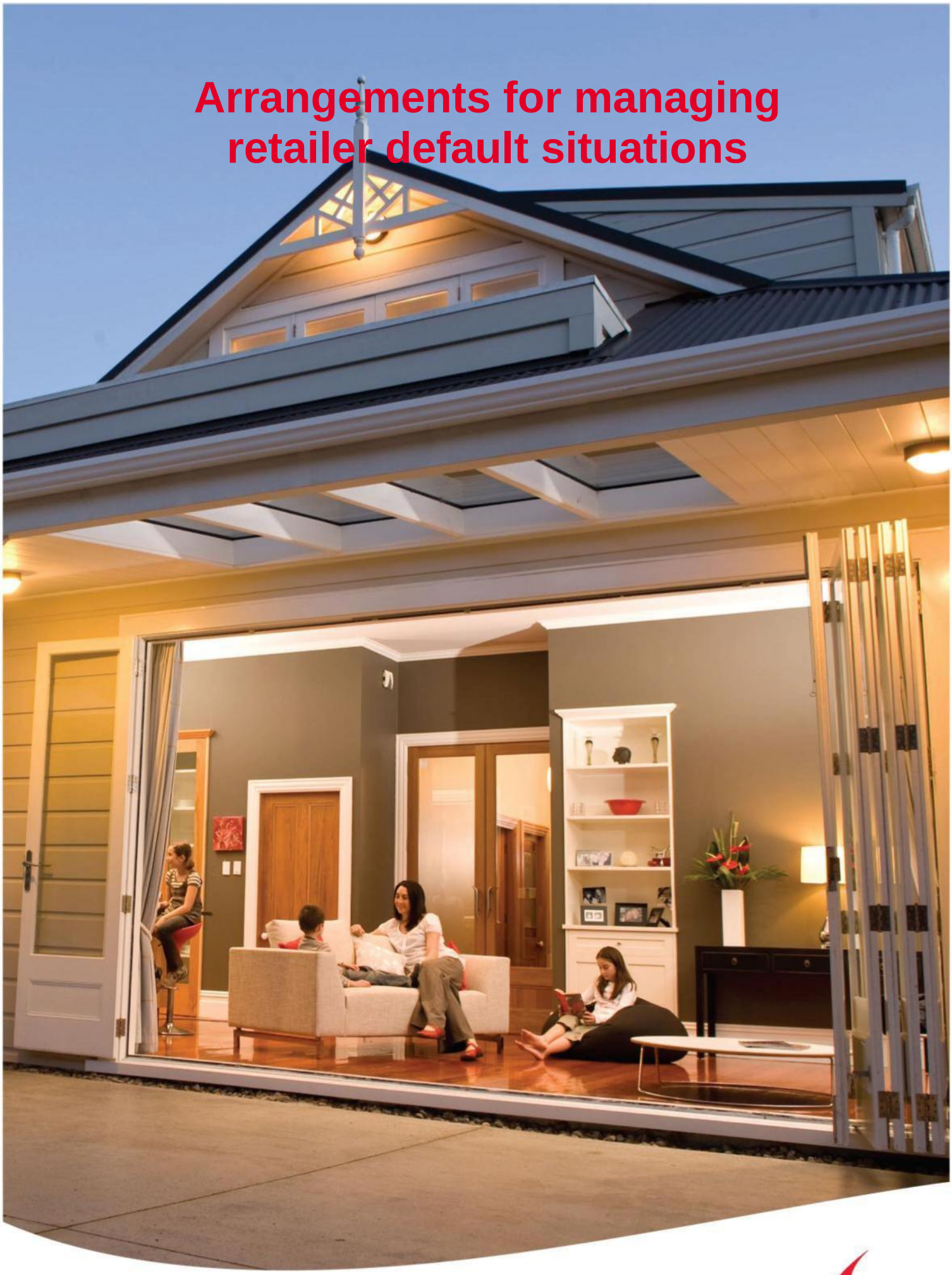
Arrangements for managing retailer default situations



contact

Introduction and summary of submission

Contact Energy Limited is pleased to be able to make a submission to the Retail Advisory Group (RAG) on managing retailer default situations.

For any questions related to this submission, please contact:

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Summary

Contact Energy Limited (**Contact**) would like to thank the Electricity Authority (**Authority**) for the opportunity to provide feedback on the Retail Advisory Group (**RAG**) discussion paper *Managing Retailer Default Situations* dated 14 August 2012.

In Contact's view, the RAG is to be commended for the work it has done in outlining the issues and proposing a solution. Issues such as retailer default are complex, not least because in many respects electricity is perceived as an essential service. In our view, the paper represents a significant step in both the right direction and to providing certainty for market participants.

Full answers to the questions proposed by the RAG are located in Appendix 1. To this Contact would also like to add the following general comments:

Stopping the financial loss is the key issue

Like the RAG, we believe that the key issue (in the event of a retailer defaulting) is not the cessation of supply to a defaulting retailer's customers, but rather that there is currently no effective mechanism under the Electricity Industry Participation Code (**Code**) to stop the financial loss incurred by industry participants.

With the exception of prudential requirements, there are no pre-qualifiers to being a retailer of electricity

It is worth noting that with the exception of prudential requirements, there are no pre-qualifiers to entering the retail electricity market. Hence, the burden falls almost entirely on prudential security. In this regard, the longer a party is in default the higher the risk that insufficient prudential security is held.

For this reason we encourage close collaboration between the RAG and the Wholesale Advisory Group (**WAG**). In fact, a number of the issues we have identified in this submission may be best addressed through the WAG's recommendations on prudential security and settlements, in particular weekly settlements and increased prudentials.

Additionally we note that the final draft interposed model use-of-system agreement published by the Authority in September has reduced the default prudential security for distributors to two weeks' line charges (from the current two-to-three months' line charges common in most existing use-of-system agreements). Resulting from this, one distributor has tabled a new use-of-system agreement proposing its own remedy for an event of default that is a serious financial breach. Such an approach is likely to frustrate the process proposed by the Authority. As an event of default is likely to affect a significant number of distributors as well as generators, it would seem sensible for the Authority to identify a solution that provides a consistent, fair and reasonable outcome for all affected participants. This may involve both Code and model use-of-system agreement changes.

Any Code change must contemplate default by both small and large players

In winter 2001, New Zealand's largest retailer at the time, TransAlta, found itself with insufficient generation capacity to withstand a prolonged period of exceptionally high prices. With no hedge contracts in place, TransAlta found itself in a precarious situation before it was finally able to sell those customers to competitors at a loss. While the situation could reoccur today, it does not follow that a sale would necessarily be achieved. Therefore, any Code provisions need to be drafted in such a way that they contemplate the implications of a default by both large and small retailers.

In our view, the reason behind the failure is likely to have a material impact on the likelihood of another retailer opting to acquire customers in the event of failure. For example, if the failure is due to fraud or poor financial/risk management, there are likely to be few issues with other retailers acquiring the defaulting retailer's customers. However, if the cause is dry year overexposure then it is likely that all retailers are stretched and no retailers may be willing to take new customers on. This is particularly pertinent during periods of high prices where this might increase a retailer's prudential requirements or take them outside their internal company risk tests.

Another example of where there may be a limited appetite for a defaulting retailer's customers is where the issue is the result of bad debt. In this instance, retailers may be unwilling to take on these customers without the provision of a significant bond or similar arrangement.

Any Code change requiring retailers to take on a defaulting retailer's customers must be carefully thought through, so as not to create systemic risk

In our view, as detailed above, one of the most probable reasons for default is a retailer having insufficient generation or hedging in place to meet its customer load during periods of sustained high prices, for example a dry winter. If the cause were dry year overexposure, it is foreseeable that all retailers will be stretched and accordingly no retailer may be willing to take on new customers.

Any Code change requiring retailers to take on these customers must therefore be carefully thought through so as not to cause, through these obligations, a domino effect, which exasperates the problem. In this respect, we cannot stress highly enough that any Code change requiring a retailer to take on a defaulting retailer's customers **must** allow retailers the ability to take on those customers on their own terms and not on the terms of the defaulting retailer.

Appendix 1 Response to specific questions

Question	Response
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?	In our view, this question is best answered by distributors. While a conveyance use-of-system agreement with direct billing of line charges (The Lines Company model) may reduce the exposure for distributors, we don't consider this an appropriate solution in the short or long-term interests of consumers. It is noted that the discussion paper does not accurately reflect the current default model for billing line charges where there is a conveyance use-of-system agreement. In the case of Vector and MainPower (as opposed to The Lines Company, which bills customers directly), the retailer bills customers for the line charges as an agent of the distributor, and settlement with the distributor is based on the actual line charges billed to the consumers (implicitly or explicitly). The lines charges are not "collected by the retailer on behalf of the distributor and held in trust" as suggested in paragraph 3.4.9, nor does the model conveyance agreement anticipate this. As noted earlier, one distributor has recently tabled a new interposed use-of-system agreement that proposes steps that are additional to the termination option in the model use-of-system agreement, namely it includes a right to appoint a receiver itself and/or facilitate the rapid transfer of the retailer's customers to other retailers.
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?	Contact is **not** supportive of a conveyance use-of-system agreement. In our view, the best way to deal with the risk being faced by distributors is by strengthening prudential requirements in the model use-of-system agreements – two weeks is not sufficient.

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?	In our view, the distributor should have an obligation to advise the Authority rather than a mere 'option'.
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?	No.
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?	While we think in principle this is a good idea, we would want to view any proposed wording before we commented further.
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?	Yes.
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?	Yes. Contact is supportive of this proposal.
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	In our view the threshold here, whereby the Authority investigates **any** notification, is too low. A threshold should be reached before an investigation is conducted; that is, the party reporting the default should 'have a genuine reason for believing the non-payment is a default event'. There may be simple reasons why a payment has not occurred on time (for example, a clerical error), in which case an investigation is not

commercial disagreement that doesn't affect the retailer's long-term ability to trade?	warranted.
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?	No.
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?	No. In our view, distributors have every reason to comply with the use-of-system agreement.
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?	Contact is supportive of this proposal.
Q12. Should the Code require that retailers include an assignment clause in their customer contracts?	Yes. We would note that our mass market contracts already include this.

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?	In our view, 8 working days is sufficient for a retailer to rectify the default before the appointment of a receiver who can transfer customers, with a further 3-5 days required to communicate with affected customers following appointment of a receiver. It could be 4-6 weeks from the event of default before a sale and transfer of customers or voluntary switches (following a letter to affected customers or an assignment of customers) is complete. We would encourage the Authority to test any potential timeframes with insolvency practitioners to ensure that what is proposed in realistic.
Q14. Should the relevant period of time be specified in working days or in calendar days?	Working days.
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?	Yes.
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?	No comment.
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?	In our view, the Clearing Manager should not be a risk-bearing agent.
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	We agree with what is proposed, but do not believe that the 8-working-days period is practical.

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?	Yes. However, this should follow a letter from the Authority to all affected customers, which advises they are required to switch to another retailer by a certain date or will be allocated to a retailer at random. The letter should also provide the customer with a list of retailers in their area. In our view, it would be very confusing for customers to receive a letter from the Authority as well as competing retailers (and potentially distributors) at the same time.
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?	In our view 10 working days is appropriate.
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?	Yes.
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?	Our preference would be to enable retailers to 'opt in'; however, we appreciate for the reasons noted earlier in this submission that this may not always be possible. Accordingly, it seems appropriate that the Code require all retailers trading on the network to accept the transfer of residual customers. Most importantly, any transfer must provide for retailers to take on customers **on their own terms** and not on the terms of the defaulting retailer.
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	No. In our view, the Code should not bind the receiver. Additionally we would note that this is likely to add substantial time to the process.

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?	For mass market (NHH) customers, the only allocation basis that would be practicable in the time available would be ICP market share. For HHR customers, fair allocation may be more difficult; however, random allocation of ICPs based on HHR volume market share would seem appropriate and workable. We would also note that any Code provisions must be drafted in such a way that they contemplate default by retailers of both small and large scale. A large-scale default has the potential to create systemic risk and therefore needs to be dealt with appropriately.
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?	N/A
Q26. Should responsibility for the customer, caused to be transferred by Authority, change to the new retailer on the date of the switch?	Yes.
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?	Yes.
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	Yes. However, we would suggest these are included in customer contracts.

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