

Improving prudential security arrangements

Issues and options paper

17 October 2025

Executive summary

The Electricity Authority Te Mana Hiko (Authority) is seeking feedback on proposed improvements to prudential security arrangements to make it easier for small retailers to operate in the electricity market.

Prudential requirements mitigate the risk of non-payment for electricity consumed

Prudential requirements are financial obligations on participants that purchase electricity on the wholesale spot market to ensure that sellers of electricity are paid for the electricity they supply (even when a retailer is in the process of defaulting). This is important because generators are required to sell all electricity to the clearing manager, preventing them from managing their default risk in the normal commercial way, and because electricity is consumed before it is invoiced and paid for.

Small retailers are most impacted by prudential requirements

As at September 2025, there are 45 retailers that purchase electricity on the spot market in New Zealand. Of these, 28 are independent (ie, they do not own their own generation assets and are not associated with a parent company that owns generation assets) and 26 are small, servicing fewer than 1,000 ICPs each.

We analysed retailer defaults and prudential data to explore the impact of prudential requirements on independent retailers. We found that although the requirements have been operating as intended, they can exacerbate underlying issues with small retailers, such as weak cashflow.

This analysis has identified two aspects of the current settings that could constrain the ability of small retailers to grow and sustain competition in the electricity market:

- small retailers often have high percentages of working capital tied up in prudential security
- small retailers cannot offset purchases with large-scale generation and may not have sufficient access to hedging offsets. This exposes them to more volatility in prudential costs.

Independent retailers play an important role in increasing the competitive supply of electricity and offering consumers more choice. We want to ensure that market settings do not create barriers to the efficient and continuing operation and growth of these participants.

We are proposing four adjustments to reduce prudential costs

The Authority has identified four options to make it easier for small retailers to meet their prudential requirements. We want any changes to produce real and enduring benefits for consumers and have focused on options that do not materially increase credit risk for generators. A key determinant of a prudential framework's risk profile is the probability of loss given default (PLGD). The Authority considers that the current PLGD of 25% strikes an appropriate balance of risk sharing between generators and purchasers.

Two of the options in this paper affect the 'exit period prudential margin'. This covers the clearing manager's exposure to a retailer for the period necessary to exit them from the market in the event of default. These options would involve:

- adjusting the ‘adder’ component of the exit period prudential margin on a dynamic basis (the adder is to account for potential unexpected upswings in wholesale prices)
- reducing the post-default exit period to 14 days (currently 18 days) for retailers with 1,000 or fewer ICPs with an equivalent reduction to the Authority’s trader default process to offset any increased risk to generators.

Both proposals could feasibly be implemented by Winter 2026. We are open to reducing the post-default exit period for all independent retailers. However, the Authority must first address broader issues with the trader default process affecting the Authority’s ability to switch commercial customers, and the impact on these customers of being placed on alternative tariffs. This will be progressed in 2026.

We are also consulting on two further measures to reduce total prudential exposure for all independent retailers:

- reallocating residual funds held in the clearing manager’s account (these funds accumulate from interest accruing on deferred payments) from generators to retailers on a scaled basis. Between June 2024 and April 2025, a total of \$2.94 million in residual funds was distributed to generators
- enable ASX hedges to be taken into account in the calculation of prudential requirements.

We are also progressing wider retail initiatives to support competition

In parallel with the measures outlined above, the Authority is working on a number of other retail market initiatives that will also support competition and choice for consumers including a new comparison and switching service, evolving retailing arrangements by allowing customers to choose different retailers for consumption and generation, introducing standards for the real-time exchange of consumer data, and requiring half-hourly reconciliation where smart meters are in place.

Once these foundational aspects of the retail market are in place, the Authority will consider whether current arrangements for entrant retailers provide appropriate confidence for consumers and hold participants to standards that reflect the risks and complexity of retail operations. This may lead to further proposals to strengthen the entry and management of retailers.

We want your feedback

We welcome your insights as to the nature and extent of the issues identified and the form in which they are best addressed. We encourage you to read this paper and email us your feedback by 5pm Tuesday 28 November. This will inform a subsequent consultation on proposed Code amendments in early 2026 if progressed.

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1. How your insights can guide our approach

What this consultation is about

- 1.1. The purpose of this paper is to consult with interested parties on four proposals to make it easier for small independent retailers to meet their prudential security requirements without increasing system risk.
- 1.2. Vibrant retail competition can drive innovation with tailored service offerings and new technologies. Our goal is to ensure that prudential requirements are proportionate and do not unnecessarily restrict small retailers from competing and expanding in the New Zealand retail electricity market.
- 1.3. Improving the efficiency and affordability of prudential requirements for small retailers in the wholesale market aligns with our main statutory objective to promote competition in, reliable supply by, and efficient operation of, the electricity industry for the long-term benefit of consumers.
- 1.4. We are interested in your views on the problem definition as well as the options for adjustment. Your insights and perspectives will inform the development of a subsequent, more targeted consultation on proposed Code amendments currently planned to be released early next year.

How to provide feedback

- 1.5. The Authority's preference is to receive submissions electronically (Microsoft Word) in the format shown in Appendix A. Submissions should be emailed to wholesaleconsultation@ea.govt.nz with "Improving prudential security arrangements: issues and options" in the subject line.
- 1.6. If you cannot send your submission electronically, please contact the Authority (wholesaleconsultation@ea.govt.nz or 04 460 8860) to discuss alternative arrangements.
- 1.7. Please note the Authority intends to publish all submissions it receives. If you consider that the Authority should not publish any part of your submission, please:
 - (a) indicate which part should not be published,
 - (b) explain why you consider we should not publish that part, and
 - (c) provide a version of your submission that the Authority can publish (if we agree not to publish your full submission).
- 1.8. If you indicate part of your submission should not be published, the Authority will discuss this with you before deciding whether to not publish that part of your submission.
- 1.9. However, please note that all submissions received by the Authority, including any parts that the Authority does not publish, can be requested under the Official Information Act 1982. This means the Authority would be required to release material not published unless good reason existed under the Official Information Act to withhold it. The Authority would normally consult with you before releasing any material that you said should not be published.

When to make a submission

- 1.10. Please deliver your submission by 5pm Tuesday 28 November.
- 1.11. Authority staff will acknowledge receipt of all submissions electronically. Please contact the Authority if you do not receive electronic acknowledgement of your submission within two business days.

2. Context

- 2.1. The current prudential security arrangements were set in 2015 following the Authority's Settlement and Prudential Security Review. This led to the replacement of Part 14 of the Electricity Industry Participation Code 2010 (the Code) and the insertion of Part 14A—Prudential Requirements bringing significant updates to the prudential methodology.
- 2.2. Since 2015, other minor adjustments have been made including a broadening of the forms of acceptable security and an increase in the types of contracts capable of offsetting prudential exposures. A 2018 post-implementation review of the 2015 changes concluded that they resulted in reduced payment risks for generators as well as lower (and less volatile) costs for retailers.
- 2.3. However, over the past year, the Authority has observed an increase in the number of retailer defaults. We have also heard from some small retailers that prudential requirements are limiting their ability to expand their businesses and compete effectively. This has prompted us to explore options for targeted improvements to the prudential settings.

Alignment to the Authority's broader competition work programme

- 2.4. More efficient and affordable prudential requirements could enable independent retailers to better compete in the electricity market. Sharper competition stimulates innovation, expands the choices available to consumers, and puts downward pressure on prices.

Prudential requirements are just one component of a retailer's capitalisation and cashflow requirements. Hedging (or the price thereof) is also an important aspect that may drive retailers' operational decisions, especially when considering expansion. The options discussed in this paper complement the Authority's broader competition work programme, including the work of the Energy Competition Task Force.
- 2.5. The electricity retail landscape is changing rapidly. New technologies and the adoption of distributed energy resources (DER) are changing how consumers use electricity and what they are looking for from retailers. The Authority is working on a number of retail market initiatives that will support competition and choice for consumers including:
 - (a) a new comparison and switching service
 - (b) requiring half-hourly reconciliation where smart meters are in place
 - (c) evolving retailing arrangements by allowing customers to choose different retailers for consumption and generation

- (d) introducing standards for the real-time exchange of consumer data.
- 2.6. Once these foundational aspects of the retail market are in place, the Authority will consider whether existing arrangements for entrant retailers are sufficient to provide appropriate confidence for consumers and hold retailers to standards that reflect the risks and complexity of retail operations. This may lead to further proposals to strengthen the entry and management of retailers.

3. The current prudential framework

Purpose of prudential requirements

- 3.1. The prudential regime is designed to reduce the risk of non-payment faced by generators. Prudential requirements provide an important safeguard given that wholesale market rules require generators to sell all physical electricity on the spot market, without receiving payment until after it is consumed.
- 3.2. The general rules concerning clearing and settlement, and prudential requirements, are outlined in Parts 14 and 14A of the Code respectively.
- 3.3. Prudential requirements apply to each industry participant that has incurred or will incur financial obligations to the clearing manager¹ under the Code. They ensure that the participant can meet those obligations.² These requirements cover every purchaser of wholesale electricity (a ‘trader’ under the Code), including retailers and direct-connect industrials³.
- 3.4. A participant complies with its prudential requirements either by providing prudential security to the clearing manager or through maintaining ‘an acceptable credit rating’ (long term A- Standard & Poors or stated equivalent). Transpower is currently the only participant with an acceptable credit rating that deals with the clearing manager. All other participants meet their obligations by providing prudential security.

The trader default process

- 3.5. Failure to comply with prudential requirements will trigger the Authority’s trader default process.⁴ An event of default is considered to have occurred when a participant fails to provide the minimum amount of security required by the clearing manager.⁵

¹ The clearing manager is the Market Operations Service Provider responsible for ensuring that industry participants pay or are paid the correct amount for the electricity they generate, or consume, and for market-related costs.

² This paper does not consider issues related to distributor prudential requirements.

³ Direct connect participants refer to electricity consumers that are connected directly to the transmission grid, rather than receiving electricity through a local distribution network.

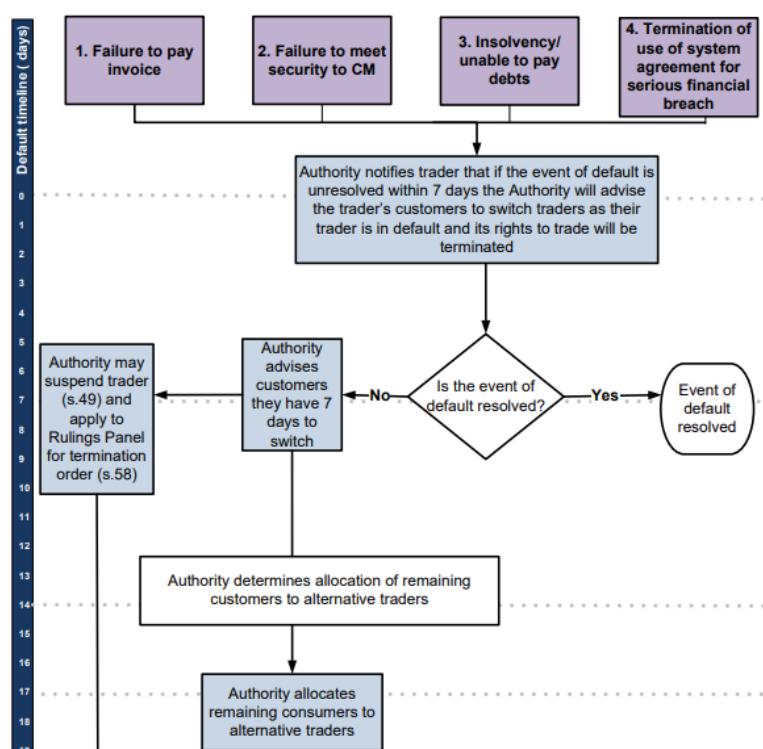
⁴ Clause 11.15C(1) of the Code.

⁵ Clause 14.41(1)(a) of the Code.

- 3.6. Once an event of default has occurred, the Authority will give notice to the trader and initiate a three-phase process:
- (a) **phase one** – the defaulting trader has seven days to resolve the default by meeting its financial obligations or transferring its customers to another trader
 - (b) **phase two** – if unresolved after seven days, the trader’s customers are notified by the Authority and encouraged to switch to an alternative retailer within seven days
 - (c) **phase three** – the Authority has three days to ensure the registry has completed the switch of all customers who have transferred – remaining customers are assigned to another retailer by the Authority on day 18.

If a default is not remedied by the retailer (eg, the retailer fails to pay its prudential debt to the clearing manager), it will be exited from the market. The trader default process timeline for retailers is illustrated in the diagram below.

Figure 1: The trader default process timeline for retailers⁶



Amount of prudential security required

- 3.7. A retailer’s minimum required security is determined by the clearing manager applying a methodology in accordance with Part 2 of Schedule 14A.1 of the Code.
- 3.8. The primary element of a retailer’s minimum security is called the ‘general prudential requirement’ which consists of:⁷

⁶ [Electricity Authority guidelines for managing trader default situations \(Version 1.4\).](#)

⁷ Specified in Schedules 14.1 to 14.5 of the Code.

- (a) general outstandings – the net amount (purchases minus generation) a participant accrued in the past month but has not yet paid for and the present month’s estimated charges
 - (b) the exit period prudential margin – the amount intended to cover the clearing manager’s exposure to the retailer for the period of time necessary to exit them from the market following a default.
- 3.9. The total minimum security⁸ is reduced by the amount of any prepayments made by purchasers that remain unsettled or fall within the prudential exit period.⁹

General outstandings

- 3.10. General outstandings include any amounts for the previous and current month that a purchaser has accrued but not yet paid for, as well as the estimated amounts that the purchaser is expected to accrue over the remainder of the month. This covers a purchaser’s actual consumption over the course of a settlement cycle.
- 3.11. The clearing manager’s financial exposure to a retailer’s general outstandings includes the net amounts for: purchases, generation, ancillary services, Hedge Settlement Agreements (described below) and GST. A retailer’s net outstandings could therefore be negative. However, their minimum security must always be greater than or equal to zero.

Exit period prudential margin

- 3.12. Two components make up the exit period prudential margin:
- (a) a prudential exit period
 - (b) an adder amount.¹⁰
- 3.13. The prudential exit period for a retailer is 18 days (the post-default exit period) plus an additional trading day. Sufficient security must be provided to cover projected consumption for the duration of the prudential exit period.
- 3.14. In calculating the prudential exit period, the clearing manager uses estimated quantities and exit period prices. These prices are based on quarterly New Zealand electricity futures prices derived from the ASX.
- 3.15. The calculation of the exit period prudential margin also includes an additional fixed component. This ‘adder’ is expressed as a \$/MWh value and is determined for a full calendar year. For 2025, the adder is set at \$33.48/MWh. This is constant across all trading periods and at all nodes. It is included in the methodology as a buffer for the purpose of further reducing risk to generators.
- 3.16. A retailer’s exit period prudential margin therefore amounts to 19 days’ worth of exposure plus the adder price.

⁸ The total minimum security also contains a ‘Financial Transmission Rights (FTR) prudential requirement’. This paper does not propose any changes to the FTR prudential requirement.

⁹ The Code, Schedule 14A.1 cl 6(1).

¹⁰ The adder reflects the historical margin between the actual exit period exposure and the forecasted (profiled) exit period exposure.

- 3.17. The Code enables a purchaser to apply to the Authority for shortened post-default exit period.¹¹ However, to date, very few applications have been made under this clause. This is likely because the Authority needs to be convinced that default period risk is managed in an alternative way (eg, through a guarantee by a parent company or a binding commitment to switch ICPs to a related retailer if a default occurs).

Hedge Settlement Agreements (HSAs)

- 3.18. Hedge Settlement Agreements (HSAs) are one mechanism by which a purchaser can offset its prudential requirements. HSAs are a hedging arrangement between two market participants and the clearing manager. Two participants who have entered into an over-the-counter (OTC) hedge contract can lodge that contract with the clearing manager who will settle it on behalf of the parties.
- 3.19. The benefit of lodging an OTC contract with the clearing manager under an HSA is that the clearing manager can take payments made in respect of the contract into account when calculating the parties' required prudential levels. For example, if a retailer has entered a contract for difference (CFD) under which it pays the fixed price for its full purchase position, even if spot prices increase, the clearing manager will only apply the fixed price to the security calculation because it has accounted for the HSA credit that will be paid to that participant. Therefore, HSAs extend the price stability benefits of an ordinary hedging arrangement to prudential prices.
- 3.20. Presently, only certain forms of contracts can be lodged under an HSA. These are usually fixed price fixed volume (FPFV) CFDs or caps. Derivatives that pay differences in only one direction, and ASX contracts, cannot functionally offset prudential requirements currently. However, the range of contracts capable of being settled under HSAs have grown over time. The clearing manager is currently implementing changes to allow fixed price variable volume (FPVV) CFDs to be settled under an HSA.¹²

Prudential security requirements were designed to be moderately conservative

- 3.21. The risk profile of the current prudential framework was determined by the Authority in the Settlement and Prudential Security Review 2013.

Probability of loss given default (PLGD) is the key determinant of the prudential framework's risk profile

- 3.22. Probability of loss given default (PLGD) estimates the probability (generally expressed as a percentage) that the collateral held by the clearing manager will be sufficient to cover a participant's liabilities if they default, are unable to remedy it,

¹¹ The Code, Clause 14A.22(4).

¹² The Authority decided to permit the clearing manager to settle fixed price variable volume hedges (effective 1 January 2026) in its decision paper on Code amendment omnibus #4. At the effective date, Form 4: Fixed Price Variable Volume will be added to Schedule 14.4.

and are subsequently exited from the market. This is a crucial metric in prudential frameworks because it reflects the likelihood of actual financial loss.

- 3.23. Under the Code, the fixed adder is set to ensure that, during a modelling period of 3 to 10 years (selected by the clearing manager), the coverage provided by the exit period prudential margin exceeds each purchaser's exposure on at least 75% of days¹³. In other words, the adder is calibrated to reduce the PLGD for the duration of the exit period to 25%.

A PLGD of 25% was considered to balance the interests of generators and purchasers

- 3.24. The Authority in its Settlement and Prudential Security Review favoured a prudential regime that is 'moderately conservative'. Alongside the Wholesale Advisory Group (WAG), it considered a PLGD of 25% (being roughly half of the expected PLGD of the framework without an adder) as a target for achieving this. However, the Authority did recognise that the precise figure was essentially arbitrary.
- 3.25. The 25% figure struck a balance between the interests of generators and purchasers, in principle allowing for a system that does not unduly burden either party with cost or risk. It also marked an improvement on the previous arrangements from the point of view of generators, which approximated a PLGD of 57%.
- 3.26. The 25% benchmark is more risk tolerant than the standards observed in some overseas markets. For example, the Australian National Energy Market (NEM) targets a prudential standard of 2%. Its December 2024 report on the effectiveness of its settings and methodology found, across all regions for the year to September 2024, a probability of exceedance ranging from 2.1-5.2%. While data for US markets is less transparent, the WAG review noted that the Northeastern Interconnection (PJM) and Texas (ERCOT) markets appeared to operate at around 6% and 4% respectively.
- 3.27. In this context, we consider that a PLGD of 25% achieves a pragmatic midpoint between cost efficiency and credit risk mitigation. The options in this paper to make it easier for small retailers to meet prudential costs seek to maintain this risk profile.

Q1. Do you agree that the current risk profile of the prudential framework is appropriate? If not, why/how should risk be redistributed?

¹³ The Code, Clause 14A.10(5)(b).

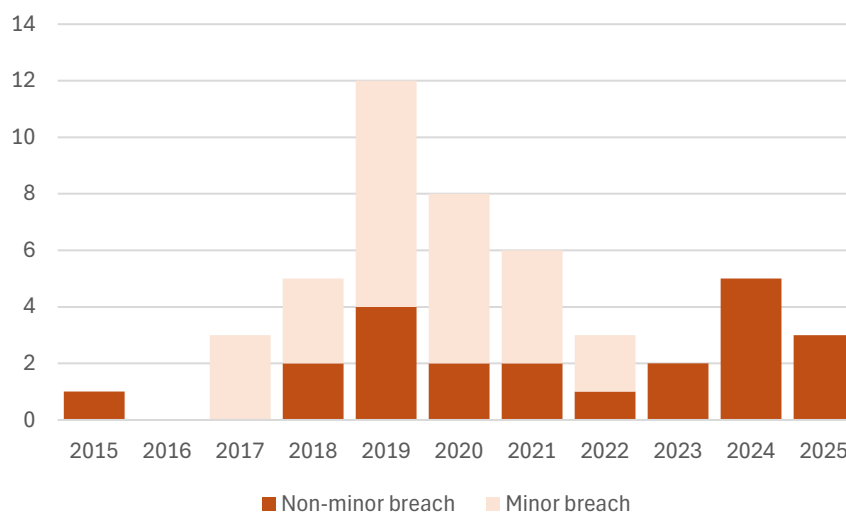
4. Outcomes of prudential requirements for small retailers

- 4.1. As at September 2025, there are 45 retailers (traders) operating in the New Zealand wholesale electricity spot market.¹⁴ The four major gentailers (or subsidiaries thereof) service 87% of all ICPs. The next four largest retailers service 12% of all ICPs. There are 28 retailers that are independent (ie, they do not own their own generation assets and are not associated with a parent company that owns generation assets) and of these 26 are small, servicing fewer than 1,000 ICPs each.
- 4.2. For the purposes of the following analysis, we consider “small retailer” to mean any independent retailer that services fewer than 1,000 ICPs. Some figures refer to “gentailer”, “large retailer” and “small retailer” to distinguish between the market share segments discussed above.

Breaches of prudential requirements are linked to a few retailers

- 4.3. Since the implementation of the decisions of the Settlement and Prudential Security Review in 2015, there have been 22 ‘non-minor’¹⁵ breaches of the requirement to provide minimum security as shown in **Figure 2**. These events of default are attributable to seven unique retailers. These prudential breaches, in combination with breaches of other financial obligations, have triggered the trader default process on 13 occasions since 2018 (some of the events of default were resolved before the trader default process could be formally triggered).

Figure 2: Breaches of Clause 14A.6(2)¹⁶



¹⁴ This excludes retailers who purchase electricity from another retailer, rather than operating in the wholesale spot market themselves. Those retailers do not incur prudential requirements because they do not purchase electricity directly from the clearing manager.

¹⁵ A breach is considered minor if the participant has paid but their payment has not been received by the clearing manager – usually because of delays within the banking system or the anti-money laundering process.

¹⁶ For each year, duplicate breaches by the same severity are excluded.

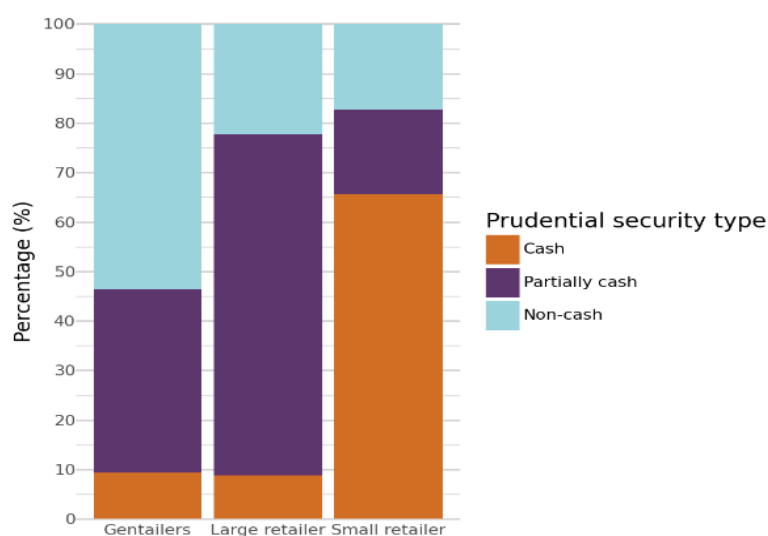
- 4.4. The frequency of non-minor breaches has increased since 2022 coinciding with higher average wholesale electricity prices and increased spot price volatility. These factors are contributing to a retail environment that is more challenging for small retailers.
- 4.5. An event of default can be considered to have occurred if a retailer's lodged security is less than the minimum security required by the clearing manager after 1600 hours each business day. For this calendar year to date, 84% of days where participants had a prudential deficit involved shortfalls of less than 10% of their total net exposure. Assuming the options discussed below would reduce small retailer's total net exposure by 10%, they would have sufficient capital to meet their requirements on 84% more days – potentially avoiding default.
- 4.6. Although a prudential breach can trigger the trader default process, this does not necessarily indicate that the prudential requirements themselves are the primary underlying cause of default. There are many factors that could contribute to retailer defaults including retailers' hedging strategies, access to and the affordability of hedges, retailers' other business risks and their approach to risk management more generally.

Small retailers more likely to use cash to meet prudential requirements

- 4.7. Prudential security can only be accepted in certain prescribed forms. These differ in degree of liquidity. The primary forms are:
- (a) cash deposit
 - (b) letter of credit, bank guarantee, or surety bond¹⁷
 - (c) an acceptable credit rating.
- 4.8. Cash is the most liquid and readily accessible form of security. It enables retailers to quickly top up their prudential accounts if required in the event of a rapid increase in prudential exposure (such as those triggered by unexpected spikes in prices or consumption). Cash can also be immediately applied to any shortfall in the event of a default. Other financial instruments are less liquid and can take slightly longer to be called on.

¹⁷ Alternative forms of bank guarantee and Swift letter of credit variation have also been approved.

Figure 3 – Percentage of prudential security type lodged by retailer size¹⁸



- 4.9. **Figure 3** illustrates that small retailers tend to use cash deposits to front their prudential security whereas larger retailers are more likely to use letters of credit or other less liquid instruments. Although using cash to meet prudential requirements ties up working capital, the financing cost of doing so is likely to be cheaper than other forms of prudential security, such as letters of credit, which require access to more expensive third-party lenders.
- 4.10. This was a key factor in the Australian Energy Market Commission's (AEMC's) recent decision to allow cash as an acceptable form of credit support in the Australian national energy market, where previously, only bank guarantees or letters of credit were permitted¹⁹. The AEMC stated that this reform is intended to enhance flexibility and optionality in credit arrangements, promote competition and help lower costs for small retailers.
- 4.11. Retailers using cash deposits earn interest on the cash while it is lodged with the clearing manager. They can also use it to settle their invoice. The minimum security required reduces immediately after settlement day by the amount of the invoice just paid. This approach allows retailers to use the cash lodged with the clearing manager as a savings account for invoice payments, while still meeting their prudential requirements.
- 4.12. As small retailers are likely at greater risk of default compared to larger retailers, particularly those with their own sources of generation, there are system benefits from having security in a form that is immediately available to the clearing manager to settle any outstanding amounts.

¹⁸ Each bar represents an average security form composition derived from a subsection of retailers at different consumption ranges. The percentages are not demand weighted ie, each retailer within a given consumption is treated as providing the same level of security.

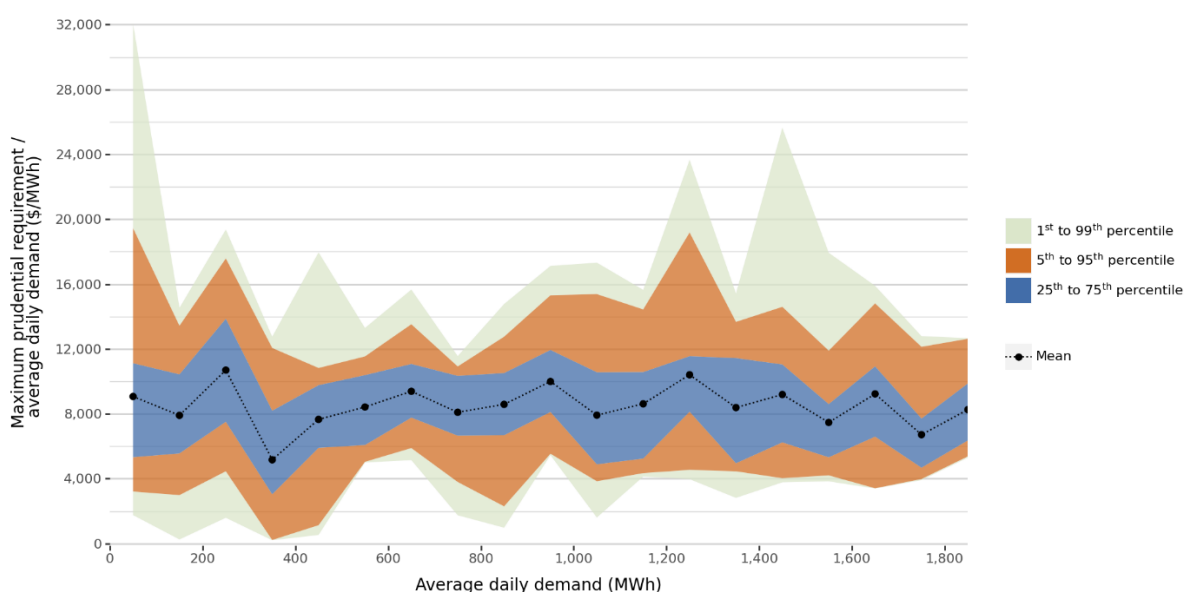
¹⁹ [Final determination - Allowing AEMO to accept cash as credit support](#).

- 4.13. However, having cash as the only viable option for meeting prudential security requirements carries a number of disadvantages for both the specific retailer and the wider market. For instance:
- (a) cash that is lodged as security cannot go towards the development or expansion of a retailer's business. Larger retailers with financial instruments retain working capital for productive use
 - (b) maintaining a prudential margin in cash increases retailers' vulnerability to periods of market stress. Larger retailers with financial instruments lodged can use cash temporarily to meet unexpected increases in exposure.
- 4.14. Over time, this combination of constrained growth and limited financial flexibility may be undermining competition and dynamism in the retail market.

Small retailers experience greater volatility in prudential costs

- 4.15. Irrespective of the form of security provided, small retailers face a greater prudential cost (relative to their actual consumption) compared to larger retailers, and also tend to experience more pronounced swings in prudential costs.
- 4.16. This is illustrated in **Figure 4** which plots the maximum prudential security required per MWh of daily consumption across different levels of average demand (to account for retailer size).

Figure 4 – Maximum prudential ratio by average daily demand



- 4.17. **Figure 4** shows that despite the strong presence of volatility at all consumption levels, retailers consuming fewer than 250 MWh per day on average experience the most volatility.²⁰ At times, and for some, this can result in prudential costs (relative to actual consumption) that are greater than the costs for most large retailers.
- 4.18. There are two likely reasons for this:

²⁰ This consumption range captures most of the retailers who are servicing fewer than 1,000 ICPs.

- (a) vertically integrated retailers (gentailers) have their purchases and generation partially netted which reduces overall exposure and can lower prudential costs. Small retailers are usually independent (ie, do not generate and are not affiliated with a generator) and so cannot reduce exposure in this way.
 - (b) small retailers may have less access to hedges capable of offsetting prudential requirements. Those who use the ASX or have substantial proportions of unhedged consumption are more likely to be subject to prudential cost volatility.
- 4.19. Greater levels of volatility, combined with greater use of cash as security, amplifies the cost pressures faced by these participants.

Related issue: costs of meeting separate prudential requirements

- 4.20. The purchasing of New Zealand electricity derivative contracts on the ASX is also subject to prudential security requirements in the form of margin payments. These include significant initial margins (at times up to 45% of contract value for certain contracts) as well as variation margins which may be called daily based on price movements in the value of the contract. Additionally, clearing participants, through whom retailers access the futures market, may impose their own collateral requirements. The only acceptable form of security for margin payments is cash.
- 4.21. These requirements are separate from those imposed under the Code for transactions made with the clearing manager. However, it is likely that a retailer's position in the futures market would (at times) offset its position in the physical/spot market (and vice versa). In practice, this means a retailer could simultaneously owe money to the clearing manager while being owed money under an ASX futures contract.
- 4.22. This offsetting position is not presently recognised for the purposes of reducing retailers' prudential requirements with the clearing manager despite total net exposure decreasing. Moreover, retailers must maintain separate obligations with both the clearing manager and their ASX clearing participant. This increases the total cash necessary to sustain their position and does not reflect their combined risk exposure.

Q2. Do you agree that the issues identified by the Authority are worth addressing?

Q3. Are there other issues with the current prudential security settings that we have not identified but are worth addressing?

5. Options to improve prudential requirements

Improved prudential security settings are consistent with our main statutory objective

- 5.1. The Authority's main statutory objective is to promote competition in, reliable supply by, and the efficient operation of the electricity industry for the long-term benefit of consumers.²¹
- 5.2. The Authority expects that adjusting the prudential security settings would promote each limb of the main statutory objective:
- (a) **competition** would be improved in the retail electricity market because:
 - (i) reduced prudential requirements would free up cash-flow for investment in innovation and expansion activities
 - (i) a more diverse pool of retailers would increase consumer choice and increase downward pressure on retail prices
 - (b) **reliability** would be improved across the electricity industry because:
 - (i) to the extent that reducing prudential requirements eases financial pressure on retailers, there is less likelihood of participants exiting the market and generators incurring losses
 - (i) broadly maintaining the risk profile of the prudential regime would continue to give generators the necessary credit confidence to make investment decisions
 - (c) **efficiency** (especially productive efficiency)²² would be improved across the settlement and prudential security framework because minimising the cost to retailers of providing sufficient security allows them to allocate more capital to their core business without needing new resources.

The Authority has developed four proposals to improve prudential requirements

- 5.3. The Authority has developed four proposals to make it easier for small retailers to meet their prudential requirements:
- (a) **Option 1:** adjusting the 'adder' component of the exit period prudential margin on a dynamic basis
 - (b) **Option 2:** reducing the duration of the post-default exit period (with an equivalent reduction to the Authority's trader default process) for retailers with 1,000 ICPs or fewer
 - (c) **Option 3:** reallocating accrued interest on residual funds in the clearing manager's account from generators to retailers on a scaled basis

²¹ Our additional objective is to protect the interests of domestic consumers and small business consumers in relation to the supply of electricity to those consumers. The additional objective only applies to the Authority's activities in relation to the dealings between participants and domestic and small consumers, under section 15(3) of the Act.

²² Productive efficiency refers to the optimisation of outputs within a system or process from a given volume of available inputs.

- (d) **Option 4:** offsetting the general prudential requirement by accounting for ASX futures positions.
- 5.4. The options are targeted at primarily at small retailers (rather than all participants subject to prudential requirements) given the issues discussed above and because:
 - (a) the relative prudential burden for retailers is generally larger as direct connects and other purchasers already benefit from a shorter post-default exit period
 - (b) competition in the retail electricity market is critical to increase innovation, choice for consumers and put downward pressure on prices.
- 5.5. The options are described in more detail below with a high-level evaluation of their expected impacts on prudential costs for small retailers, competition and risk. Any option that is progressed will be subject to a more rigorous evaluation and cost-benefit analysis in a subsequent consultation on proposed Code amendments.
- 5.6. Your insights and feedback will help inform the further development and prioritisation of each option. If a combination of options is progressed, we expect to take a phased approach to implementation with a view to having eased prudential requirements in place by Winter 2026.

Q4. Do you consider that there are other adjustments that the Authority could make that would better reduce cost and enhance efficiency in prudential requirements for small retailers without significantly increasing credit risk for generators.

Option 1: Adjusting the adder dynamically

- 5.7. The clearing manager has identified limitations in the current adder component of the exit period prudential margin. It has observed that prudential margins have been disproportionately high during stable market conditions (such as low-demand seasons or off-peak intervals) and insufficient during recent periods of heightened volatility (2022–2024) when extreme wholesale price spikes have occurred. They have recommended transitioning to a dynamic approach for adjusting the adder.
- 5.8. The Authority considers that introducing some flexibility into the adder mechanism could provide real value to all retail participants. Small retailers specifically would be better incentivised to monitor and manage their exposure more accurately while benefiting from relief on working capital when market risk is lowest. Over the course of a year, it is expected that a dynamic adder would reduce the total amount of security required.
- 5.9. This flexibility could be implemented through seasonal or quarterly recalibrations, adjusting adder values for summer, winter, and shoulder periods. While this approach may increase the amount of security required during periods of elevated and volatile wholesale prices, it would more substantially reduce requirements during stable intervals.
- 5.10. This could be achieved by tailoring the adder to historical patterns of seasonal and peak-demand volatility. This would enable exit period prices to respond more effectively to both anticipated and sudden market fluctuations. Recalibrating the adder on this basis would improve the alignment between coverage and exposure,

smoothing out over-coverage in stable periods and mitigating under-coverage during volatile periods.

- 5.11. The clearing manager's system already has the functionality to update the adder value on a seasonal basis meaning that system changes would be incremental rather than fundamental. Some systems development would be required to adjust the adder in response to changes in volatility.

Evaluation of Option 1

- 5.12. The Authority considers that this option could deliver cost savings on prudential requirements over time because the extent of over-procurement of security would decrease. While prudential costs may increase during periods of increased spot prices and volatility, our initial expectation is that these would be more than offset by decreases in prudential costs during periods when the market is stable. This change could further incentivise retailers to more actively manage short term increases in exposure (for example by increasing hedge coverage or by offering time of use pricing).
- 5.13. The overall impact on risk of this option is likely to be neutral as it adjusts levels of required security based on market conditions – lower during stable conditions and higher during times of elevated and volatile prices. However, since retailers are more prone to default during these periods of high and volatile prices, the increased security would help mitigate the risk of non-payment. Any net cost savings for small retailers could provide additional working capital that can be put to growth, supporting greater competition.

Q5. Do you support the transition to a more dynamic adder? If not, what are your concerns?

Option 2: Reducing the duration of the post-default exit period

- 5.14. The post-default exit period constitutes a significant portion of participants' minimum required security. As noted above, for retailers, this margin is set at 18 days, equivalent to the time needed for the Authority to exit a retailer from the market under the trader default process in the Code.
- 5.15. The Authority considers that aspects of the trader default process could be changed to reduce the time needed to exit a retailer to 14 calendar days. The exit period prudential margin could then be adjusted accordingly.
- 5.16. An outline of the current timeframe for the retailer default process is included above at 3.5 and 3.6. Many defaults are resolved in the first seven-day period when the default is kept confidential allowing capital raising or sale without negative publicity. The Authority considers that there is scope to shorten phase three and potentially phase two for some retailers.
- 5.17. Phase three of the trader default process for retailers runs from Day 15 to Day 18 and provides for the mandatory assignment of any remaining customers. This period is prescribed as three days to allow the Authority to run a competitive tender process for remaining customers prior to the Authority's mandatory assignment of

customers to alternative retailers. The Authority has not used the tender process in any default to date and would be unlikely to do so in the future because:

- (a) during (and prior to) Phase 1 of the trader default process, it is likely that the defaulting retailer has already attempted to sell some or all of its customers to prospective tenderers
- (b) a tender process is unlikely to be strongly competitive because prospective tenderers know that the Authority will likely assign them a fair proportion of the customers at no cost just days later
- (c) the resources required to run the tender process in such a short timeframe make it difficult to justify.

5.18. Phase two of the trader default process runs from Day 8 to Day 14 and involves public notification that a retailer has defaulted, allowing customers time to switch to an alternative provider. For most residential customers, this timeline may be longer than necessary. Residential customers can switch retailers at any time and typically face few barriers to finding a broadly comparable alternative. In contrast, commercial and industrial customers often have more complex supply needs and fewer viable options, making it more difficult to secure a suitable replacement within a short timeframe.

A shorter post-default exit period is possible for small retailers

5.19. At this stage, the Authority considers that it is possible to shorten the post-default exit period for small retailers with 1,000 or fewer domestic and small business consumer ICPs (combined). Their post-default exit period could be reduced by four days (from 18 days to 14 days).

5.20. This reflects:

- (a) a three-day reduction to phase 3 of the trader default process on the basis that the Authority will not tender the customer base of a small defaulting retailer, and
- (b) a one-day reduction to phase 2 of the trader default process on the basis that the Authority is confident that it can adequately provide for the switching of commercial and industrial customers despite the reduced timeframe.

5.21. To ensure a fair application of this option, we would provide for a function-over-form approach, so that all domestic and small business consumer ICPs of related or subsidiary entities are pooled for the purposes of determining whether a retailer qualifies for a shorter post-default exit period.

5.22. Subject to consultation on proposed Code amendments, it is likely that this option could be implemented by Winter 2026.

We are open to reducing the post-default exit period for more retailers

5.23. Despite the 1,000 ICP threshold, the Authority is interested in reducing the post-default exit period for all independent retailers. However, the existing mechanisms for processing trader defaults for retailers with higher ICP counts present operational challenges. The software used to assign ICPs to alternative retailers does not allow for efficient assignment of commercial customers. Therefore, we are

not confident that a shorter trader default process is currently feasible for retailers with more than 1,000 ICPs.

- 5.24. The Authority is considering a broader review of its default management procedures, expected to commence in the first half of 2026. This review will aim to streamline the process for commercial customers. If, as a result, these issues are resolved such that the Authority can confidently assign commercial customers as quickly as it does residential customers, consideration would be given to extending the reduction to a wider range of retailers. This change could be progressed through a Code amendment omnibus on the basis that it largely confers benefits to participants.
- 5.25. We do not propose shortening the post-default exit period for gentailers as they are generally unaffected by the issues outlined above and typically meet prudential requirements through financial instruments.

Evaluation of Option 2

- 5.26. If implemented, this option could result in meaningful prudential cost savings for small retailers. Assuming a 57-day exposure period and a four-day reduction, initial analysis suggests total net exposure for some small retailers could decrease by 10-14%. This would improve the ability for these retailers to operate effectively in the market.
- 5.27. A reduced post-default exit period would not necessarily result in decreased exposure for all retailers as this may vary with factors such as HSA receipts, spot-sales or GST credits that raise the possibility of cash-flow timing loss. However, most small retailers are unlikely to be affected by such losses.
- 5.28. This reduction in exposure would offer a similar (but likely greater) competition benefit to that of option 1, albeit limited to small retailers at this stage. Working capital that is not required to meet prudential costs can be used to invest and grow these businesses.
- 5.29. This option would not increase risk within the prudential framework because the decrease in exposure is mitigated by the decrease in the duration of the trader default process.

Q6. Do you support the proposal to allow reductions in the post-default exit period? Why/why not?

Q7. Do you agree that the threshold for qualifying for a reduced post-default exit period should be 1,000 ICPs?

Q8. If broader changes to the trader default process make it feasible to reduce the post-default exit period for all independent retailers, should the Authority pursue this? Why/why not?

Adjustment 3: Reallocating residual funds to retailers

- 5.30. Residual funds are additional funds which are left-over in the clearing manager's operating accounts after settlement. They largely occur as a result of the accrual of interest on deferred payments (eg, when funds are retained by the clearing

manager for GST payments) or on payments made after a settlement invoice is issued but before the due date. Interest on pre-payments is not considered residual funds and is credited to the participant who made the prepayment.

- 5.31. In 2024 the Authority clarified allocations of residual funds and interest in its Code Review Programme #5. We decided that the funds would be disbursed to generators to provide compensation for excess credit risk in the prudential framework. At the time of this decision, shortfalls had been realised in two defaults although the amounts were nominal.
- 5.32. The Authority now considers that disbursing these funds to retailers is more appropriate because:
- (a) residual funds largely arise from the accrual of interest on payments made initially by retailers
 - (b) residual funds were not initially contemplated as a tool for managing credit risk to generators and they were not considered as necessary for determining the risk profile of the settings
 - (c) residual funds reallocated to retailers could be put to meeting prudential security requirements and therefore reduce the likelihood of default
 - (d) residual funds reallocated to retailers could help to stimulate competition and growth in the retail market.

Reallocating residual funds to retailers on a scaled basis would increase affordability and promote competition

- 5.33. Between June 2024 and April 2025, a total of \$2.94 million in residual funds was disbursed to generators. These funds were allocated on the basis of percentages of electricity sold. Reallocating to retailers on a similar basis (ie, based on percentages of electricity purchased) would largely benefit the same participants because most spot sales and purchases are made by the same large, vertically integrated 'gentailers'.
- 5.34. Reallocating residual funds to retailers on a scaled basis would help alleviate the issues facing small retailers that are outlined in this paper. **Table 1** outlines a possible purchase volume percentage model by which these funds could be disbursed to relieve the prudential burdens on small retailers.

Table 1: Possible model for residual funds reallocation to retailers

Percentage of total residual funds	Allocated to
50%	All spot market purchasers (including major gentailers) by percentage of total purchase volumes
50%	All retailers (excluding major gentailers) by relative percentage of total purchase volumes

- 5.35. Under this approach, half of the funds would effectively be allocated on a similar basis to current settings (ie, major gentailers will still receive a significant portion of

this allocation but it will be credited to their retail arm) while the remainder would be returned to independent retailers to better enable them to operate in the market.

Evaluation of Option 3

- 5.36. Scaling the allocation of residual funds benefits small retailers. If all residual funds were allocated to spot market purchasers by percentage of total purchase volumes, then the gentailers would receive \$2.55 million of the \$2.94 million that was allocated between June 2024 and April 2025. However, by applying the scaling factor, an additional \$1.47 million would be allocated amongst all other retailers.
- 5.37. This option maintains current risk settings because residual funds accumulate outside of the prudential framework. Moreover, the change may reduce overall system risk as the additional cash-flow will better enable small retailers to meet their requirements which would reduce their likelihood of default.

Q9. Do you agree with the proposal to reallocate residual funds to retailers on a scaled basis?

Q10. Is there an alternative model by which residual funds could be reallocated to retailers in a fair manner that still achieves the policy objectives?

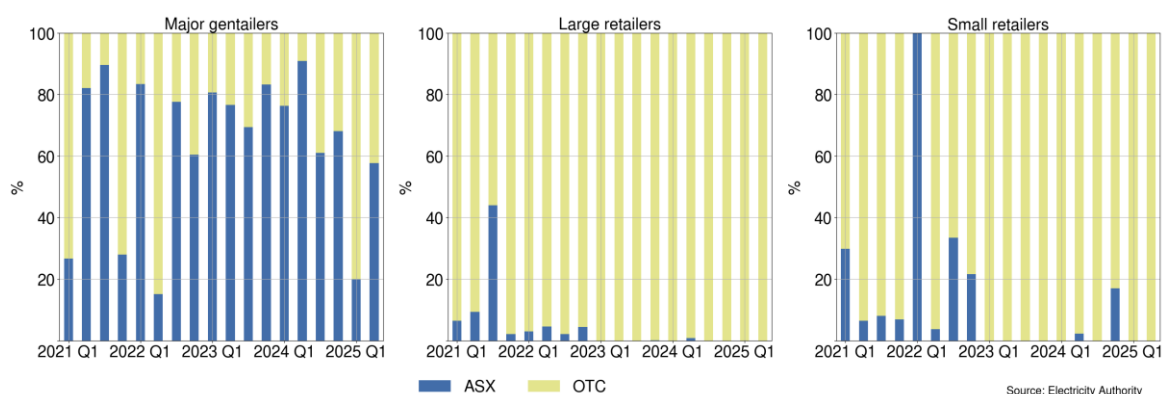
Option 4: Providing for ASX prudential offsetting

- 5.38. The issues of forward and physical offsetting, as well as separate prudential security requirements, have been considered by the Authority in the past. In 2018, the Authority decided against the integration of clearing and settlement across both the physical and futures markets. This was on the basis that:
- (a) doing so would not materially reduce the costs for participants and therefore would be unlikely to have significant net benefits
 - (b) the resources required to develop and operate integrated arrangements were likely to be significant
 - (c) the available methods for achieving integrated arrangements were complex and possibly created risks.
- 5.39. Since that decision, the Authority has begun receiving deanonymised daily trading data directly from the ASX. We are now considering whether it may be possible to deploy this data with the clearing manager to develop a solution to the offsetting issue.
- 5.40. Presently, there are market-based workarounds open to participants who would value this offsetting functionality. For instance:
- (a) flexible bank guarantees can be structured to replicate a futures offsetting arrangement
 - (b) financial entities can purchase an ASX future, sell it to a retailer over the counter and structure this contract as an HSA.
 - (c) excess spot market prudential security held in cash can be returned to a purchaser in one business day to be put towards an ASX margin payment
 - (d) other parties may be providing commercial services which reduce the issue.

Evaluation of Option 4

- 5.41. The degree of possible cost savings and prudential burden reduction for small retailers under this option is unclear to the Authority at this point. We are not aware of the extent to which retailers are utilising the workarounds noted above.
- 5.42. The following **Figure 5** shows that most small retailers appear to prefer purchasing risk-management contracts OTC compared with the ASX. This indicates that immediate offsetting benefits are likely to be minimal. However, retailers may increase their participation in the futures market if offsetting functionality existed.

Figure 5: Percentage of risk management contracts purchased – OTC vs ASX



- 5.43. We are interested in stakeholders' views on physical and futures offsetting arrangements. We seek better understanding of who it would potentially benefit and what those benefits would be. Your insights will be valuable in shaping the future direction of any work on this issue.

- Q11.** Do you support a possible physical and futures offsetting arrangement? Why/why not?
- Q12.** Are existing market-based approaches to physical and futures offsetting arrangements sufficient for managing the issue?
- Q13.** If ASX futures positions could offset spot market prudential requirements, would you be more likely to trade in the futures market?

6. Next steps

- 6.1. We welcome feedback on the issues and options discussed in this paper
- 6.2. The experience of market participants and other stakeholders who engage directly or indirectly with prudential security requirements will help us better understand the implications of the current arrangements and their potential for improvement.
- 6.3. Consideration of your submissions will assist in assuring that the potential development of any of the options outlined in this paper is informed, proportionate and ultimately benefits consumers.
- 6.4. If the Authority decides to proceed with the implementation of any of the options discussed in this paper, we intend to prepare a consultation on Code amendments for release in March 2026.

Appendix A Format for submissions

Submitter	
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Questions	Comments
Q1. Do you agree that the current risk profile of the prudential framework is appropriate? If not, why/how should risk be redistributed?	
Q2. Do you agree that the issues identified by the Authority are worth addressing?	
Q3. Are there other issues with the current prudential security settings that we have not identified but are worth addressing?	
Q4. Do you consider that there are other adjustments that the Authority could make that would better reduce cost and enhance efficiency in prudential requirements for small retailers without significantly increasing credit risk for generators.	
Q5. Do you support the transition to a more dynamic adder? If not, what are your concerns?	
Q6. Do you support the proposal to allow reductions in the post-default exit period? Why/why not?	
Q7. Do you agree that the threshold for qualifying for a reduced post-default exit period should be 1,000 ICPs?	
Q8. If broader changes to the trader default process make it feasible to reduce the post-default	

exit period for all independent retailers, should the Authority pursue this? Why/why not?	
Q9. Do you agree with the proposal to reallocate residual funds to retailers on a scaled basis?	
Q10. Is there an alternative model by which residual funds could be reallocated to retailers in a fair manner that still achieves the policy objectives?	
Q11. Do you support a possible physical and futures offsetting arrangement? Why/why not?	
Q12. Are existing market-based work arounds to physical and futures offsetting arrangements sufficient for managing the issue?	
Q13. If ASX futures positions could offset spot market prudential requirements, would you be more likely to trade in the futures market?	

Appendix B Glossary of abbreviations and terms

Prudential security lodged or *Security*

The amount of security lodged by participants with the clearing manager in an acceptable form eg, cash deposit, bank guarantee or letter of credit. *Security* is used as shorthand for prudential security lodged.

Total net exposure or *Exposure*

The amount of prudential security for both actual financial outstandings (eg, spot market purchases, GST or HSAs) and the exit period prudential margin that is unsettled and must be provided to the clearing manager. *Exposure* is used as a shorthand for total net exposure.

Coverage

The ratio of prudential security lodged to total net exposure. There is over-coverage when security is greater than exposure and under-coverage when exposure is greater than security.

Minimum security required

The clearing manager makes four estimates of a participant's total net exposure for each day. Minimum required security is the least of these, which the participant must provide to the Clearing Manager by 1600 hours on each business day.

Excess prudential security or *Excess*

Prudential security held by the clearing manager less the minimum security required. The clearing manager must return this to participants if requested within one business day.

Post-default exit period

The period of time the Code requires for the Authority to exit a trader – 18 days for retailers and 7 days for direct purchasers or other participants.

Prudential exit period

The period over which the clearing manager forecasts liabilities. It is the post-default exit period plus one trading day.

Exit period prudential margin

The forecast amount the clearing manager expects a participant to incur over that participant's prudential exit period. This includes the prudential exit period and the adder.

Hedge contract or risk management contract

A contract between a buyer and seller used to reduce exposure risk. In this context, hedge contracts are used by retailers to reduce spot price exposure risk and to offset prudential requirements. OTC and ASX contracts are considered hedge contracts.

Abbreviations and acronyms

Authority	Electricity Authority
Act	Electricity Industry Act 2010
ASX	Australian Securities Exchange
Code	Electricity Industry Participation Code 2010
CFD	Contract for difference
OTC	Over the counter
PLGD	Probability of loss given default
WAG	Wholesale Advisory Group