Retail Advisory Group

Arrangements for managing retailer default situations

Discussion paper

14 August 2012

Note: This paper has been prepared for the purpose of the Retail Advisory Group. Content should not be interpreted as representing the views or policy of the Electricity Authority.

The Retail Advisory Group

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Contents

Tables

Figures

Executive summary

The Retail Advisory Group (RAG) has been requested by the Electricity Authority (Authority) to identify arrangements to facilitate the orderly resolution of a default situation when an electricity retailer becomes insolvent or otherwise rapidly exits the market leaving its customers without a retailer. The RAG considers that the desired outcomes are to manage a retailer default situation in a way that:

a) maintains the confidence of consumers that the electricity market will maintain a reliable electricity supply;

b) maintains the confidence of industry participants in the electricity market by establishing a mechanism for stopping the financial losses being incurred by industry participants; and

c) provides an efficient way of transferring customers of the defaulting retailer to another retailer.

The RAG published a discussion paper in February 2012 which considered the implications for consumers and industry participants should a retailer fail to pay (default on) amounts due to the clearing manager or a distributor, or in the event of the appointment of a receiver or statutory manager to the retailer, or if the retailer becomes insolvent or enters liquidation.

The RAG has concluded that a default by a retailer will not in itself cause a disruption of supply to the retailer's customers. However, creditors of the defaulting retailer may not be paid for services provided: for example, staff of the retailer may not receive their wages, distributors may not be paid line charges, metering equipment providers may not be paid for metering services and the clearing manager may not be paid for wholesale electricity purchased by the retailer. The critical problem identified by the RAG is that there is no effective mechanism to cease electricity supply to the defaulting retailer's customers, and hence no effective means under the Electricity Industry Participation Code 2010 (Code) for stopping the financial loss incurred by industry participants. The Code does not establish an effective remedy if a retailer defaults on its obligations.

In considering solutions to the identified problems, the RAG has sought, where feasible, to use existing commercial and market processes rather than relying on regulatory intervention. An unnecessarily heavy handed intervention might raise the cost of exit from and entry to the retail market, raise the cost of finance to retailers by altering the security of other debtors, and impose higher costs on sound retailers required to take on the customers of the failed retailer. These imposts would reduce the long-term competitive benefits for consumers and may raise consumer charges directly if some of the industry costs of managing a retailer default were recovered through a levy as occurs in some jurisdictions overseas.

The RAG has developed the following proposed approach for addressing a retailer default situation:

a) the Code should specify certain situations as events of default (as is currently the case). These situations should include:

    i. a failure to pay an invoice due to the clearing manager and/or a failure to restore wholesale prudential security levels (in each case, within a specified period of time); and

    ii. certain events external to the Code, for example, an appointment of a receiver or liquidator to the retailer.

b) this paper considers whether a distributor, after terminating a use-of-system agreement with a retailer as a result of an unresolved serious financial breach by that retailer, should have an option of advising the Authority that it considers an event of default exists and that this event should be subject to the proposed arrangements under the Code to manage a retailer default situation;

c) on being advised of an event of default, the Code would require the Authority to investigate the claimed event of default to determine whether an event of default exists and, if so, whether the event is material and further action is needed under the Code to manage a retailer default situation;

d) if an event of default is material, the Code could give the Authority the ability to advise the retailer and its agent (for instance, any receiver appointed to the retailer) that, unless the default had been rectified within a specified number of days, that the Authority would:

   i. communicate with all of the failed retailer's customers advising them that their retailer had defaulted, that they should switch to another retailer and that if they did not switch by a specified date the Authority would assign them to another retailer; and

   ii. proceed to terminate the retailer's rights to trade electricity under the Code.

e) as the customer base would likely comprise the main asset of the retailer, the retailer (or its agent such as a receiver) would have powerful incentives to either rectify the default if feasible or enter into a commercial sale of some or all of the customer base if a sale is achievable. The defaulting retailer faces strong incentives to act because any residual value of the customer base would diminish rapidly as customers switched away following receipt of the advice from the Authority;

f) the time period provided to the retailer under the Code to rectify the default would aim to strike a reasonable balance between providing sufficient time for the retailer (or its agent) to effect a commercial sale or rectify the default and minimising any additional financial losses where such actions are not achievable, and to maintain the confidence of consumers that the electricity market will maintain reliable electricity supply;

g) the specified period of time to rectify the default could only be extended with the approval of the parties (for example, generators) who would bear the financial risk of an extended period of time, in much the same manner that creditors might agree a plan by a debtor if that is a better option for the creditor than bankruptcy of the debtor;

h) if the default is not rectified during the specified time period, the Authority would communicate with each customer advising them that their retailer was in default and that the retailer's right to trade would be terminated. Customers would be provided with information on how to switch retailers and advised that if they had not switched within a specified number of days after the date of the letter the Authority would assign the customer to another retailer. The intent of this step is to provide the impetus and information for the great majority of customers (remaining after efforts by the retailer to sell or transfer the customers) to choose to switch to a competing retailer;

i) to cover the possibility that customers are not transferred through a commercial sale and do not voluntarily switch to another retailer, the Code would impose on retailers an obligation to have in their contracts with their customers a provision that the contract may be terminated on notice from the Authority. The Code would also require that retailers include a provision that if the contract is terminated in these circumstances, the customer would become bound by a contract with another retailer;

j) retailers in the same network area would be required by the Code to enter into contracts with customers of the defaulting retailer whose contracts have been terminated by the Authority;

k) the retailers receiving the customer would determine the prices and other terms on which they would supply the customer transferred to them; and

l) the Authority would also proceed to terminate the rights of the retailer in default to trade under the Code.

This discussion paper reviews each of the important steps in this preferred approach and evaluates the choices and implications for the design of these steps. Key questions are identified in the discussion and submissions are invited on the approach as a whole and on the design choices for each step in the preferred approach.

1 Introduction

1.1 Introduction

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

1.2 Purpose of this paper

1.2.1 The RAG has been requested by the Authority to identify arrangements to facilitate the orderly resolution of a default situation when an electricity retailer becomes insolvent or otherwise exits the market and is unable to supply its customers.

1.2.2 This discussion paper sets out the preferred approach that has been developed by the RAG and explains the rationale and implications of the steps in the preferred approach. This paper includes a regulatory statement assessing the costs and benefits of the preferred approach against the alternatives. The RAG considers that the preferred approach promotes competition in, reliable supply by, and efficient operation of the electricity industry for the long-term benefit of consumers.

1.2.3 Submissions are invited on the approach as a whole and on the design choices for each step in the preferred approach.

1.3 Provision of advice and recommendations to the Authority Board

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

1.3.2 The RAG will use feedback from industry participants and consumers on the preferred approach and design choices presented in this paper to develop advice and recommendations to the Authority Board on arrangements for managing retailer default situations.

1.4 Relationship with the Wholesale Advisory Group Settlement and Prudential Security Review

1.4.1 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.

1.4.2 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 for identifying a retailer default until either the default is rectified or all customer exposures are transferred to another, viable retailer. This interest is based on a view that the level of prudential security is sensitive to movements in the length of time taken to achieve the transfer of risk. A longer period of time allowed for resolving a retailer default situation could potentially require higher levels of prudential requirements. On the other hand, should insufficient time be allowed to effect a commercial solution (a commercially negotiated transfer of customers to a viable retailer), the industry and consumers would incur the costs of a retailer of last resort type scheme – costs that would be avoided were a commercial

resolution feasible. The nature of this trade-off, and the factors influencing the least over-all cost approach, are discussed in this paper and summarised in the regulatory assessment in chapter 6.

1.5 Relationship with distributor model use-of-system agreements and minimum terms and conditions for domestic contracts for delivered electricity

1.5.1 In addition to discussing possible Code amendments, this discussion paper refers to provisions within the draft model use-of-system agreements and the minimum terms and conditions for domestic contracts for delivered electricity. These model agreements specify timelines and processes to be followed when a retailer fails to pay a distributor and a distributor terminates its use-of-system agreement with the retailer. These timelines and processes are relevant to considering the actions that the Authority might take following an event of default by a retailer.

1.6 Relationship with Gas Industry Company arrangements for managing a retailer default situation

1.6.1 Some retailers offer their customers both electricity and gas, raising the possibility that a retailer in default may serve both electricity and gas customers. These retailers are regulated by the Gas Industry Company (GIC), which has statutory authority over services to gas consumers, and by the Authority, which has statutory authority over services to electricity consumers. Regulatory coherence, and hence least cost regulation, is promoted by intersecting regulatory agencies taking a co-ordinated, cross-disciplinary approach.

1.6.2 The GIC has commenced its own work programme to consider its arrangements for managing a default by a gas retailer. The GIC released a report in June 2012 on whether normal insolvency processes can be relied upon to produce acceptable outcomes when a gas retailer becomes insolvent. Some of the key themes in the GIC paper include:

a) for the most part, the general processes for insolvency should work in the gas sector in much the same manner as they work in any sector;

b) there is the prospect that not all customers of a failed gas retailer will be transferred through a trade sale or similar to another retailer, potentially leaving some orphaned customers;

c) the cost of supplying these orphaned customers may be picked up as unaccounted for gas and hence this can be viewed as a market failure; and

d) the prospect of the market failure is likely to be a rare event and the report's authors suggest that the cost of a regulatory intervention to address that event (such as a retailer of last resort) may outweigh the cost of the market failure.

1.6.3 The GIC paper acknowledges the differences between the electricity market and the gas market – in particular the bilateral contract basis for the gas market, where each counterparty to the contract determines its risk and prudential requirements, compared with the multilateral/Code basis for the electricity market. It is these differences between the electricity market and other markets that have led the Group to develop its back-stop provision that would ensure, ultimately, that the financial loss to participants is stopped and all customers are transferred to a viable retailer, without incurring the cost of a full retailer of last resort type scheme.

1.6.4 The RAG will continue to follow the progress of the GIC work with the objective of ensuring that the arrangements for managing a retailer default implemented by the Authority, and those implemented by the GIC, are as co-ordinated as possible, allowing for any differences due to their respective statutory powers and duties.

1.7 Structure of this paper

1.7.1 The body of this discussion paper is structured as follows:

a) *work to date* – this section provides a summary, or recap, of the critical problems identified by the RAG in its February discussion paper, summarises the main themes made in the submissions, and outlines a preferred approach to addressing the critical problems;

b) *design* – this section reviews each important step in the preferred approach and evaluates the choices and implications for the design of these steps. The issues are categorised under three main headings:

i) default events;

ii) response by the Authority; and

iii) transfer of any remaining customers; and

c) *regulatory statement* – this section provides a regulatory impact statement evaluating the Code changes necessary to implement the preferred approach, including a cost-benefit analysis and assessment of the alternative options.

1.8 Submissions

1.8.1 The RAG's preference is to receive submissions in electronic format (Microsoft Word). 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 RAG – Arrangements for managing retailer default situations" in the subject line.

1.8.2 If submitters do not wish to send their submission electronically, they should post one hard copy of their submission to one of the following addresses:

Retail Advisory Group
c/o Electricity Authority PO Box 10041
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

1.8.3 Submissions should be received by 5pm on Tuesday 25 September 2012. Please note that late submissions are unlikely to be considered. The Authority will acknowledge receipt of all submissions on behalf of the Group. Please contact the Submissions' Administrator if you do not receive acknowledgement of your submission within two business days.

1.9 Next steps

1.9.1 The RAG will consider and summarise all submissions on this discussion paper. Subject to the feedback in submissions, the RAG will develop recommendations to the Authority on a preferred approach for managing retailer default situations.

2 Work to date

2.1 The problem – a recap

2.1.1 The RAG has concluded that a default by a retailer will not in itself disrupt electricity supply to the retailer's consumers. However, creditors of the defaulting retailer may not be paid for services provided, for example, staff of the retailer may not receive their wages, distributors may not be paid line charges, metering equipment providers may not be paid for metering services and the clearing manager may not be paid for wholesale electricity purchased by the retailer. The critical problem identified by the RAG is that there is no effective mechanism to cease electricity supply to the defaulting retailer's customers, and hence no effective means under the Code for stopping the financial loss incurred by industry participants.

2.1.2 The Authority has no effective remedy if a payment is not made to the clearing manager. If a distributor is not paid for its services, there exists a contractual remedy whereby the distributor could terminate the retailer's use-of-system agreement and eventually disconnect the customers of the retailer. However, a commonly held view is that it is highly unlikely that distributors would disconnect consumers en masse in these circumstances. Disconnection of customers who have paid their bills is not seen as a tenable solution by the industry.

2.1.3 Figure 1 below summarises the existing role of the Authority under the Code following an event of default – the diagram allows for the possibility that the Authority adopts its Backstop provisions as an emergency code change. The top of the flow chart shows the various 'triggers' within the Code for an event of default.[1] These triggers can be grouped as follows:

a) An action taken against the retailer that affects its ability to meet its obligations under the Code; these actions include the appointment of a statutory manager, receiver, a liquidator or similar;[2]

b) A failure to pay the full amount invoiced to it by the clearing manager;[3] and

c) A failure to satisfy a call to top up security held by the clearing manager.[4]

2.1.4 These triggers primarily concern amounts due to the clearing manager, rather than amounts due to other industry participants, though it is conceivable that a liquidator or receiver may be appointed by a third party as a result of the retailer failing to pay that entity.

2.1.5 The immediate steps taken by the clearing manager differ depending upon the category of default – these steps include the rights of the clearing manager to call and apply prudential security following a late or missing payment and to call for additional security. However, these steps converge to the same point – an assessment by the Authority, under its Guidelines, of the risk level arising from the event of default.

2.1.6 It is at this assessment stage that the weaknesses in the existing Code become apparent:

a) there is no effective means available to the Authority to stop the financial loss incurred by generators should a retailer fail to make payments due to the clearing manager and exhaust its prudential cover;

1 Clause 14.55.

2 Clauses 14.55 (c) to (g).

3 Clause 14.55 (b).

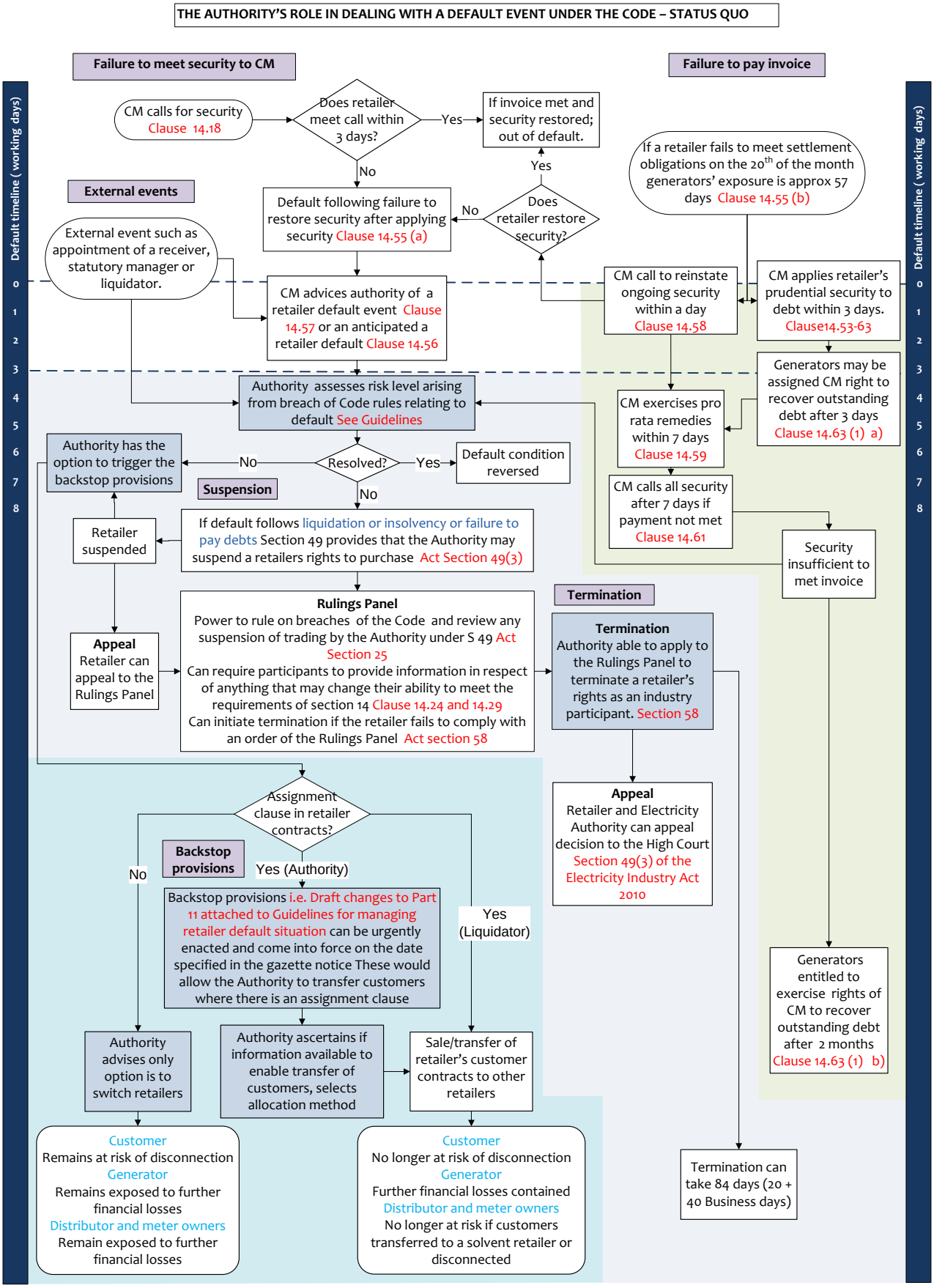
4 Clause 14.55 (a).

b) there is no role for the Authority should a retailer fail to make payments to distributors (perhaps while continuing to make payments to the clearing manager);

c) the termination and suspension provisions in the Electricity Industry Act 2010 may take over 84 days to progress and even then provide no mechanism for stopping the financial loss (if the retailer's customers have not transferred to a viable retailer). The termination and suspension provisions do not in themselves assist the Authority to ensure the orderly operation of the market or continuing supply to consumers; and

d) the Backstop provisions would be ineffective if the retailer's contracts with its customers do not include a right of assignment, as the Authority could not require a customer to transfer to a viable retailer; the Authority's only option would be to advise the customer to switch to another retailer.

Figure 1 Current Code decision process following a retailer default


THE AUTHORITY'S ROLE IN DEALING WITH A DEFAULT EVENT UNDER THE CODE – STATUS QUO
Failure to meet security to CM
Failure to pay invoice
Default timeline (working days)
0 1 2 3 4 5 6 7 8
CM calls for security Clause 14.18
Does retailer meet call within 3 days?
Yes
If invoice met and security restored; out of default.
No
Yes
External events
Default following failure to restore security after applying security Clause 14.55 (a)
No
Does retailer restore security?
External event such as appointment of a receiver, statutory manager or liquidator.
If a retailer fails to meet settlement obligations on the 20th of the month generators' exposure is approx 57 days Clause 14.55 (b)
CM advices authority of a retailer default event Clause 14.57 or an anticipated a retailer default Clause 14.56
CM call to reinstate ongoing security within a day Clause 14.58
CM applies retailer's prudential security to debt within 3 days. Clause14.53-63
Generators may be assigned CM right to recover outstanding debt after 3 days Clause 14.63 (1) a)
Authority assesses risk level arising from breach of Code rules relating to default See Guidelines
CM exercises pro rata remedies within 7 days Clause 14.59
Authority has the option to trigger the backstop provisions
No
Resolved?
Yes
Default condition reversed
Suspension
No
CM calls all security after 7 days if payment not met Clause 14.61
Retailer suspended
If default follows liquidation or insolvency or failure to pay debts Section 49 provides that the Authority may suspend a retailers rights to purchase Act Section 49(3)
Security insufficient to met invoice
Termination
Rulings Panel
Power to rule on breaches of the Code and review any suspension of trading by the Authority under S 49 Act Section 25
Can require participants to provide information in respect of anything that may change their ability to meet the requirements of section 14 Clause 14.24 and 14.29
Can initiate termination if the retailer fails to comply with an order of the Rulings Panel Act section 58
Appeal
Retailer can appeal to the Rulings Panel
Termination
Authority able to apply to the Rulings Panel to terminate a retailer's rights as an industry participant. Section 58
Appeal
Retailer and Electricity Authority can appeal decision to the High Court Section 49(3) of the Electricity Industry Act 2010
Assignment clause in retailer contracts?
Backstop provisions
No
Yes (Authority)
Yes (Liquidator)
Backstop provisions i.e. Draft changes to Part 11 attached to Guidelines for managing retailer default situation can be urgently enacted and come into force on the date specified in the gazette notice These would allow the Authority to transfer customers where there is an assignment clause
Generators entitled to exercise rights of CM to recover outstanding debt after 2 months Clause 14.63 (1) b)
Authority advises only option is to switch retailers
Authority ascertains if information available to enable transfer of customers, selects allocation method
Sale/transfer of retailer's customer contracts to other retailers
Customer
Remains at risk of disconnection
Generator
Remains exposed to further financial losses
Distributor and meter owners
Remain exposed to further financial losses
Customer
No longer at risk of disconnection
Generator
Further financial losses contained
Distributor and meter owners
No longer at risk if customers transferred to a solvent retailer or disconnected
Termination can take 84 days (20 + 40 Business days)

2.1.7 In considering solutions to the identified problems, the RAG sought, where feasible, to use existing commercial and market processes to mitigate the costs of a regulatory intervention that might otherwise incur some or all of the following costs:

a) raise the cost of exit and entry to the retail market, reducing long-term competitive benefits for consumers;

b) raise the cost of finance to retailers by altering the security of other debtors, raising industry costs;

c) pre-determine the outcome from a default by implementing measures that would always be terminal for the retailer concerned, rather than leave open the possibility that the firm may trade back to solvency and hence competitiveness;

d) impose costs on consumers, through a levy, to compensate retailers for the costs of customers assigned to them by mandated transfer; and

e) risk a cascading failure of other retailers by forcing other retailers to take large numbers of customers from the failed retailer, particularly if the reason for the retailer failing is due to external factors such as high wholesale prices.

2.2 Synopsis of main themes in the submissions

Submissions received

2.2.1 At its 23 April meeting the RAG considered the submissions received on the February discussion paper. Submissions had been received in late March from: Contact, Genesis, Meridian, Mighty River Power, Orion, Powerco, Simply Energy, Trust Power, Vector and Unison.

Submitters agree there is a problem with the status quo

2.2.2 Submitters agreed that the RAG has identified a problem with the current arrangements governing a retailer default: that is, there is no effective mechanism to cease supply to the defaulting retailer's customers, and hence no effective means for stopping the financial loss incurred by industry participants. Submitters also agreed that it is unlikely that distributors would disconnect consumers en masse in these circumstances.

2.2.3 All submitters supported the RAG and the Authority in pressing on with the work required to identify options for managing the outcomes of a retailer default.

2.2.4 A number of submitters felt that there was too much focus in the paper on a failure of a retailer to pay the clearing manager as distinct from a failure to pay distributors. Some considered that the discussion paper underestimated the extent of the problem, particularly in regard to its analysis of the level of financial exposure faced by distributors and generators in the event of a retailer default.

2.2.5 Submitters encouraged co-ordination between the RAG's work on retailer default and the related review of settlement and prudential requirements.

2.2.6 The first discussion paper had suggested three options:

a) do nothing;

b) re-establish power to appoint a receiver; and

c) provide for the Authority to allocate customers to another retailer.

Option 1 – do nothing

2.2.7 All but one submitter ruled out the possibility of doing nothing. The one submitter that did not rule out the possibility that no Code change was needed took that position subject to the outcome of further work. There was engagement from all submitters on options 2 and 3.

Option 2 - power to appoint a receiver or equivalent qualified expert

2.2.8 There was wide support from submitters for the RAG to explore whether it is feasible to re-establish a mechanism for the clearing manager (or Authority) to appoint a receiver or equivalent qualified expert to a retailer in default. This option was viewed as potentially having the benefits of:

a) exposing retailers to additional consequences from a default and as a result compel them to more effectively manage risk;

b) utilising a process (for example, receivership) which is well understood and consistent with what would occur in other markets; and

c) providing a process which does not preclude the possibility of the defaulting retailer trading back to profitability.

2.2.9 Submitters recognised that the objectives for the Authority/clearing manager in appointing a receiver would be broader than simply recovering a debt. The Authority is obliged to consider the long-term interest of consumers. This involves facilitating *all* consumers being served by a viable retailer, and in facilitating the orderly operation of the wholesale market. These are not objectives that would typically focus the mind of a receiver.

2.2.10 A power to appoint a receiver was therefore not perceived by submitters to be a complete solution. To effect a whole or partial sale of customers, a receiver would rely on the market supplying a willing purchaser for each block of customers. There is a common view that the value of a retailer's customer base is now likely to be worth less in circumstances in which a retailer has failed than it was previously. Some submitters suggest that there might not be a willing purchaser available for a defaulting retailer's customer base, or for some segment of that customer base. For this reason option 3 was generally regarded as a complement to option 2.

2.2.11 Submitters raised important questions concerning how a mechanism to appoint a receiver might be achieved and how it would work in practice, particularly in regard to:

a) how the clearing manager (or Authority) could be given the power to appoint a receiver;

b) the impact a Code power to appoint a receiver might have on the ability of industry participants to secure funding;

c) whether the power to appoint a receiver should include circumstances where the retailer defaults on payments to other industry participants, especially distributors; and

d) the legal position if there were competing rights to appoint a receiver, for example, between the clearing manager and an existing creditor of participant (such as a bank) and/or a distributor.

Option 3 - provision for the Authority to allocate customers

2.2.12 The majority of submitters supported the Authority having a backstop mechanism to require the transfer of customers in the event of a default. This mechanism was generally viewed as

necessary to ensure that, in all circumstances, all customers would be served by a viable retailer and there would be an end to the financial loss due to ongoing supply to the customers of a failed retailer.

2.2.13 Some submitters noted that such a mechanism may have adverse impacts and the design of the mechanism should try and minimise these costs. Some of the adverse impacts identified include the potential for a mandatory transfer mechanism to:

a) undermine the success of voluntary, commercially-based transfers;

b) impose costs and risks to viable retailers forced to take on customers, particularly in dry years with high spot prices;

c) increase the difficulties in securing bank financing and raise 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; and

d) strip economic value from the defaulting retailer to the detriment of other creditors.

2.2.14 Submitters suggested that some of the major points that will have to be resolved in the design of a regulated customer transfer mechanism include:

a) how to identify which retailers should take on customers especially given that some retailers will be better able than others to absorb new customers;

b) if, and for how long, retailers that acquire customers should be bound to honour the terms offered by the defaulting retailer;

c) how to go about mandating all retailers to include rights of assignment into agreements with customers;

d) whether it will be possible to give the Authority the capability to backdate the financial responsibility for a customer to an earlier date than the date of actual switch;

e) whether affected customers would be free to switch to an alternative supplier of their choice during the transfer process;

f) how to synchronise the scheme for electricity customers with the equivalent gas market regulations and the way these are applied by the GIC given that some affected customers may be dual fuel customers;

g) whether it is possible to extend the Authority's power to transfer customers beyond default events as defined in the Code; that is, to include default on other market participants such as distributors; and

h) how to ensure that all customers are identified and transferred to a new retailer.

Further advice on legal matters

2.2.15 To assist the RAG to identify feasible options for managing the outcomes of a retailer default, the Authority commissioned advice on relevant legal matters. The advice considered:

a) whether a receiver could act to achieve objectives in the long-term interests of consumers should a retailer default (that is, objectives including the orderly operation of the market and continued supply to consumers, in addition to the recovery of a debt);

b) whether an alternative mechanism could be created so that the appointed manager could also act to achieve these objectives; and

c) the mechanisms available to achieve a transfer of customers to a viable retailer.

2.2.16 The advice identified the legislative restrictions on a receiver taking into account considerations other than the interest of secured creditors.. A receiver might, for example, prefer a higher offer for a select group of customers than a lower monetary offer for the entire customer base. The advice suggested that it could be feasible to provide for a new regime which did place additional obligations on the receiver (such as an obligation to ensure the transfer of all customers to a viable retailer), , but such a regime would require Code changes and might also require changes to primary legislation. The main shortcoming of an approach that would allow a receiver to consider the wider objectives of the Authority, is that it may undermine the rights of secured financiers of a retailer and therefore make it more difficult for a retailer to obtain finance. A retailer of last resort mechanism that provides for the mandated transfer of a customer base before a secured creditor can take action may also undermine the ability of retailers to obtain finance.

2.3 Development of a preferred option

2.3.1 The RAG discussed the submissions and the advice on legal matters and worked through the incentives on the parties and the legal and commercial constraints governing the behaviour of the entities involved. From this review of incentives and constraints, the RAG developed a preferred approach for further consideration and development.

2.3.2 In June, the RAG tested this preferred approach by undertaking a simulation exercise with executives of a small retailer. A legal review of the preferred approach was also undertaken. These initiatives did not identify any fundamental flaws in the preferred approach nor did they raise significant new issues that might alter the judgements evaluated by the RAG in designing the preferred approach. However, the work provided important information and insights and resulted in the RAG identifying some improvements to the detailed design of the approach at its July meeting.

2.3.3 In summary form, the preferred approach is as follows:

a) the Code should specify certain situations as events of default (as is currently the case). These situations should include:

   i) a failure to pay an invoice due to the clearing manager and/or a failure to restore wholesale prudential security levels (in each case, within a specified period of time); and

   ii) certain events external to the Code, for example, an appointment of a receiver or liquidator to the retailer; and

   iii) this paper considers whether a distributor, after terminating a use-of-system agreement with a retailer as a result of an unresolved serious financial breach by that retailer, should have an option of advising the Authority that it considers an event of default exists and that this event should be subject to the proposed arrangements under the Code to manage a retailer default situation;

b) on being advised of an event of default, the Authority would investigate the claimed event of default to determine whether an event of default exists and, if so, whether the event is material and further action is needed under the Code to manage a retailer default situation;

c) if an event of default is material, the Authority would advise the retailer and its agent (for instance, any receiver appointed to the retailer) that unless the default had been rectified within a specified number of days, that the Authority would:

   i) communicate with all of the failed retailer's customers advising them that their retailer had defaulted and that they should switch to another retailer and that if they did not switch by a specified date the Authority would assign them to another retailer; and

   ii) proceed to terminate the retailer's rights to trade electricity under the Code.

d) as the customer base would likely comprise the main asset of the retailer, the retailer (or its agent such as a receiver) would have powerful incentives to either rectify the default if feasible or enter into a commercial sale of some or all of the customer base if a sale is achievable. The failed retailer faces strong incentives to act because any residual value of the customer base would diminish rapidly as customers switched away following receipt of the advice from the Authority;

e) the time period provided to the retailer to rectify the default would aim to strike a reasonable balance between providing sufficient time for the retailer (or its agent) to effect a commercial sale or rectify the default and minimising any additional financial losses where such actions are not achievable, and to maintain the confidence of consumers that the electricity market will maintain reliable electricity supply;

f) the specified period of time to rectify the default could only be extended with the approval of the parties (for example, generators) who would bear the financial risk of an extended period of time, in much the same manner that creditors might agree a plan by a debtor if that is a better option for the creditor than bankruptcy of the debtor;

g) if the default is not rectified during the specified time period, the Authority would communicate with each customer advising them that their retailer was in default and that the retailer's right to trade would be terminated. Customers would be provided with information on how to switch retailers and advised that if they had not switched within a specified number of days after the date of the letter the Authority would assign the customer to another retailer. The intent of this step is to provide the impetus and information for the great majority of customers (any remaining after efforts by the retailer to sell or transfer the customers) to choose to switch to a competing retailer;

h) to cover the possibility that customers are not transferred through a commercial sale and do not voluntarily switch to another retailer, the Code would impose on retailers an obligation to have in their contracts with their customers a provision that the contract may be terminated on notice from the Authority. The Code would also require that retailers include a provision that if the contract is terminated in these circumstances, the customer would become bound by a contract with another retailer;

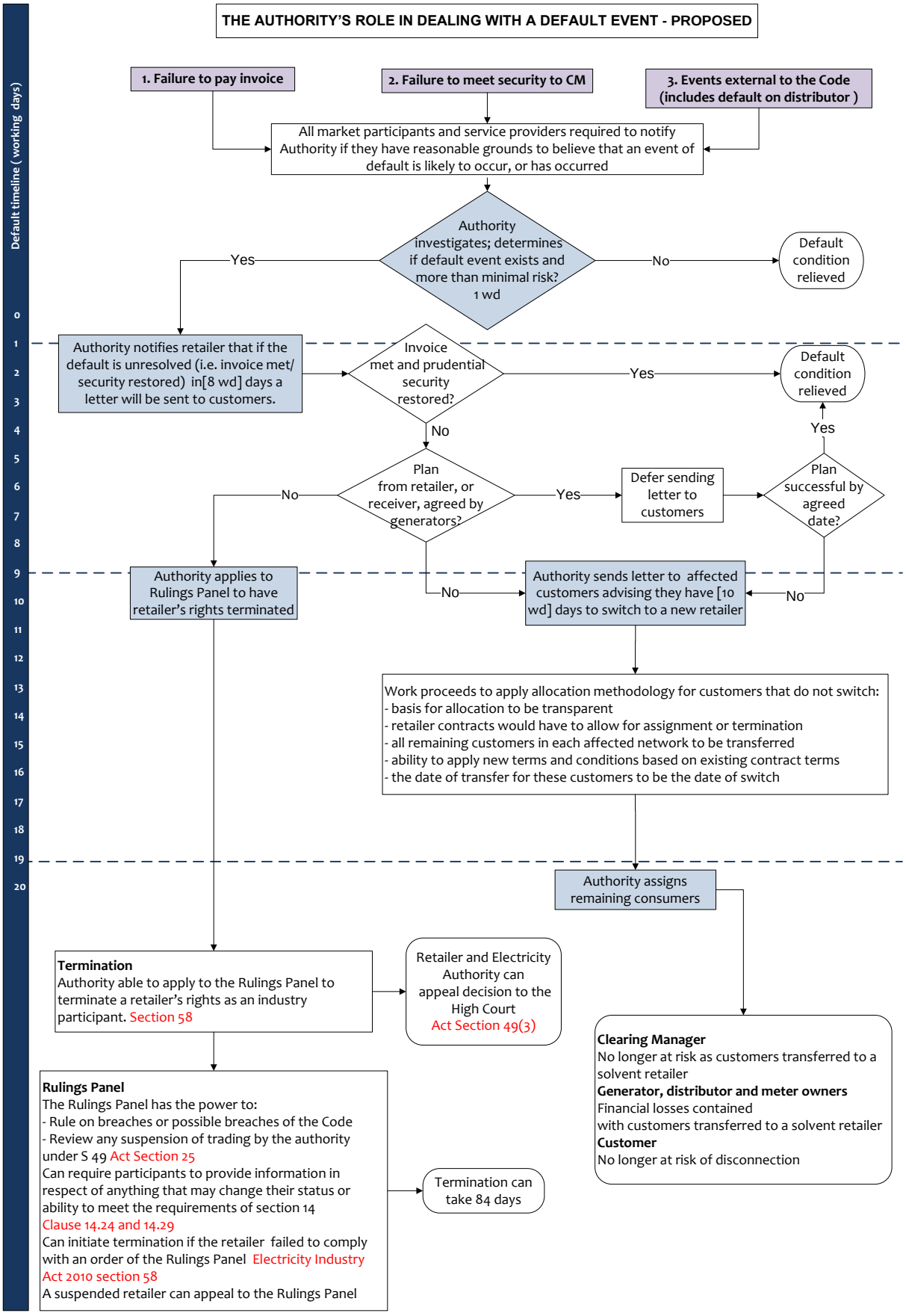
i) retailers in the same network area would be required by the Code to enter into contracts with customers of the defaulting retailer whose contracts have been terminated by the Authority;

j) the retailers receiving the customer would determine the prices and other terms on which they would supply the customer transferred to them; and

k) the Authority would also proceed to terminate the rights of the retailer in default to trade under the Code.

2.3.4 This broad framework is shown in picture form in the flow diagram in figure 2 below.

Figure 2 Outline of the RAG's proposed decision process following retailer default


THE AUTHORITY'S ROLE IN DEALING WITH A DEFAULT EVENT - PROPOSED
Default timeline (working days)
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
1. Failure to pay invoice
2. Failure to meet security to CM
3. Events external to the Code (includes default on distributor)
All market participants and service providers required to notify Authority if they have reasonable grounds to believe that an event of default is likely to occur, or has occurred
Authority investigates; determines if default event exists and more than minimal risk? 1 wd
Yes
No
Default condition relieved
Authority notifies retailer that if the default is unresolved (i.e. invoice met/ security restored) in[8 wd] days a letter will be sent to customers.
Invoice met and prudential security restored?
Yes
Default condition relieved
No
Yes
Plan from retailer, or receiver, agreed by generators?
No
Yes
Defer sending letter to customers
Plan successful by agreed date?
No
Authority applies to Rulings Panel to have retailer's rights terminated
No
Authority sends letter to affected customers advising they have [10 wd] days to switch to a new retailer
No
Work proceeds to apply allocation methodology for customers that do not switch:
- basis for allocation to be transparent
- retailer contracts would have to allow for assignment or termination
- all remaining customers in each affected network to be transferred
- ability to apply new terms and conditions based on existing contract terms
- the date of transfer for these customers to be the date of switch
Authority assigns remaining consumers
Termination
Authority able to apply to the Rulings Panel to terminate a retailer's rights as an industry participant. Section 58
Retailer and Electricity Authority can appeal decision to the High Court
Act Section 49(3)
Clearing Manager
No longer at risk as customers transferred to a solvent retailer
Generator, distributor and meter owners
Financial losses contained
with customers transferred to a solvent retailer
Customer
No longer at risk of disconnection
Rulings Panel
The Rulings Panel has the power to:
- Rule on breaches or possible breaches of the Code
- Review any suspension of trading by the authority under S 49 Act Section 25
Can require participants to provide information in respect of anything that may change their status or ability to meet the requirements of section 14
Clause 14.24 and 14.29
Can initiate termination if the retailer failed to comply with an order of the Rulings Panel Electricity Industry Act 2010 section 58
A suspended retailer can appeal to the Rulings Panel
Termination can take 84 days

2.3.5 The following sections discuss each of the important steps in the preferred approach and evaluate the choices and implications for the design of these steps. The issues are categorised under three chapter headings:

a) default events;

b) response by the Authority; and

c) transfer of any remaining customers.

3 Default events

3.1 Existing definition of an event of default

3.1.1 Clause 14.55 of the Code defines an event of default as follows:

Each of the following events constitutes an event of default:

(a) the failure of a payer to comply with clauses 14.2 to 14.17 or to satisfy a call in accordance with clause 14.18(4):

(b) the failure of a payer to pay the full amount invoiced to it in accordance with clauses 14.36 to 14.54:

(c) any action taken for, or with a view to, the declaration of a payer as a corporation at risk under the Corporations (Investigation and Management) Act 1989:

(d) a statutory manager being appointed under the Corporations (Investigation and Management) Act 1989 (or a recommendation or submission is made by a person to the Securities Commission supporting such an appointment):

(e) a person being appointed under section 19 of the Corporations (Investigation and Management) Act 1989 to investigate the affairs or run the business of the payer:

(f) if a payer is (or admits that it is or is deemed under any applicable law to be) unable to pay its debts as they fall due or is otherwise insolvent, or stops or suspends, or threatens to stop or suspend, or a moratorium is declared on, payment of its indebtedness, or makes or commences negotiations or takes any other steps with a view to making any assignment or composition with, or for the benefit of, its creditors, or any other arrangement for the rescheduling of its indebtedness or otherwise with a view to avoiding, or in expectation of its inability to pay, its debts:

(g) a holder of a security interest or other encumbrancer takes possession of, or a receiver, manager, receiver and manager, liquidator, provisional liquidator, trustee, statutory or official manager or inspector, administrator or similar officer is appointed in respect of the whole or any part of the assets of the payer or if the payer requests that such an appointment be made.

3.1.2 These events of default can be grouped into four categories of increasing risk:

a) a failure to meet a call for additional security;

b) a failure to pay the full amount invoiced;

c) an appointment of a receiver, statutory manager or similar; and

d) insolvency or liquidation.

3.1.3 Each of these categories of default is considered in turn below, as is the question of whether additional events (such as a failure to make a payment to a distributor or other market participant) should be added to the list of default events.

3.2 Failure to meet a call for additional security

3.2.1 Participants purchasing from the clearing manager are required to provide collateral sufficient to cover their expected net purchases for a period of 57 days, or hold an acceptable credit rating. The clearing manager is 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 are likely within the next week. The approach taken to calculating the required collateral is discussed in some detail in the Wholesale Advisory Group draft Discussion Paper, Settlement and Prudential Security Review, dated 14 May 2012.

3.2.2 A retailer defaults under the Code if it fails to provide the security required by the clearing manager (clauses 14.2 to 14.17), fails to reinstate the collateral if the collateral has been applied against a shortfall in the payment of an invoice (clause 14.58), or fails to satisfy a call for additional security as a result of weekly monitoring by the clearing manager (clause 14.18(4)).

3.2.3 There is no materiality assessment under the Code; a shortfall in the required level of security is an event of default whether that shortfall is $100 or $1,000,000.

3.3 Failure to meet invoice

3.3.1 Clause 14.36 of the Code requires the clearing manager to issue invoices two business days after receiving reconciliation information. These invoices specify amounts due for:

a) electricity taken in each trading period for the previous calendar month;

b) ancillary service costs for the previous calendar month; and

c) amounts owing under a Financial Transmission Right (FTR).[5]

3.3.2 These invoices must be paid by the 20th of the month (clause 14.37).

3.3.3 If the amount received by the clearing manager is less than the amount invoiced, the clearing manager is required under the Code to take a number of actions. The clearing manager must:

a) apportion the amount received from the payer between the amounts payable under the invoice for FTRs, and the amounts payable under the invoice for electricity taken (and other services such as ancillary services), according to the proportion that each amount bears to the total amount invoiced (clause 14.48B);

b) prioritise payments in the following order: GST and other government agencies; system operator for ancillary services; loss and constraint rentals, constrained on compensation; generators (clause 14.47);

c) apply the security held by the clearing manager to meet the default amount (clause 14.58); and

d) prorate any remaining short fall across generators (clause 14.49).

[5] If the publication of final prices is delayed, the invoice for amounts due under financial transmission rights must be issued two days after final prices are published (clause 14.36(3)).

3.3.4 While these actions by the clearing manager are important, they do not remove the default. An event of default remains until the full amount invoiced and any interest due on that amount is paid, and the appropriate level of security is restored (clauses 14.55, 14.52). There is no materiality assessment under the Code. Nor do these actions stop further financial loss being incurred by industry participants if the retailer's customers continue to consume electricity, and the retailer does not pay its bills.

3.3.5 Hence, while the default event should continue to trigger the actions by the clearing manager summarised in paragraph 3.3.3 above, it should also trigger actions that are intended to address the default itself and to stop further financial losses. These actions are discussed further below.

3.4 Events external to the Code

3.4.1 Clause 14.55 (reproduced at paragraph 3.1.1 above) currently lists a number of events outside of the Code that would result in an event of default. These events, listed in bullets (c) to (g) of clause 14.55, concern actions under the Investigation and Management Act 1989, insolvency, rescheduling of debt to avoid an inability to pay, and appointment of a receiver, manager, liquidator or similar officer.

3.4.2 Including these events as events of default is consistent with other forms of organised markets. The rules of an organised market intend to give those who trade on the market confidence in the reliability of the transactions executed. In the absence of the market rules, transacting parties would need to address issues of integrity and moral hazard through costly bilateral negotiations and long-term contracts. A fundamental function of the market rules is to deter opportunistic behaviour and obviate costly self-protective measures. Allowing a party to continue to trade as normal when they are insolvent or in receivership would not be consistent with protecting the integrity of the settlement process and would encourage market participants exposed to the settlement process to engage in costly self-protective measures.[6]

3.4.3 A number of submitters proposed that additional events external to the Code should be included as an event of default. In particular, several distributors proposed that events of default should include a failure by a retailer to meet payments due to distributors. It seems reasonable to assume that a retailer in default to the clearing manager will also likely default on its payments to distributors. However, it is possible for a retailer to default on payments due to the distributor but not default on its payments due to the clearing manager. A retailer short of funds is likely to prioritise the use of its available cash and take into account whether the remedies available to one creditor are more severe than the remedies available to another.

3.4.4 Historically, there was a clear separation between services bought and sold via the market rules and services bought and sold via contracts outside of the market rules. The multilateral contract that formed NZEM was an arrangement for trading wholesale electricity and some closely related services such as ancillary services. The arrangements governing the payment of those services naturally formed part of that multilateral contract. Transport and other services such as metering were historically bought and sold under contractual terms, including payment terms, agreed (or posted) outside of the market rules.

3.4.5 However, the boundaries between services bought and sold under the Code, and services bought and sold under commercially negotiated contract, are now less clear. Many aspects of the

[6] The wording of the provisions 14.55(c) to (g) have yet to be reviewed to ensure the provisions remain consistent with any legislative changes to the Act referenced in those bullet points since clause 14.55 was drafted.

transmission services are now governed by the Code, including the pricing of the service, the entities that must pay for the services, and the obligation to pay for those services. The prudential arrangements between a distributor and retailers are now specified in the Code.

3.4.6 In consulting on its mandated changes to distribution prudential levels, the Authority observed that the RAG was "*progressing initiatives to manage retailer default situations which are intended to facilitate the orderly transition of a failed retailer's customers to other retailers, thereby limiting the extent of time for which customers may be consuming power while being associated with a failed retailer*."[7] The Authority was anticipating that an effective mechanism will be implemented to minimise the financial loss borne by participants arising from a retailer default, and that this mechanism will lower the risk to distributors (along with the minimising the financial loss to generators).

3.4.7 Most distributors have entered into an interposed use-of-system agreement with retailers. Under these arrangements, the distributor does not have a direct contractual relationship with the consumer and relies on the retailer to pay for distribution services. The draft model use-of-system agreement provides that, in the event of a "serious financial breach" by a retailer, the distributor may (after a defined notice period) terminate the use-of-system agreement and advise the retailer's customers that they will be disconnected unless they transfer to an alternative retailer.[8]

3.4.8 The existing remedy available to distributors in circumstances where a retailer with an interposed use-of-system agreement has failed and defaulted (as opposed to a commercial dispute between the retailer and distributor) has several weaknesses. It would seem no more tenable, as an industry solution, for a distributor to disconnect consumers en masse because the retailer had not paid its bill than it would be to disconnect those consumers because the retailer had not paid the clearing manager. The consumers may well have paid their accounts with the retailer as those accounts become due. A remedy of disconnecting consumers who have met their obligations may undermine consumer confidence in the market (though it would reinforce incentives on consumers to consider the stability of their retailer and factors other than just price). A failed retailer may also default on two or more distributors, raising the prospect of different and uncoordinated actions over different network areas.

3.4.9 A distributor with a conveyance use-of-system agreement retains a direct contractual link with the end consumer. Under this contractual form, the distributor may choose to bill its connected customers directly for distribution services. A distributor might prefer to bill its customers when those customers (for example, a landlord or private line owner) are different parties to the retailer's consumer (for example, a tenant). However, in most cases the distributor's connected customer and the retailer's customer is the same person. In these circumstances, the distributor typically enters into an agency agreement with the retailer to bill the customer on its behalf (so the customer receives a single invoice). The funds collected by the retailer on behalf of the distributor are generally held in trust and may not be available to the retailer's other creditors. Hence a distributor with a conveyance use-of-system agreement may have a contract structure that provides it with a potentially more effective means of managing default risk by a retailer.

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7 Electricity Authority, Consultation Paper Standardisation: Model Use-of-System Agreements and Proposed Code Amendments, 11 August 2011, paragraph 4.8.33.

8 The definition of serious financial breach is the lesser of $100,000 or 20% of the monthly lines charges and is discussed further below.

3.4.10 An option for distributors concerned about the prospect of retailer default would be for those distributors to insist on a conveyance use-of-system agreement for the use by retailers of its networks. As both the interposed and conveyance approaches are in current use, a shift by distribution networks to a conveyance use-of-system agreement would result in transaction costs (costly self-protection measures) and the loss of benefits of the interposed agreement – the Authority observed in its consultation paper on the model use-of-system agreement that it does not intend to standardise a single approach because the variation of contractual approaches reflects a diverse range of business and operating needs in New Zealand.[9] Distributors would therefore trade off the costs to them of changing the contractual form of its use-of-system agreement against the costs and risks they perceive of an unresolved serious financial breach by a failure.

3.4.11 An alternative option would be to include a termination of a use-of-system agreement following an unresolved serious financial breach by a retailer under a use-of-system agreement as an event of default under clause 14.55 in the same manner that an appointment of a receiver or similar to the retailer is an event of default. This would mean the distributor could advise the Authority that it considered there was an event of default and that the Authority should initiate a Code-prescribed process for transferring customers from the defaulting retailer to a viable retailer. The distributor would have the option of referring the termination of the use-of-system agreement to the Authority rather than commencing a process of disconnection of the retailer's customers.

3.4.12 The intent would be that non-payment by a retailer should continue to first be addressed between the distributor and retailer (for example, following the process outlined in the model use-of-system agreement). Only if these processes do not resolve the matter, and the distributor had terminated the use-of-system agreement, could it advise the Authority that it considered that an event of default existed. The Authority would need to satisfy itself that an event of default existed and would not necessarily act to initiate the process for transferred customers to another retailer. Materiality is discussed in section 4.2.

3.4.13 The same concerns do not appear to arise for other services purchased by the retailer, for example, meter services, because these services are supplied in a workably competitive market, unlike the services by the clearing manager and distributors. Meter service providers compete to provide metering services to retailers. Meter service providers contracting with the retailer may determine the prudential requirements as they see fit and this forms part of their competitive service offering.

Q1. *Do you agree with the summary of the options available to a distributor in the event of a default by a retailer, or are there other remedies available to a distributor?*

Q2. *Do you consider that a distributor could be sufficiently concerned about the prospect of a default by a retailer to insist on a conveyance use-of-system agreement for the use by retailers of its network, and if so, would this be an undesirable outcome?*

Q3. *Should a distributor, after terminating a use-of-system agreement with a retailer as a result of an unresolved serious financial breach by that retailer, have an option of advising the Authority that it considers an event of default exists and that this event should be subject to the proposed arrangements under the Code to manage an event of default?*

[9] Electricity Authority, Consultation Paper Standardisation: Model Use-of-System Agreements and Proposed Code Amendments, 11 August 2011, paragraph 3.4.2.

Q4. *Are there any other events not currently captured by clause 14.55 that should be defined as an event of default and if so on what rationale?*

3.5 Notification of a default

3.5.1 Two clauses currently specify the notifications that must occur in the event of a default or if a default is anticipated. Clause 14.56 stipulates:

> *Anticipated events of default must be referred to Authority*
>
> *If the clearing manager has reasonable grounds to believe that an event of default is likely to occur, the clearing manager must refer the matter to the Authority for its urgent consideration and instruction of an appropriate course of action to minimise the risk of default occurring.*

3.5.2 There appear to be two deficiencies with this clause. First, the obligation is only on the clearing manager to notify the Authority of potential defaults. However, other parties, including the entity that might default, may have better or earlier information than the clearing manager of some potential default events, for example, impending insolvency. This clause could be broadened to place an obligation on all participants and service providers to notify the Authority if they have reasonable grounds to believe that an event of default is likely to occur, including an obligation to self-notify. However, there is a risk that a requirement to notify the Authority when "an event of default is likely" may be difficult to enforce and may lead to participants lobbying the Authority rather than engaging in good faith commercial negotiations.

3.5.3 The second weakness is that the clause creates an impression that the Authority will instruct the clearing manager to take some course of action to minimise the risk of the default occurring. This impression is potentially misleading in two regards. In most cases it is unlikely that the clearing manager can take any action to minimise the prospect of default. The clearing manager cannot, for example, address an insolvency or find funds for an entity that could not otherwise meet a payment that is due. In addition, any instruction that the Authority can give to the clearing manager to intervene in a potential default should be set out in the Code. Clause 14.56 should therefore be amended to address notification obligations, with the actions the Authority might take specified separately (the actions the Authority would take on an event of default under the preferred solution are discussed in the following section).

3.5.4 The procedure to be followed by the clearing manager in the event of a default is specified in clause 14.57 and stipulates:

> *Procedure upon event of default*
>
> *(1) Upon an event of default occurring, the clearing manager must, without prejudice to its rights under clause 14.58, notify the person in default that it has committed an event of default.*
>
> *(2) Without prejudice to its rights under clause 14.58, the clearing manager must refer an issue concerning an event of default to the Authority.*

3.5.5 There appear to be two deficiencies with this clause. First, the obligation on the clearing manager to notify the entity in default that it has committed an event of default seems to be specified too broadly. The clearing manager may have no effective means of establishing whether an entity has committed an event of default (for example, whether an entity has become insolvent). This clause might be tightened to require the clearing manager to advise an entity if it has not complied with

a requirement of Part 14 of the Code (such as meeting a payment or a call for additional security) and that this non-compliance is an event of default.

3.5.6 The second bullet point seems to be drafted too narrowly. Parties other than the clearing manager, including the entity in default, may have better or earlier information than the clearing manager of some default events, for example, insolvency. This clause could usefully be broadened to place an obligation on all market participants and service providers to notify the Authority if they have reasonable grounds to believe that an event of default has occurred, including an obligation to self-notify.

3.5.7 In short, these clauses governing the notification of a default should be broadened to require all participants and service providers to notify the Authority if that entity has reasonable grounds to believe that an event of default is likely to occur, or has occurred. The clearing manager should also have an obligation to advise an entity if it has not complied with a requirement of Part 14 of the Code and that this non-compliance is an event of default. Participants and service providers should be obliged to notify the Authority as soon as they learn of a default event.

Q5. *Should the Code provisions governing the notification of a default be broadened to require all participants and service providers to notify the Authority as soon as that entity has reasonable grounds to believe that an event of default is likely to occur, or has occurred?*

Q6. *Should the clearing manager have an obligation to advise an entity if it has not complied with a requirement of Part 14 of the Code and that this non-compliance is an event of default?*

4 Response to a default event

4.1 Response by clearing manager

4.1.1 The Code specifies the actions that the clearing manager may take "as appropriate" following an event of default. These actions include:

a) applying the balance of the defaulting payer's cash deposit (clauses 14.58 – 14.62A, 14.9(a), 14.9(aa), and 14.47);

b) making a demand under a guarantee, letter of credit or bond (clause 14.58 – 14.62A);

c) setting off the unpaid amount against any amounts payable to the person by the clearing manager (clause 14.58); and

d) prorating a reduced payment across generators (clause 14.49).

4.1.2 Presumably, the "as appropriate" qualification in clause 14.58 allows the clearing manager to take these steps when an event of default arises from a shortfall in payment and in some cases from a failure to meet a call for additional security. However, none of the actions seem appropriate should an event of default arise from the retailer becoming insolvent or being placed in receivership while continuing to meet all payments in full and maintain the required security. Indeed, there does not appear to be any action required of the clearing manager, other than to notify the Authority, in circumstances where the default event arises outside of the Code.

4.1.3 Clause 14.53 requires the clearing manager to exercise its rights under the Code "as is reasonable" to recover any amounts outstanding from a payer in default. However, the clause is phrased in a manner that might be misleading. The clause requires that:

The clearing manager must exercise such rights, including those rights under the Act and this Code, as is reasonable to recover any amounts outstanding from a payer is [sic] in default.

4.1.4 The inference is that the clearing manager has rights under the Electricity Industry Act, as well as other rights not specified in the Code, which it can exercise to recover any shortfall in payment by a retailer. However, the reviews undertaken by the Authority's (and the former Electricity Commission's) legal advisers have not identified *any* effective rights held by the clearing manager, other than those specified in the Code, except for the statutory right under the Companies Act as an unsecured creditor to apply to the High Court for an insolvent company to be placed into liquidation.[10]

4.1.5 The Code could be clarified and simplified by bringing the actions that may be taken by the clearing manager in the event of a default into one sub-part as the relevant clauses are currently spread through part 14. In bringing the clauses into a sub-part, the clauses could be re-drafted to stipulate, to the extent practical, the actions the clearing manager would take in relation to a shortfall in payment or a failure to meet a call. Redrafting the clauses in this manner would increase the certainty of the application and interpretation of the rules, as would removing inferences to rights that do not exist, including the reference in clause 14.63(2) that implies the clearing manager could appoint a receiver (though it has no effective mechanism to do so).

Q7. *Should the Code be clarified and simplified by bringing the actions that may be taken by the clearing manager in the event of a default into one sub-part and re-drafted to stipulate, to the extent practical, the actions the clearing manager would take in relation to a shortfall in payment or a failure to meet a call?*

4.2 Authority to investigate claimed event of default

4.2.1 The Code does not currently require the Authority to take any action on being notified of an event of default or provide it with powers to intervene to minimise the impact of an event of default, or to resolve an event of default. Under its *Guidelines*, the Authority has undertaken to:[11]

a) monitor an event of default, or the possibility of an event of default;

b) consider suspending a retailer's rights to trade or applying to the Rulings Panel for a termination order in respect of the retailer;

c) provide information to participants, the public, and the Minister as required; and

d) if a retailer ceasing to trade is a possibility, consider what steps can be taken, within the Authority's powers, to facilitate the orderly exit of the retailer from the market and continuity of supply at reasonable prices for the retailer's customers.

4.2.2 The *Guidelines* explain that once the Authority becomes aware of an event of default, it will assess the risk and categorise the event as either:

a) *minimal risk event* resulting from a temporary failure to meet security or a payment which is rectified within 24 hours or so (this temporary failure may arise from a technological or administrative failure);

[10] The reviews done for the Authority and the former Electricity Commission were summarised in the RAG's Discussion Paper: *Retail customers in retailer default situations,* February 2012.

[11] Electricity Authority, *Guidelines for Managing Retailer Default Situations*, 19 January 2011, page 9.

b) *low risk event* resulting from an extended failure to provide security or meet settlement obligations, but does not involve the retailer ceasing or potentially ceasing to trade; or

c) *high risk event* resulting from a default that indicates the retailer has ceased or may cease to trade while still having settlement obligations.

4.2.3 Under the preferred approach outlined in section 2.3 above, the Authority would be provided with powers to respond to a default event and this assessment by the Authority of the risk resulting from the event of default would become an important 'drafting gate' in the actions that follow. The initial assessment of the event of default should therefore be codified to provide greater clarity to the process that would follow an event of default.

4.2.4 If default events are to be referred to the Authority, this raises the question as to whether *any* shortfall, no matter what amount, should be considered an event of default. Currently, if a retailer short pays on an invoice from the clearing manager or fails to meet a call from the clearing manager, this shortfall is an event of default regardless of the amount. By contrast, under the Authority's draft model use-of-system agreement,[12] a shortfall in payment by a retailer to a distributor is a "serious financial breach" where the failure by the retailer to pay the distributor an amount due that exceeds the greater of $100,000 or 20% of the monthly lines charges or a material breach of the prudential requirements. This definition of a serious financial breach was developed by industry working groups in early 2000's. The development of these arrangements did not consider whether there should also be some materiality assessment of a retailer default in the wholesale market.

4.2.5 Although the Authority may become aware of an event of default, it may not initially have the information to confidently establish whether the event of default is a low risk or a high risk event. The Authority's initial assessment for the existing categories of default (not including termination of a use-of-system agreement) could therefore be limited to establishing whether the default event is a minimal risk event. The *Guidelines* suggest that a minimal risk event is an event that is easily resolved and is generally resolved on the same day that the default occurs.[13] The Code could therefore stipulate that on being notified of an event of default, the Authority would immediately investigate and determine:

a) whether an event of default exists; and

b) if an event does exist, whether that event is a minimal risk event arising from a technical or administrative failure that has or will be corrected within one business day.

4.2.6 Section 3.4 discussed requiring distributors to notify the Authority that the distributor had terminated a use-of-system agreement following an unresolved serious financial breach. In this situation, the Authority would assess whether the distributor had complied with the terms of the use-of-system agreement with the retailer and whether the Authority should become involved to transfer affected customers to an alternative retailer. Reasons the Authority may not act could include if the situation appeared due to a failure of parties to engage in good faith to resolve a commercial dispute. In the absence of action by the Authority, a distributor would be entitled to notify consumers that they would be disconnected unless they switched to an alternative retailer.

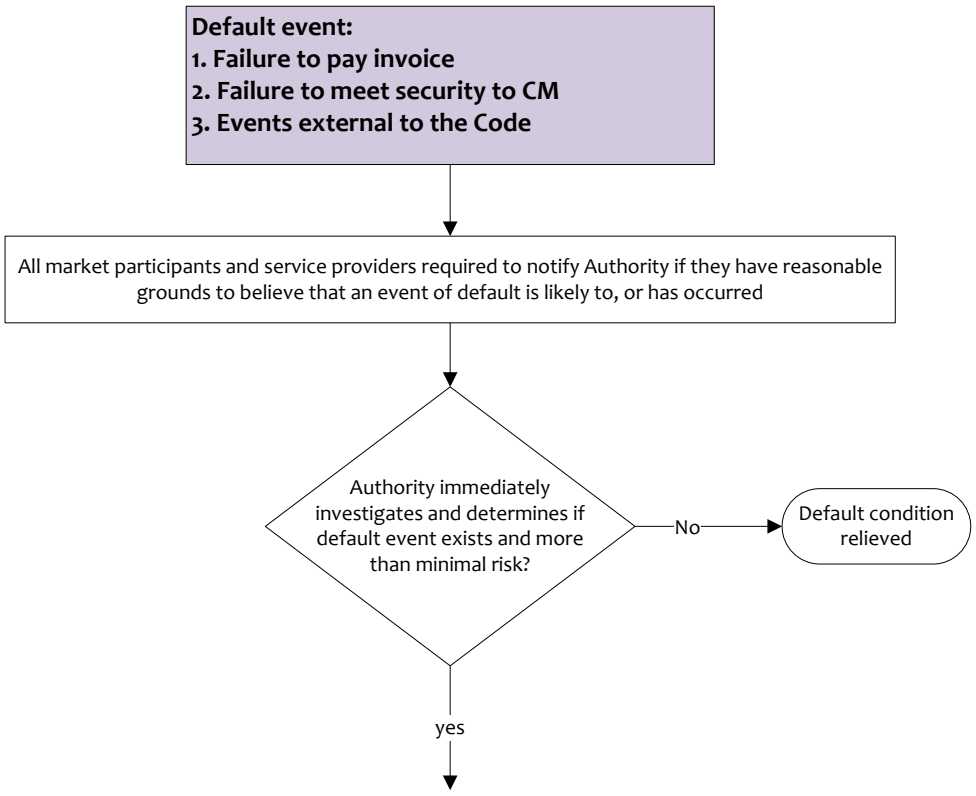
[12] The Authority's draft model use-of-system agreements are available at http://www.ea.govt.nz/our-work/consultations/retail/model-use-system-agreements/.

[13] Electricity Authority, *Guidelines for Managing Retailer Default Situations* page 7, ibid.

4.2.7 To reflect this approach, the definition of a minimal risk event should include a commercial disagreement that doesn't affect the retailer's long-term ability to trade.

4.2.8 If the Authority finds that an event of default exists and that it should not be categorised as a minimal risk event, the Authority could determine to take the actions discussed in the following section. This process of notification and initial assessment of an event of default is shown in figure 3 below.

Figure 3 Notification and initial assessment of default event



Q8. *Should the Code stipulate that on being notified of an event of default, the Authority would immediately investigate and determine:*

a. whether an event of default exists; and

b. if an event does exist whether that event is a minimal risk event arising from a technical or administrative failure that has or will be corrected within one business day or a commercial disagreement that doesn't affect the retailer's long-term ability to trade?

Q9. *Should any assessment by the Authority of whether the event is a minimal risk include a materiality threshold, equivalent to the serious financial breach threshold under the draft model use-of-system agreement?*

Q10. *If distributors are provided with an option of notifying the Authority that they had terminated a retailer's use-of-system agreement as a result of an unresolved serious financial breach, should the Authority be tasked with assessing whether the distributor had complied with the notice terms of*

the use-of-system agreement and, in the absence of action by the Authority, would be entitled to notify consumers that they would be disconnected unless they switched to an alternative retailer?

4.3 Action by Authority in event of default

Authority to write to the retailer

4.3.1 Commercial realities place strong incentives on a retailer in financial difficulty to attempt to sell its customer base quickly to another retailer if it cannot trade back to profitability. The retailer's customer base is likely to comprise its most significant asset. A delay in action by the retailer or its agent would risk customers switching away of their own volition as customers become concerned at the prospect of disruption or higher prices, and hence delay by the retailer would diminish its most significant asset by the day.[14] These same incentives would apply equally, if not more so, to any agent of the retailer, for example, a receiver appointed by a third party such as a bank, or an agent of the shareholders.

4.3.2 The Authority's minimum terms and conditions for domestic contracts for delivered electricity – which retailers may choose to adopt – already provide for an assignment clause and the great majority of retailer contracts currently provide for assignment.[15] The Code could be amended to require that retailers include in their customer contracts an assignment clause so that a commercial transfer of customers in event of a default is contractually feasible.

4.3.3 Based on informal feedback from industry participants and receivers the RAG considers that any trade sale would likely be for 100 per cent of customers (at least in any geographic area). This is because the failing retailer or its agent is unlikely to hand over its customer list until a sale has been concluded. This view is consistent with all previous retailer exits from the New Zealand electricity market. However, the E-Gas experience remains an anomaly, as not all customers were included in the sale.

4.3.4 A risk remains that a retailer, for whatever reason, might fail to act quickly to try and transfer its customers to another retailer or otherwise take action to stop the accumulation of financial losses (the section below considers the circumstances in which the retailer is unsuccessful in transferring some or all of its customers). Because of the possibility that the retailer, or its agent, might not take all feasible actions or act sufficiently quickly, the RAG considered re-establishing the power that existed under the former NZEM rules for the clearing manager to appoint a receiver.

4.3.5 Although the option of re-establishing a power for the clearing manager to appoint a receiver gained broad support in submissions at a conceptual level, the submissions and further legal advice raised practical problems which outweigh its benefits. These practical problems include:

a) a retailer is likely to have secured interests as a result of its financing arrangements and these interests would likely rank in front of the clearing manager;

b) a retailer without bank finance would likely be supported by shareholders and these shareholders would almost certainly be attempting some action before the Authority could react;

[14] This departure of customers 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.

[15] RAG Discussion Paper: *Retail customers in retailer default situations,* February 2012, paragraph 3.9.2.

c) a receiver (appointed under existing law) could act only in the interests of a secured creditor and might not advance the broader objectives of ensuring all customers are transferred to a viable retailer (a receiver might, for example, prefer a higher offer for a select group of customers than a lower monetary offer for the entire customer base);

d) re-establishing a right for the clearing manager to appoint a receiver will undermine, or may be viewed as undermining, the rights of the secured financiers of a retailer and therefore make it more difficult for a retailer to obtain finance and hence raise entry barriers to the market; and

e) a receiver appointed by the clearing manager would initially have less information than the retailer about its circumstances and could not act as quickly as the retailer; the appointment might conceivably delay rather than bring forward a solution.

4.3.6 The RAG therefore turned its mind to sharpening the existing commercial incentives on the failed retailer (and any agent such as a receiver or shareholder appointee) to take action to quickly transfer its customers to another retailer or rectify the default event. This 'tightening of the screw' could be effected by the Authority advising the retailer and its agent that unless the default had been rectified within a specified number of days, the Authority would:

a) communicate with all of the retailer's customers advising them that their retailer had defaulted and that the customer should switch to another retailer and that if they did not switch by a specified date the Authority would assign them to another retailer; and

b) proceed to terminate the retailer's rights to trade electricity under the Code.

Q11. *Should the Code stipulate that on determining that an event of default of more than minimal risk exists the Authority would advise the retailer and its agent(s) that unless the default is rectified within a specified number of days, the Authority would:*

a. communicate with all of the retailer's customers advising them that their retailer had defaulted and that the customer should switch to another retailer and that if they did not switch by a specified date the Authority would assign them to another retailer; and

b. proceed to terminate the retailer's rights to trade electricity under the Code?

Q12. *Should the Code require that retailers include an assignment clause in their customer contracts?*

Time period to rectify the default

4.3.7 Should a retailer default by failing to make a payment to both the clearing manager and the distributor on the 20th of the month, the clearing manager would be holding about seven days of net prudential security,[16] and the distributor using an interposed use-of-system agreement may be out of pocket by a net 36 days.[17] If the Authority is provided with 24 hours to determine that

[16] Currently, prudential security is provided for 57 days; at the time of default, the retailer would not have paid for 30 days of electricity consumed in the previous month plus electricity consumed in the 20 days up to the date payment was due, leaving just seven days of prudential cover.

[17] Calculated by the 30 days of lines function services for the previous month, plus the 20 days of service up to the date payment was due, less the 14 days of prudential cover allowed under the Code (assuming the distributor has not elected to take up the two month option and compensate the retailer for time value of money of the additional security). Under a conveyance contract, the funds received by the retailer for lines services are typically held on trust for the distributor and hence should be available to settle the distributor's account.

an event of default exists and that it should not be categorised as a minimal risk event (see discussion in section 4.2 above), the collateral remaining for the clearing manager would reduce to a net six days, and the exposure for distribution companies who have not taken up the two-month option would increase to a net 37 days.

4.3.8 The timeline in the draft model use-of-system agreement for managing a default of payment by a retailer to a distributor that constitutes a "serious financial breach" is:

a) the retailer must rectify the serious financial breach within two working days (clause 20.1);

b) the distributor may provide notice that it is terminating the use-of-system agreement not less than one working day after the two day period provided to rectify the default (clause 21.2); and

c) this termination would take effect after not less than a further five working days (clause 21.2).

4.3.9 Hence, under the draft model use-of-system agreement, an agreement may be terminated after an elapsed period of eight working days from the date when the distributor gives notice to the retailer that payment is overdue. This timeline was developed by industry working groups in early 2000's and the development of these arrangements did not take into account the implications of a retailer default in the wholesale market. The Authority is currently finalising the model use-of-system agreements.

4.3.10 If the time period for actions by the Authority in response to an event of default event were to be aligned with these existing time frames operating in the industry (to the extent contracts reflect the model use-of-system agreement), this would suggest that the Authority would provide a window of eight working days for the retailer to rectify the default. At the end of this eight working day period, the Authority would communicate with the retailer's customers and proceed to terminate the retailer's rights to trade under the Code.

4.3.11 A critical aspect of this eight working day window is whether it provides sufficient time for the retailer, or its agent such as a receiver, to transfer its customers to another retailer or to rectify the default.[18] The intent is to sharpen the existing commercial incentives on the failed retailer (and any agent such as a receiver or shareholder appointee) to take action to quickly transfer its customers to another retailer or rectify the default event. If the time frame is insufficient for this purpose, then the provision becomes self-defeating and all of the costs of an immediate transfer of customers would be realised (these costs were discussed in the RAG's first discussion paper and are summarised in paragraph 2.1.7 above). Allowing too long a period of time would increase the exposure of creditors unnecessarily.

4.3.12 The RAG understands that "default event" is likely to begin long before the Authority is notified of a default. The defaulting retailer will have known that cash was tight for some time prior to a default event, may already be under pressure from other creditors, and would likely have been prioritising its payments. The notification from the Authority to the retailer that it is in default sets a timeline for ending the 'juggling' by the defaulting retailer. The implication is that other retailers in the market are likely to have surmised that the retailer is in trouble and have already made preliminary assessments of whether they would be interested in acquiring the failing retailer's

[18] A seven working day period involves nine days if the clock starts on a Monday to Wednesday, and 11 days if the clock starts on any other day (ignoring statutory holidays).

customer base. Because this preliminary work has already been done, a shorter rather than longer notice period may be all that is required.

4.3.13 Informal discussions with receivers suggest that a receiver or liquidator would - to protect themselves from potential claims that they had not realised the best value - probably advertise a prospective sale and give potential purchasers three to five days to come forward. Because retail electricity is an essential service the receivers considered that a quick sale would be justified. The receivers also supported the assessment by the RAG that a receiver would seek a quick sale to minimise the risk of losing customers prior to the sale. A typical sale process might take four to six weeks, though sale processes of around two weeks are not uncommon. These comments suggest that a period eight working days, to align with the model use-of-system agreement time periods, may be at the 'tight end' of the continuum of possibilities.

Q13. *What period of time, measured in days, is necessary to allow sufficient time for a retailer to transfer responsibility for its customers to another retailer or to rectify the default?*

Q14. *Should the relevant period of time be specified in working days or in calendar days?*

Allowing more time if entities owed money agree

4.3.14 This period of eight working days provided to the retailer to rectify the event of default, including any interest payable, would be fixed in the Code. A mechanism could be included whereby the Authority could extend the timeframe with the approval of the parties (for example, generators) who would bear the financial risk of an extended time period, in much the same manner as creditors might agree a plan by a debtor if that is a better option for the creditor than bankrupting the debtor. An example of circumstances where it might be in the interests of the parties owed money to allow more time might be where another retailer had agreed to take the customer base, but the transaction could not be completed by the due date and it was in the interests of the entities owed money for that transaction to proceed rather than for the Authority to communicate with the customers and potentially undermine the sale by prompting customers to switch of their own accord.

4.3.15 As with a proposal for a compromise with creditors under section 228 of the Companies Act, a decision by the entities owed money to accept an extended time period might require approval of a majority in number representing 75% in value of the money owed (that is, generators, or distributors if the event of default is a non-payment of a distributor's invoice).[19] It would be the responsibility of the acquiring retailer to seek and gain these approvals.

Q15. *Should a mechanism exist to extend the number of days provided to the retailer in default to rectify the event of default, including any interest payable, if that extension of time is approved by the parties who would bear the financial risk of an extended time period?*

Q16. *Should any extension of time for rectifying the default require approval of a majority in number representing 75% in value of the money owed or some other threshold?*

[19] These voting rights might be determined as at the day of default, for simplicity, accepting that the amounts owed would potentially increase daily and the portion owed to each entity may change over time (but probably not significantly or rapidly).

4.4 Assigning or subrogating rights to generators and other participants

4.4.1 Several clauses under Part 14 provide for generators, if not paid in full, to be assigned or subrogated to the rights of the clearing manager. Generators may, in the name of the clearing manager, take the actions that the clearing manager should have taken to enforce repayments or exercise its other rights (clause 14.54). These provisions appear to be a legacy of the multi-lateral contract structure of the original NZEM rules. The provisions in effect provide for the generators to undertake the actions of the clearing manager should the clearing manager fail to complete its responsibilities.

4.4.2 The need for generators to step into the shoes of the clearing manager has been supplanted by the Electricity Authority under the Electricity Industry Act. Section 16(2) of the Act provides that:

> *Instead of, or as well as, contracting for market operation services, the Authority may itself perform—*
>
> *(a) the functions of the market administrator, if the Authority considers it desirable to do so; and*
>
> *(b) any other market operation service, but only on a temporary basis (such as when there is no current contract, or the contractor is unable or unwilling to perform the service).*

4.4.3 The Authority has the statutory power to undertake the functions of the clearing manager when the clearing manager is "unable or unwilling to perform the service". There is no useful purpose in allowing generators to also undertake the functions of the clearing manager, and the possibility that one or more generators might assert that right during an event of default could add confusion and complexity. The provisions that provide for generators to be assigned or subrogated to the rights of the clearing manager should therefore be removed from Part 14.

Q17. *Should the Code provisions that provide for generators to be assigned or subrogated to the rights of the clearing manager be removed from Part 14?*

5 Transfer of any remaining customers

5.1 Authority to communicate customers of failed retailer

5.1.1 By 'tightening the screw' the Authority's actions should prompt the failed retailer, or its agents, to take all feasible actions to transfer its customers to another retailer or rectify the default event. However, if, at the end of the eight-day period, the retailer has not satisfied the Authority that the retailer is no longer in default, or has not transferred all of its customers to another retailer, the Authority would communicate with the retailer's customers. The Authority would advise those customers that their retailer had defaulted, that they should switch to another retailer and, that if they did not switch by a specified date, the Authority would arrange for them to be transferred to another retailer. This communication could include written communications, advertising in the media and/or notices on the Authority's website. The Code could also be amended to allow the Authority to provide the customer list to competing retailers so that they may make their own approaches to the customers of the retailer in default.

Q18. *If, at the end of the eight-day period, the defaulting retailer has not satisfied the Authority that it (the retailer) is no longer in default, or has not transferred all of its customers to another retailer, should the Authority have the ability to communicate with the retailer's customers advising those*

customers that their retailer had defaulted, that they should switch to another retailer and, that if they did not switch by a specified date, the Authority would arrange for them to be transferred to another retailer?

Q19. *Should the Authority be able to facilitate this voluntary transfer by providing the customer list of the retailer in default to competing retailers so that they may make their own approaches to the customers of the retailer in default?*

5.2 Time period for customers to switch before Authority arranges transfer

5.2.1 Under the draft model use-of-system agreement, a distributor must provide a consumer with at least ten working days' notice of a temporary disconnection in circumstances where a retailer's use-of-system agreement has been terminated because of an event of default. To maintain consistency with these existing industry arrangements, the Authority could provide a period of ten working days for the consumer to voluntarily switch to an alternative retailer.

Q20. *What period of time, measured in days, should be provided by the Authority to the customer of the retailer in default to voluntarily switch to an alternative retailer?*

5.3 Arrangements for transferring remaining customers

5.3.1 The 'tightening of screw' on the retailer to transfer its customers through commercial means, and then the appeal by the Authority to each remaining customer to switch to an alternative retailer, should provide the impetus for all, or almost all, customers to switch. In all exits by a retailer from the New Zealand electricity market, the commercial incentives (including commercial reputation) have been sufficient to ensure 100% of customers were transferred prior to the retailer exiting the market and no short-fall in payment occurred.[20] However, the experience of E-gas in the gas market was different, in that not all customers were transferred as a result of the commercial sale process, and a costly and time consuming process for the gas distributor followed in locating each remaining customer and persuading them to transfer to a new retailer.

5.3.2 Hence it is possible that, despite the efforts of the Authority, some customers (not transferred through a commercial arrangement) may not have switched of their own accord for any of a number of reasons. The customer may simply have not acted quickly enough, may have been on holiday or pre-occupied with other matters that were more important for them at the time, or the customer may not have received the advice from the Authority. Alternatively, a customer may not have been able to identify a retailer that was willing to supply them on terms acceptable to the customer.

5.3.3 To achieve the objective of stopping the financial loss incurred by industry participants and ensuring that customers that pay their bills receive continuity of supply, some process may be necessary to transfer quickly any residual customers. In considering the design of this 'tidy up' process, it will be important to keep in mind that the number of customers involved is expected to be comparatively small (relative to say a retailer of last resort mechanism that is designed to switch the entire retail base of a failed retailer and might involve the forced transfer of tens of thousands of customers).

[20] The history of exits by retailers from the New Zealand electricity market was summarised in the RAG Discussion Paper: *Retail customers in retailer default situations,* February 2012.

5.3.4 The Authority has no power to instruct customers to switch to another retailer.[21] Section 32(2)(a) of the Electricity Industry Act 2010 provides that the Code may not impose obligations on any person other than an industry participant or a person acting on behalf of an industry participant, or the Authority.[22]

5.3.5 However, the Code could require retailers to have two provisions in their customer contracts:

a) a provision allowing the retailer to terminate the contract with their customer (if they are in default and on notice from the Authority) and to establish a new contract with a different retailer. This provision would be used if the defaulting retailer successfully sells its customer base; and

b) a provision allowing the Authority to terminate the contract and a new contract to be established with a different retailer. This provision would be used if customers of the defaulting retailer are left without a retailer.

5.3.6 Retailers in the same network area would be required by the Code to enter into contracts (under the new retailer's terms and conditions) with customers of the defaulting retailer whose contracts have been terminated by the Authority.

Q21. *Should the Code impose on retailers an obligation to have the following provisions in their contracts:*

a. in a default situation, the Authority may terminate the contract between the retailer and its customer; and

b. if the Authority terminates the contract under (a), the customer would become bound by a contract with another retailer stipulated by the Authority?

Q22. *Should retailers in the same network area be required by the Code to enter into contracts with customers of the defaulting retailer whose contracts have been terminated by the Authority?*

5.4 Allocation of customers by the Authority

5.4.1 If the Code provides for the Authority to direct a retailer to exercise its rights under its customer contracts and transfer those contracts to other specified retailers it will be important to provide clarity and certainty for both the receiving retailer and affected consumers. An intervention by the Authority to cause consumers to be transferred to another retailer may be an unhappy experience for all parties. Consumers remaining with the retailer in default have previously elected to switch to that retailer and to stay with the retailer and may face (eventually) additional costs from a transfer to a retailer not of their choosing. The recipient retailer presumably would prefer not to receive the customers on their existing terms, or it would have reached some agreement with the failed retailer prior to the forced transfer. The retailer in default (and any agent appointed to it such as a receiver) may not be happy with the remaining elements of its business being taken from it.

5.4.2 The RAG anticipates that any mandatory transfer of customers would involve only a very small number of consumers. The mechanisms discussed above are intended to achieve a commercial

[21] Letter from Tony Dellow, Buddle Findlay, to Electricity Authority, 21 March 2011, paragraph 3, 7-11.

[22] By contrast, section 43G of the Gas Act provides for regulations to be made to provide a system of transition arrangements in the event of a gas retailer becoming insolvent.

transfer of the entire retail base (and reinforce the historical experience in the New Zealand electricity sector of achieving a 100% transfer of the retail base), and then provide for an appeal by the Authority to each remaining customer to switch to an alternative retailer.

5.4.3 The Authority in its *Guidelines* commits to following one of three methods should it enact its backup code and mandate a transfer of customers. These methods are:

a) mandatory allocation of customers in each network to the largest retailer operating on that network;

b) mandatory pro-rating of customers across all retail customers on each network; and

c) voluntary competitive tender.

5.4.4 It would also be possible for the Authority to try and achieve a commercial transfer (perhaps at zero price). As the Authority would be transferring customers, to be supplied on the terms set by the receiving retailer, it may have a greater prospect of success relative to the receiver of the failed retailer (which may have offered the customer base on their existing terms). The prospect that the Authority may propose a more attractive 'tender' may create a disincentive for retailers to negotiate a transfer with the failed retailer.

5.4.5 The Guidelines suggest that an approach of allocating the customers in each network to the largest retailer may be appropriate because (at the time the Guidelines were written) it was the norm for the largest retailer on a network to be significantly larger than the other retailers on that network. Because of its size, the largest retailer might have the organisational capacity to absorb into its operations the customers of the failed retailer. However, the 'norm' of one retailer being substantially larger than the others may not be sustained over time through competition between retailers, and it is at least feasible that the retailer that defaults is the largest retailer on a particular network.

5.4.6 A clearer and more sustainable approach might be for the Authority to allocate any remaining customers of the retailer in default amongst retailers on the affected network on a pro rata basis based on a historic retail volume measure. This approach would have the attribute of having a proportionate impact (positive or negative) on competitors within a network area. As the residual number of customers to be allocated through this means is likely to be small, the competitive effects are also likely to be small. It would also leave the task of matching, over time, retailer service offerings to customer preferences to the experts – the customers and the retailers. However, the approach would be less flexible and provide less scope for the Authority to fine tune the allocation to fit the circumstances. Against the benefits of flexibility, clear and certain rules may limit the scope for an aggrieved party to challenge the actions by the Authority and will assist all parties to anticipate the actions of the Authority and plan accordingly.

Q23. *Should the Code provide for the Authority to invite other retailers to tender to provide contracts to the customers of the failed retailer whose contracts the Authority has terminated?*

Q24. *Should the Code enable the Authority to allocate, as a last resort, any remaining customers of the retailer in default amongst retailers on the affected network on a pro rata basis based on a historic retail volume measure?*

Q25. *If you do not agree with a pro rata basis, what method should the Authority use to allocate any remaining customers of the retailer in default amongst retailers on the affected network?*

5.5 Date at which transfer takes effect

5.5.1 The mandatory transfer of any remaining customers of the failed retailer (under the time frames discussed above) would likely occur part way through a billing cycle. The industry standard is that responsibility for a customer changes on the date of the switch and it would seem preferable for any mandatory switch to dovetail into existing processes as much as is feasible. Hence, the transfer would not be backdated. The RAG considers that the transaction costs of establishing a non-standard switching regime for a small number of customers was not worthwhile, especially as the intent of the preceding mechanism is to avoid the need for any mandatory transfer.

Q26. *Should responsibility for the customer, caused to be transferred by Authority, change to the new retailer on the date of the switch?*

5.6 Requirement for retailer in default to provide information

5.6.1 If the approach outlined above is to be adopted, the Code should be amended to require a retailer in default to provide the Authority with the information it would need to communicate with all of the retailer's customers advising them that the retailer is in default. The Code should also require the retailer to provide any information required by the Authority to transfer any remaining customers.

5.6.2 Ideally, the Authority would communicate with all of the retailer's customers in writing. However, a defaulting retailer has little incentive, at least during the period when it is attempting to achieve a commercial sale of its customer base, to provide its comprehensive customer list to the Authority or to any other party, even if obliged to do so. Should the retailer not provide the Authority with its customer list, then replicating that list so that the Authority can write to all of the retailer's customers would be difficult. It may be possible for the Registry to compile a list but there may be errors and omissions. Some distributors (especially those with a conveyance contract) may have customer databases that would assist the Authority.

5.6.3 Should the retailer cease functioning, a counterparty may also be required for switching those customers that voluntarily moved to an alternative retailer. The counterparty provides the information, such as last meter read, for the switching process. The Code could provide for the Registry, acting on instruction from the Authority, to undertaken these counterparty requirements in a default event, if needed.

5.6.4 The potential for information difficulties suggest that the Code changes associated with implementing the proposed arrangements should provide for the Authority to:

a) advertise to advise customers of the retailer in default that they should choose an alternative retailer;

b) access information held by the Registry and distribution utilities to reconstruct a customer database if necessary; and

c) instruct the Registry to act as counterparty for customers switching voluntarily from the retailer in default, if required.

5.6.5 If the retailer in default does not make its records available, then the Authority (and any retailer to which it ultimately transfers customers) will not have a list of the medically dependent customers. This suggests that the Authority, in its communications, should stress that the customer should advise its new retailer if he or she is medically dependent and the recipient

retailer will need to take greater care until it can establish whether any customers transferred to it from the defaulting retailer are medically dependant.

Q27. *Should the Code be amended to require a retailer in default to provide the Authority with the information it would need to write to all of the retailer's customers advising them that the retailer is in default, and if necessary, to cause any remaining customers to transfer to another retailer?*

Q28. *Do you agree that to address the potential for information difficulties the Code should provide for the Authority to:*

a. advertise to advise customers of the retailer in default that they should choose an alternative retailer;

b. access information held by the Registry and distribution utilities to reconstruct a customer database if necessary; and

c. instruct the Registry to act as counterparty for customers switching voluntarily from the retailer in default, if required?

6 Regulatory impact assessment

6.1 Statement of objectives

6.1.1 The objective of the proposed arrangements is to manage the outcome of an event of default by a retailer in a way that:

a) maintains the confidence of consumers that the electricity market will maintain a reliable electricity supply;

b) maintains the confidence of industry participants in the electricity market by establishing a mechanism for stopping the financial losses being incurred by industry participants; and

c) provides an efficient way of transferring customers of the defaulting retailer to another retailer.

6.1.2 A retailer default situation includes failure to pay an amount due to the clearing manager, failure to maintain required prudential security, the appointment of a receiver or statutory manager, or the retailer becoming insolvent or entering liquidation.

6.2 Evaluation of the costs and benefits of the proposal

6.2.1 A quantitative analysis of the costs and benefits of the proposal does not appear practical, as it would involve, amongst other things, assumptions about the number of customers supplied by the defaulting retailer, the size of their demand, the date of the default, the number who are sold or voluntarily switch and the billing cycle of the individual customers. A qualitative analysis has therefore been used to discuss the merits of the proposal.

6.2.2 It is expected that the benefits of this proposal arise from both a reduced probability of default and a reduced cost in the event that default occurs. The primary benefits of the proposal are:

a) Retailers' risk-taking behaviour (moral hazard) is reduced. This will manifest as higher (efficient) prices and a lower probability of default. Higher prices mean that a lower (efficient) level of electricity will be consumed. The threat of action by the Authority,

ultimately to confiscate the customer asset, will reduce inefficient competition from retailers with excessively risky pricing strategies.

b) This reduction in moral hazard reduces the risk of default and therefore loss to generators and distributors. In addition, under the proposal, were a default to occur, losses to generators would be capped at 21 days, and losses to distributors capped at 65 days, based on current levels of prudential security.[23] The more secure generators' income, the lower the entry costs, in particular for non-vertically-integrated generators. Competition between generators will increase, putting downward pressure on wholesale prices, and ultimately prices to consumers will be lower than they otherwise would have been.

c) The capping of the loss to generators and distributors reduces the inefficient searching for, and implementation of, other risk instruments.

d) All customers are transferred to a viable retailer, with no loss of supply. This enhances the reliability of the electricity industry.

e) The incentive for consumers to switch voluntarily to a viable retailer is maximised by allowing two weeks for this to occur and supplying relevant information to customers and other retailers to facilitate the transaction.

f) The incentive for the defaulting retailer or its agent to rectify the default or sell the customers is preserved by allowing a defined period of time for this to occur.

g) If retailers were deterred from entering the market or expanding due to uncertainty over what costs they would face if another retailer defaulted, then this mechanism would increase (efficient) competition at a retail level.

h) The costs of establishing and maintaining a retailer of last resort type scheme are avoided.

6.2.3 Costs may arise from the proposal in the following ways:

a) There are administrative costs associated with establishing the mechanism. This may include changes to the Registry, Code changes, introducing mandatory assignment clauses to retail contracts. The requirements of the Authority's processes for these types of changes suggest these costs could be significant.

b) There will be some on-going operating costs associated with monitoring the market. It seems unlikely that these would be significant as the Authority already has a substantial compliance role, and the clearing manager already monitors default events. In the event of a default there would be operating costs associated with executing the proposal. Intuitively these should be lower than the operating costs the Authority would incur if they had to establish a mechanism at the time of default (ie, the process was developed urgently), but higher than doing nothing (the status quo).

[23] This is calculated as the minimum prudential security left at the time of default less one working day for the Authority to determine that it is an event of default, eight working days for the defaulting retailer or its agent to rectify the default, one working day for the Authority to issue a letter to customers advising them to switch and ten working days to allow them to do so before the Authority requires the defaulting retailer to assign their contracts to other retailers. This process requires a total of 20 working days (and therefore 28 calendar days) irrespective of the day of the week the retailer defaults. For a generator, this equates to seven days of security less 28 days of losses. For a distributor this equates to 37 days of net loss at the time of default less a further 28 days of losses.

c) The success of voluntary, commercially-based transfer of customers may be undermined by the restricted period of time in which this can occur. This cost is mitigated by the possibility of generators and distributors agreeing to extend the timeframe.

d) Costs, including risk, may be imposed on viable retailers that are required to take the customers of the defaulting retailer. This may be exacerbated if the default were to occur in winter, in a dry year, or both, when spot prices are high relative to the new retailer's retail price..

e) Small retailers who have balance sheets dominated by significant customer debts and whose assets largely consist of their customer contracts may find it more difficult and costly to obtain finance, as the value of the defaulting retailer to other creditors is decreased. Ultimately this may dampen retail competition.

6.2.4 While the RAG considers that the benefits of the proposal outweigh the costs, it is aware that these changes may have implications for small retailers in particular, or distributors that it has not considered. The RAG invites comment on this evaluation of costs and benefits and in particular whether there are other costs and benefits it has not considered.

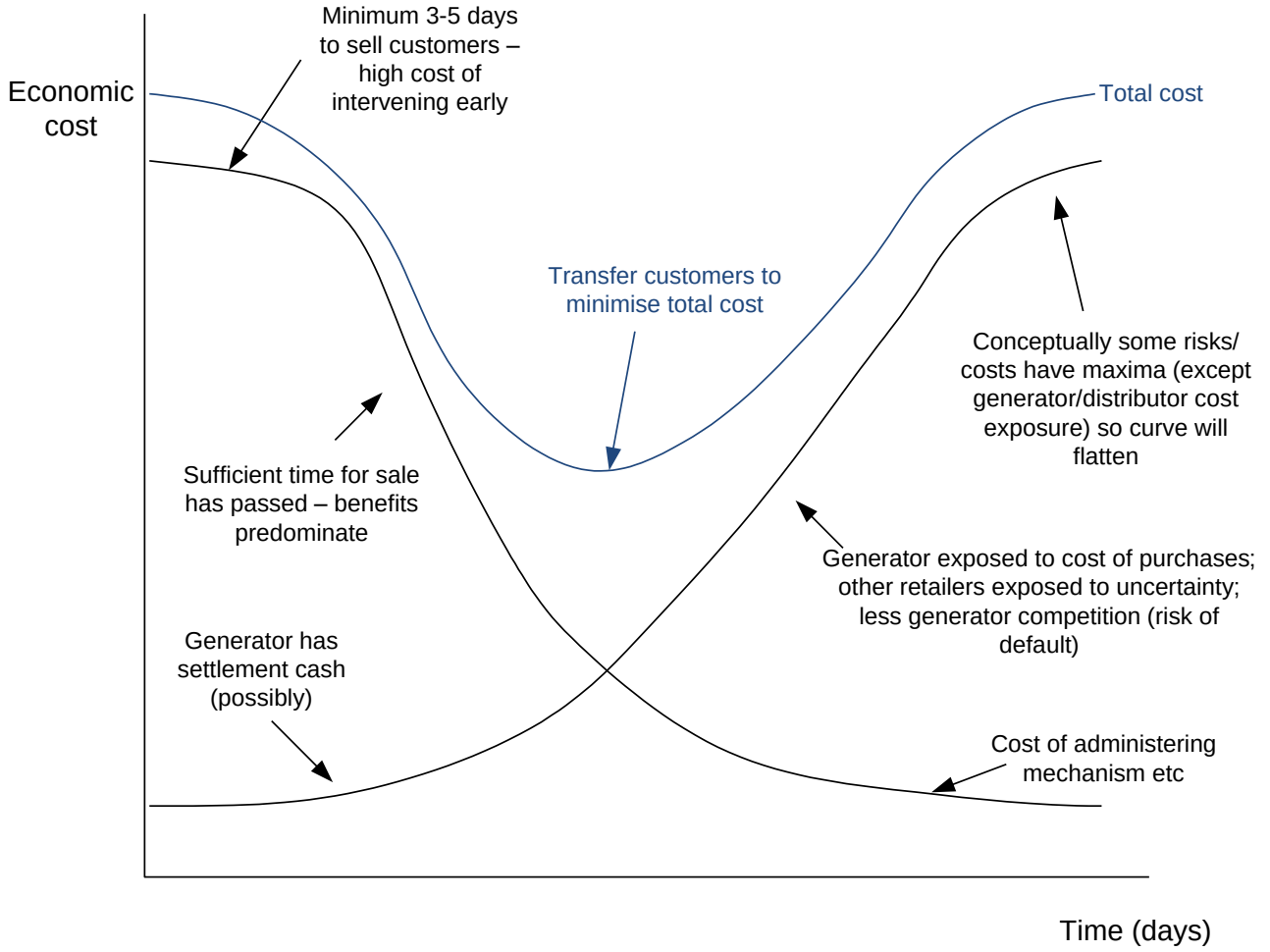
6.3 Timing of intervention

6.3.1 Figure 4 below represents conceptually the costs discussed in the previous section. This allows consideration of the appropriate timing of intervention to minimise the total economic cost of a retailer default.

6.3.2 The upward-sloping line in the figure represents those economic costs that increase the longer the defaulting retailer's customers continue to use electricity. These are principally costs to generators and distributors. The curve shows that costs rapidly rise as generators and distributors are exposed to the full cost of electricity use by the defaulting retailer's customers. In addition, the negative implications of reduced generator competition and inefficient risk-taking behaviour by retailers increase the longer the delay in transferring customers (these costs are efficiency losses, whereas non-payment by the defaulting retailer involves a mix of transfers and efficiency losses).

6.3.3 The latter competition and reliability effects probably reach a maximum, or at least diminish substantially, at some point, for example, because there are no independent generators in the market. In contrast, the exposure of generators and distributors to on-going electricity use by the defaulting retailer's customers continues, abating only if customers become nervous about their continuity of supply and voluntarily switch. This is illustrated in the diagram by the flattening of the curve.

Figure 4 Economic costs of the time for resolving a retailer default situation



6.3.4 There are another set of economic costs that decline over time. These are associated with the mandatory assignment of customers, and are represented by the downward sloping line in the figure.

6.3.5 If the Authority intervened early (say within the first week after the default), the likelihood of a successful, commercial transfer of customers away from the defaulting retailer would be low. This would impose a high cost in terms of reduced retail competition (because of uncertainty over the security of the asset base), high financing costs (especially for stand-alone retailers), the exit of a retailer that might otherwise have traded back to profitability, and a significant effect on viable retailers who are required to accept the defaulting retailer's customers.

6.3.6 After some period of time, probably one to two weeks, the retailer or its agent has had sufficient time to complete a sale. This means that the economic cost of intervention declines rapidly as the opportunity cost falls and the positive effects of intervention predominate.

6.3.7 It is possible to aggregate the two curves and identify that total costs are minimised by ensuring all customers are transferred to a viable retailer in a timely way. While it is not possible to identify

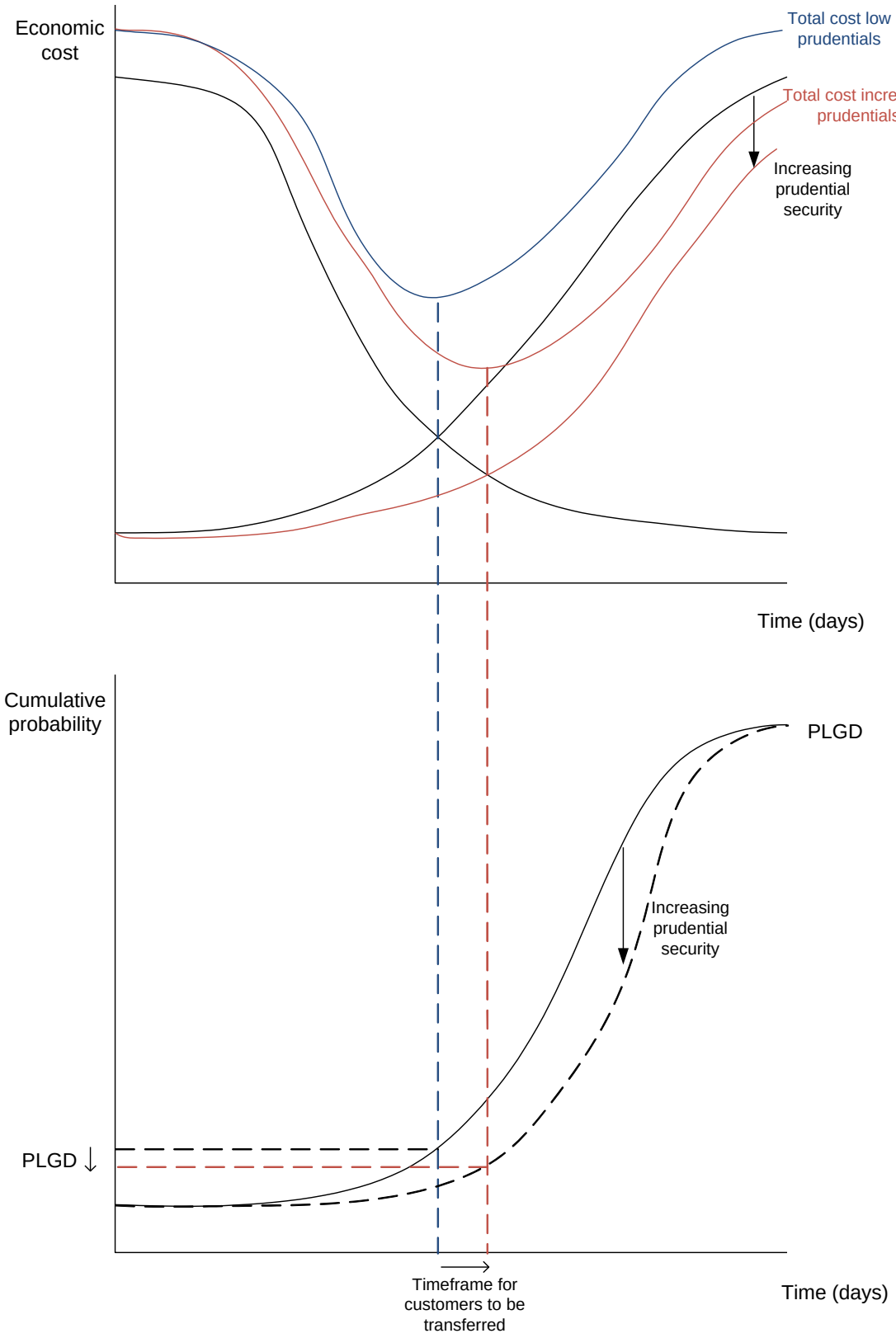
that timeframe from this conceptual analysis, it is clear that there is some delay involved while the possibility of a commercial outcome is tested.

6.4 Interaction with prudential requirements

6.4.1 As has been acknowledged, there is a link between the arrangements for the exit of a defaulting retailer and the level of prudential security held by the clearing manager (on behalf of generators) and by distributors. It is straightforward to illustrate this relationship and the interdependency between the level of security held and the efficient timeframe for intervention. The figure below does this using the probability of loss given default (PLGD) concept from the Wholesale Advisory Group's recent paper on Settlement and Prudential Security.

6.4.2 The figure shows the two variables (the timeframe for transferring customers and the level of prudential security) being determined together.

Figure 5 Implications for prudential security levels of the time for resolving a retailer default situation



6.5 Evaluation of alternative means of achieving the objective of the proposed amendment

6.5.1 The RAG considered two alternative means of achieving the objective of the proposed amendment:

a) do nothing (the status quo); or

b) re-establish a mechanism for the clearing manager (or the Authority) to appoint a receiver.

6.5.2 The RAG considers that the option of not addressing the issues identified and leaving the Code un-amended would leave market participants exposed to potentially continuing financial losses resulting from a retailer failure. Like the rules of any organised market, the Code is intended to give those who trade on the market confidence in the reliability of the transactions executed. In the absence of these rules, transacting parties would need to address issues of integrity and moral hazard through costly bilateral negotiations and long-term contracts. A fundamental function of the Code is to deter opportunistic behaviour and obviate costly self-protective measures. Allowing a party to continue to trade as normal when they are insolvent or in receivership would not be consistent with protecting the integrity of the settlement process and would not deter opportunistic behaviour or obviate costly self-protective measures.

6.5.3 The possibility of re-establishing a power for the clearing manager to appoint a receiver gained strong support at a conceptual level in submissions on the RAG's February 2012 discussion paper. This option has the primary benefits of:

a) exposing retailers to additional consequences from a default and as a result compelling them to more effectively manage risk;

b) utilising a process (receivership) that is well understood and consistent with what would occur in other markets; and

c) providing a process that does not preclude the possibility of the retailer trading back to profitability.

6.5.4 However, the submissions and further legal advice obtained by the RAG raised practical problems that outweigh the benefits:

a) the retailer is likely to have secured interests as a result of its financing arrangements and these would rank ahead of the clearing manager;

b) a retailer without bank finance would likely be supported by shareholders and these shareholders would almost certainly be attempting some action before the Authority could react;

c) a receiver could only act in the interests of a secured creditor (under current law) and could not advance the broader objectives stated above, including ensuring all customers are transferred to a viable retailer;

d) re-establishing a right for the clearing manager to appoint a receiver will undermine, or be viewed as undermining, the rights of secured financiers of a retailer and therefore make it more difficult for a retailer to obtain finance and hence raise entry barriers to the market; and

e) a receiver appointed by the clearing manager would initially have less information than the retailer about its circumstances and could not act as quickly as the retailer; the appointment might conceivably delay rather than bring forward a solution.

6.5.5 The RAG recognises that in addition to these alternative mechanisms, there may be alternatives to individual elements of the proposed mechanism and invites comment on these.

6.6 Assessment against the Authority's statutory objective

6.6.1 The statutory objective of 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.

6.6.2 The Authority considers it useful to break down its statutory objective into three limbs as follows:

a) Limb 1: promoting competition in the electricity industry for the long-term benefit of consumers.

b) Limb 2: promoting reliable supply by the electricity industry for the long-term benefit of consumers.

c) Limb 3: promoting the efficient operation of the electricity industry for the long-term benefit of consumers.

Table 1 Assessment of preferred option against statutory objective

Limb of statutory objective	Contribution of proposal to limb
Limb 1: Competition	• Increase in generator competition due to lower risk and cost of default. • Reduction in inefficient retailer competition due to certainty about the price of risk. • Uncertain effect on retail competition overall: increases due to increased certainty, but decreases due to cost of mandatory transfer of customers, as well as potentially higher finance costs for small, stand-alone retailers.
Limb 2: Reliable supply	• All customers are transferred after default with no loss of supply (disconnection).
Limb 3: Efficiency	• Prices reflect risk (efficient prices). • Efficient way to manage risk so that generators and distributors do not search for other instruments and retailers do not take inefficiently risky positions and price risk appropriately. • Certainty enhances efficiency of the industry: transaction costs are reduced (and potentially administration costs if otherwise the Authority would have to introduce a scheme when a default occurred). • Maximises incentive for customers to voluntarily switch and preserves incentive for defaulting retailer to rectify default/sell customers.