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Peter Allport
Retail Advisory Group
c/o Electricity Authority
2 Hunter Street
WELLINGTON

By email: rag@ea.govt.nz

Dear Peter

Arrangements for managing retailer default situations – discussion paper – suggested improvements to reduce risks with regulatory intervention

Genesis Power Limited, trading as Genesis Energy, welcomes the opportunity to provide a submission to the Retail Advisory Group ("the RAG") on the consultation paper "Arrangements for managing retailer default situations – Discussion Paper" dated 14 August 2012.

Genesis Energy would appreciate the opportunity to discuss our submission with the RAG.

Current commercial arrangements and insolvency law can be relied upon for retailer default situations

Genesis Energy remains of the view that current commercial arrangements and insolvency law can be relied upon to transfer customers when a retailer exits the market. Given that market forces can be relied upon as the most efficient means for transferring affected customers to viable retailers, we consider there remains no substantial case for the creation of industry specific regulations to address retailer default situations.

Genesis Energy appreciates that the recent E-gas insolvency in the gas market has heightened concerns about the risk of stranded customers. However, the circumstances surrounding this event of insolvency were highly unusual and the Gas Industry Company's recent expert report on insolvent retailers[1] supports this view. The report notes that future events such as these are likely to be rare and retailer of last resort regulation may not be necessary.

Suggested amendments to regulation to address retailer default situations

However, if the RAG does continue to proceed with regulatory arrangements for customer transfer, we recommend that the RAG consider four specific amendments to the proposed process to minimise risks associated with such an intervention. Our suggested amendments leverage off the existing contractual arrangements in the market and we expand on these points below.

Risks associated with regulatory intervention

As the RAG acknowledges, there are a number of risks in managing retailer default situations through regulatory intervention. The RAG has sought to contain these risks by designing a process that allows for a commercial outcome to take place. However, we remain of the view that the proposed process has the real potential to reduce prospects for a defaulting retailer (or its agent) to successfully sell its customer base, or rectify a default. In particular, we are concerned that RAG's proposed process would potentially:

- increase the number of stranded customers and the costs for viable retailers who must absorb these customers;
- devalue the assets of the defaulting retailer (the retail customer base), thereby raising the cost of finance for independent retailers in future;
- reduce the rights of secured creditors over the assets of a defaulting retailer. This could unnecessarily expose the Authority to future legal challenges; and
- the method of transferring the stranded customers to viable retailers may not protect those retailers from the cost of absorbing these customers.

To address these concerns, we propose four amendments to the RAG's proposed process for consideration.

[1] *Insolvent Retailers workstream: Castalia Strategic Advisors report*, prepared by Castalia Strategic Advisors for the Gas Industry Company, 22 June 2012.

Recommendation one: Limit the definition of "default event"

Genesis Energy recommends that the RAG amend the definition of "default event" so that it is limited to:

- situations of default to the Clearing Manager (prudential check or failure to pay invoices); or
- where formal insolvency proceedings have been initiated.

In our view, the definition of "default event" does not need to capture contractual disputes between a distributer and a retailer (as proposed by the RAG). We consider that distributors should, as far as possible, be encouraged to exercise effective risk management through bilateral contracts with retailers. Distributors, unlike generators, can also seek liquidation or receivership proceedings under normal insolvency processes. Regulatory interventions by the Electricity Authority ("the Authority"), in our view, would only divert parties away from the appropriate contractual remedies and the existing procedures to address these issues.

We also consider that there may be legal risks in the Authority to becoming involved in commercial disputes between distributors and retailers. The Authority may not be informed of the terms and conditions of the agreements governing the two parties. It also may not be the correct body to make a determination of whether parties have complied with these terms and conditions. Limiting the definition of "default event" as suggested will ensure that the circumstances for the Authority exercising a regulated default process remain within the scope of the Electricity Industry Participation Code ("the Code").

Recommendation two: Further consultation on timeframes for regulated transfer

We recommend that further industry consultation is undertaken on the timeframes required for communicating with customers and imposing a regulated transfer. It is important that these timeframes provide reasonable opportunities for normal insolvency processes and commercial arrangements to work.

We consider that the RAG's proposal of allowing a defaulting retailer only eight working days to rectify the default, or to sell its entire customer base, is unlikely to be an achievable timeframe in all cases of insolvency.

We consider that communications between the Authority and a retailer's customers at this early stage would diminish any on-going efforts by the retailer, or its agent, to negotiate a sale of the entire customer base. As commercially desirable customers start to switch away from a retailer, this will devalue the

remaining customer base. In this way, the actions of the Authority could in fact increase the risk of stranded customers and the need to resort to a mandated transfer.

There is also a risk that pre-emptive action by the Authority at this early stage could be perceived as defeating the interests of secured creditors and shareholders, particularly if these parties consider that there is still a chance of the retailer trading itself out of difficulty. This early intervention could expose the Authority to future legal challenges and may also raise the cost of finance for independent retailers in the future.

Genesis Energy considers that anything less than 21 working days is likely to be inappropriate. We suggest that the RAG consult with a wide variety of insolvency practitioners to "stress-test" a suitable timeframe for inclusion within regulation. To accommodate default situations that fall outside of the regulated timeframe, we endorse the proposal to provide some flexibility for the Authority to extend the timeframes in specified circumstances.

Recommendation three: Customers should be transferred in a way that minimises financial loss to retailers

Genesis Energy considers that a regulated customer transfer scheme should seek to minimise the financial losses for those retailers who may be required to take on the customers of a defaulting retailer.[2] To enable this to occur, we recommend that the RAG further consider the provisions addressing the price and terms and conditions of supply, and the methodology for transferring customers.

Assignment clauses may not be legally effective

We recommend that further legal advice be sought to establish if it would be legally possible for retailers to determine the prices and other terms and conditions which are to be applied to customers accepted under a regulated transfer scheme.

We have concerns that whilst the contract may provide for the transfer of the customer to a new retailer under the regulated transfer scheme, it is doubtful whether the contract could provide for the consumer to be bound by a different set of contractual terms, without specifying what those terms would be.

[2] As the RAG acknowledges, requiring retailers to absorb customers in a way that financially disadvantages their business would not be in the long-term interests of consumers.

We note that retailers could face significant financial loss if they are forced to take customers at the existing defaulting retailer prices, or even on their own existing prices. For example, in hydrological dry years where wholesale spot prices are high, retailers may not be sufficiently hedged to supply new customers on the basis of their existing prices.

Methodology for transferring customers

We recommend that under the regulated transfer scheme, retailers be assigned customers based on their existing market share and the types of customers they already supply in that distribution network area. We note that information about market share and customer classification for each trading retailer at a given Grid Exit Point (GXP) is already available from the Registry.

We recommend that retailers should also retain the right to decline customers that do not meet their standard customer acceptance criteria – including credit criteria.

Recommendation four: Support legal mechanism for the Clearing Manager to place a retailer in default

Genesis Energy still supports the option of re-establishing a legal mechanism for the Clearing Manager to place a retailer in default under receivership ("option two").[3] We consider that this is a targeted way for the Clearing Manager to instigate a timely transfer of a retailer's customer base and to reduce potential losses for generators. From our understanding of the legal advice the RAG has received, it would be legally achievable for the Clearing Manager to appoint an insolvency practitioner for this purpose. We refer the RAG back to the comments we made in our prior submission, in support of this option.[4]

[3] As proposed in *Retail customers in retailer default situations*, Retail Advisory Group discussion paper, 7 February 2012.

[4] *Genesis Energy supports the need for policy changes to address the allocation of risk for generators*, Genesis Energy submission to the Retail Advisory Group, 15 March 2012.

Genesis Energy's responses to the consultation questions are provided in Appendix A. If you would like to discuss any of these matters further, please contact me on 04 495 6357.

Yours sincerely

Lizzie Wesley-Smith
Regulatory Advisor

Appendix A: Responses to Consultation Questions

QUESTION	COMMENT
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?	Distributors are able to manage their risk through other aspects of their bilateral contracts with retailers. They are not, as implied by the consultation paper's summary, limited to the contractual remedies set out under the terms of the Authority's draft model use of system agreement ("the model UoSA"). For example, distributors can establish a right to appoint a receiver or place a retailer into liquidation.
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?	We consider it is more likely that a distributor would pursue options under an interposed UoSA with a retailer, rather than insist on a conveyance UoSA. As discussed in question one above, we consider that these bilateral contracts should provide distributors with a level of comfort so that they can continue to rely on their interposed UoSA.
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?	We do not support creating a statutory role for the Authority to manage non-payment by a retailer to distributor as an event of default under the Code. As noted in our cover letter, we consider that distributors should be encouraged to exercise effective risk management through existing bilateral contracts with retailers. We also consider that there may be issues with the Authority seeking to get involved in commercial disputes between parties.

QUESTION	COMMENT
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?	As discussed in our cover letter, we recommend that regulatory intervention should be limited to events of default within the Code and any normal insolvency process.

QUESTION	COMMENT
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?	We do not support this obligation being imposed on participants, Participants are not best placed or equipped to make this assessment. Further, whether the facts amount to "reasonable grounds" may often be unclear, and a participant seeking to comply with the Code provision may be in effect speculating on the credit worthiness or otherwise of other participants. This may create legal risk for participants and the Authority. There is also a risk that this requirement may not be used in good faith, and may result in the Authority having to enquire into contractual disputes between the parties involved. The terms of that individual contract would need to be worked through to make a determination about whether an event of default is likely to occur. The Authority may not be the correct body to make this determination. We recommend a more suitable approach would: • require participants to notify the Authority of any insolvency process being formally initiated (e.g., the commencement of legal proceedings); and • require the Clearing Manager to inform the Authority of any default on invoices or prudentials. This process would create clearer parameters for notification and remove the risk of speculation.

QUESTION	COMMENT
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?	We agree that the Clearing Manager should have an obligation to advise non-compliance with Part 14. However, our understanding of the process put forward by the RAG is that the Authority would be responsible for deciding and notifying entities whether that non-compliance "is an event of default".
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.
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?	There may be a need to distinguish between defaults notified by the Clearing Manager and defaults notified by other parties. We consider that in the case of commercial disputes between other parties, the Authority may not have the information available to immediately determine whether an "event of default" exists. In this scenario, the terms of the individual contract may need to be worked through first.

QUESTION	COMMENT
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?	We agree with setting a financial threshold for materiality. However, this financial threshold should only be relevant for an assessment of whether the event is a "minimal risk event". We consider that any shortfall in payment to the Clearing Manager should continue to be recognised as an event of default. This is necessary to preserve the on-going integrity of payments into the wholesale spot market. <u>Setting the threshold</u> It is not clear why the materiality threshold should be set on the basis of what is provided for in the Authority's draft model UoSA. We consider that the Authority's model UoSA is not necessarily reflective of existing industry standards, as we are aware of a number of different versions of this agreement that are currently being used by retailers and distributor. We recommend that the threshold should be based on what the industry agrees is an appropriate amount to trigger the proposed regulatory response. Further consultation is required to determine this threshold.

QUESTION	COMMENT
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. As discussed in our cover letter, we do not support the Authority having the ability to initiate a regulated transfer of customers, on the basis of a contractual dispute between a distributer and a retailer. If the Authority is to be tasked with this role, consideration should be given to the process by which the Authority is to determine whether the distributor's purported termination is valid. Particular issues for consideration include: (a) whether the Authority's jurisdiction to determine these issues (is intended to or) will preclude the retailer from bringing legal proceedings alleging an invalid termination, or resolving the dispute by way of any alternative dispute resolution mechanism contained in the contract between the parties; (b) what, if any, appeal rights will be available to the parties following the Authority's decision; (c) the consequences to the process of the retailer seeking injunctive relief from the courts; (d) whether the procedure adopted by the Authority to determine this issue will satisfy the requirements of natural justice; and (e) the broader legal status of any such determination, for instance in relation to a claim between the distributor and retailer for damages We consider that if the distributor has terminated the UoSA without complying with the relevant provisions in the UoSA, then some form of arbitration or legal proceedings is the appropriate mechanism to address this issue.

QUESTION	COMMENT
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?	As outlined in our cover letter, we consider that the ability for the Authority to communicate with a retailer's customer should be appropriately timed so that it does not pre-empt opportunities to secure a transfer of that customer base, or to rectify the default. We consider that the proposed timeframe of eight working days may not be sufficient in all instances of retailer default.

QUESTION	COMMENT
Q12. Should the Code require that retailers include an assignment clause in their customer contracts?	Yes. However, as outlined in our cover letter, we recommend that further legal advice be sought to establish whether these types of assignment clauses could legally bind a customer to a different set of terms and conditions than that offered by their existing retailer. We have a concern that whilst the contract may make provision for the transfer of the customer to a new retailer, it is doubtful whether the contract could provide for the consumer to be bound by a different set of contractual terms, without specifying what those terms would be. We also suggest there may need to be a clause that states that reassignment will only occur if the customer has not voluntarily chosen another retailer within ten working days.
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?	We suggest that the RAG consult with a wide variety of insolvency practitioners to "stress-test" any recommended timeframe. We also support providing some degree of flexibility for the Authority to extend the timeframes in specified circumstances.
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.

QUESTION	COMMENT
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?	Yes.
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?	No, we consider that generators should continue to have the legal means to enforce repayment, in the event that the clearing manager fails to do so. While the Authority could also enforce these rights on behalf of generators, there is no guarantee that it will. We note that the powers for the Authority to act under section 16(2) of the Electricity Industry Act 2010 are discretionary only. We consider that these types of subrogation rights are important for maintaining generators confidence in the wholesale spot market.
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?	Refer to cover letter.

QUESTION	COMMENT
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?	No. We consider that this proposal replicates the receiver's role and could conceivably delay a solution, rather than assist the process.
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?	Ten working days.
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?	We agree that this obligation would be necessary to allow a mandatory transfer of customers to take place. However, in relation to 21 (b) please see our comments in relation to Q12.

QUESTION	COMMENT
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 is for customers to be assigned to all trading retailers on a GXP based on market share and customer classification. In a situation where there is no current UoSA between a distributor and a retailer on a distribution network, provisions should be made to enable the retailer to notify the Authority of their availability (or lack of) to be assigned customers on that network.
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?	No. We consider that this proposal replicates the receiver's role and could conceivably delay a solution, rather than assist the process.
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?	Refer to response for question 22.
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?	Refer to response for question 22.

QUESTION	COMMENT
Q26. Should responsibility for the customer, caused to be transferred by Authority, change to the new retailer on the date of the switch?	We recommend that process for assigning responsibility for a customer should be consistent with the current switching provisions in the Code, where responsibility for a customer's Installation Control Point (ICP) is transferred on the effective date of the switch. However, it must be clear that retailers are not held responsible for any unpaid bills prior to the date of re-assignment.
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.

QUESTION	COMMENT
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?	a) No. b) Yes. We consider that access to information held by distributors would be critical for constructing a customer database, as information from solely the Registry would be insufficient. c) Yes.