear that the Authority has the right to appoint a receiver. In our view, any such change to market rules should be seen as complementary, not a substitute, to the implementation of option 3.</p>

	<p>However, Vector does not support this option as a sole solution to the retailer default problem. We consider that the process for the Authority to appoint a receiver would take too long and fail to provide certainty for market participants as the Authority would need to gather information to inform the decision on receiver appointment and the Authority may also be subject to lobbying to influence their decision.</p>
<p>Question nine: 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?</p>	<p>Vector is unclear about what is being proposed as the question does not match the title of option 3 or the description of option 3 that precedes the question.</p> <p>The question implies that only the Clearing Manager would be able to transfer customers. However, option 3's title and the discussion of option 3 indicate that the Authority will be the party with that power.</p> <p>Vector strongly supports the option of regulations being in place for the <u>Authority</u> to transfer customers of a failed retailer to other retailers as quickly as practicable after a default.</p> <p>This power should <u>not</u> be vested in the Clearing Manager as that will not cover all default situations. Nor should the Authority's power be limited to situations where there is a failure to pay the Clearing Manager – the power should extend to all failures by a retailer to pay a market participant (including metering providers, who are not mentioned in paragraph 6.4.6).</p> <p>While some of the concerns raised in paragraph 30 of the consultation paper are valid, we do not consider them significant enough to outweigh the benefits of implementing a customer transfer scheme. We note that customer transfer schemes exist in overseas jurisdictions and they appear to have overcome the problems identified here.</p> <p>We submit that problems caused by the transfer of unprofitable customers could be addressed by the same approach that was taken in the equivalent gas market regulations. Under these regulations, customers are switched on the terms of their existing contract for one month and the new retailer may then negotiate a new contract. If the customer is a bad risk the retailer may choose to move them to a prepay mechanism.</p>

	<p>In relation to the concern expressed in paragraph 6.4.8(c), we consider that the risk of customers being transferred in accordance with regulations could well act as a catalyst to a sale. For example, if a retailer wants to purchase customers from an existing retailer it would need to make that purchase quickly to mitigate the risk that the regulator will step in and transfer customers.</p>
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APPENDIX B: CODE DRAFTING RECOMMENDATIONS

37. This appendix sets out some recommendations for new Code requirements to transfer customers of retailers that enter into liquidation. These recommendations are based on the emergency regulations developed by the GIC and the Authority's Guidelines for Managing Retailer Default Situations.
38. The Authority's Guidelines for Managing Retailer Default Situations contain some draft Code amendments that the Authority may make urgently during a retailer default situation. These are a good start (although they focus only on the wholesale market) but we recommend that the Authority improve them by drawing on some useful provisions from the Gas (Insolvent Retailers) Regulations 2010, which were developed during the E-gas insolvency event.
39. We recommend that the following specific improvements are made in any Code amendments:
 - a) The definition of "events of default" should be narrowed so that the event that triggers the Code amendments to come into effect is the appointment of a liquidator or receiver at a retailer. At present the draft Guidelines provide that a default payment is the trigger for customers to be transferred. This seems to be excessive – a default payment does not necessarily mean a retailer is insolvent. However, if that default payment means that the retailers' customers are transferred to other retailers, then the retailer will undoubtedly end up in liquidation.
 - b) Further, the definition of "events of default" should be broadened to include defaults in payment to a distributor and meter owner that are not remedied within the relevant notice period. As the default trigger is default in settlement, a retailer could prolong the appointment of a liquidator/receiver by continuing to settle but defaulting in payment to the distributor. The Code amendments should not incentivise this kind of behaviour and the customer transfer provisions should apply to the entire electricity market, not just the wholesale market.
 - c) Provision that any or all customers are switched to alternative retailers *with effect from the date of default/receivership/liquidation* (and, in the case of a sale of customers, provision for payment of charges incurred from the date of liquidation to the date of sale of customers). This is beneficial to both retailers and distributors as retailers will acquire the right to invoice the customer for charges from that date (instead of those customers continuing to take electricity and potentially not paying for that

electricity). It will also mean that customers do not have any incentive to delay switching retailers in order to reduce their electricity bills⁷.

- d) Clarification of the status of the transferred customer contract (e.g. a time period after which the recipient retailer can put the customers onto the recipient retailer's contract).
- e) Provision that inactive customers are also allocated a new retailer on the basis that sometimes the Registry records are not correct and inactive customers are still consuming electricity.
- f) A requirement for the Authority to pass on information from the defaulting retailer to whichever industry participants require it to give effect to the transfer of customers (see clause 9(4) of the Gas (Insolvent Retailers) Regulations).
- g) The defaulting retailer should be required to provide meter reading information and this information should also be made available to participants (see clause 15 of the Gas (Insolvent Retailers) Regulations).
- h) Clarification of what happens if a customer switches before the transfer date but the switch hasn't been completed (See clauses 9(5), 11, 12, 13 and 14 of the Gas (Insolvent Retailers) Regulations).
- i) Clarification of the status of contracts that a liquidator has disclaimed (see clause 10 of the Gas (Insolvent Retailers) Regulations).
- j) A provision allowing asset owners (e.g. meter owners) to access a property to recover equipment, check connections and, if required, disconnect sites that are not active.

⁷ This could be managed by nominating a default retailer and giving customers time to switch to an alternative retailer e.g. "you will be assigned to [name of retailer] as your energy retailer on [insert date] unless you choose another retailer before then. Charges will back date to [date of liquidation]."