29 June 2012

Wholesale Advisory Group Submissions
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by email: wag@ea.govt.nz

SUBMISSION ON SETTLEMENT AND PRUDENTIAL SECURITY REVIEW

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the "Settlement and Prudential Security Review" (the **paper**) released by the Wholesale Advisory Group (WAG) in May 2012.

2 Our submission is in two parts:

2.1 Comments on key aspects of the paper, and

2.2 Responses to the paper's specific questions as an Appendix.

3 We agree that the wholesale market prudential requirements were overdue for review. In essence they date back before the regulation of the market to the days of the multi-lateral contract that was NZEM. There have been more than a few changes since then, and in particular, with the creation of the Electricity Authority, a much greater emphasis on competition via market entry. On the other hand the arrangements can be said to have served the market well based on the somewhat negative evidence of absence of material default.

4 As a distributor Orion has a significant indirect interest in the wholesale market prudential arrangements, as any material wholesale market default will almost certainly flow on to distributors via non-payment to then. This is even more significant given the changes the Authority recently made to the Code to limit distributors' ability to require adequate security from retailers.

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5 Our more detailed comments on the paper follow.

Relevance of distributor prudentials approach

6 While it was probably outside WAG's brief, we note that the paper does not refer to the recent changes made to distributor prudentials, or the rationale given for those changes. We would characterise this rationale, with which we strongly disagree, as:

6.1 Distributors generally have strong balance sheets and have a strong capacity to absorb loss,

6.2 Failing retailers are likely to be small, and / or the consequences of failure on distributors are likely to be small,

6.3 The costs of such failure can and should be socialised across all consumers, and

6.4 The credit risk is reflected in the Commerce Commission's WACC in any case.

7 We are pleased to see that the WAG paper takes a very different and, in our view, economically superior approach, focusing on the moral hazard consequences of lax prudentials and seeing that this can be to the long term detriment of consumers if risk is inappropriately managed as a result.

8 However we believe the Authority, as it moves to implement any changes in wholesale market prudentials in line with the WAG paper, needs to explain how the two very different approaches can be reconciled.

Credit ratings

9 We agree with a number of the comments in the paper about credit ratings. In particular we agree that it has always been anomalous that a particular credit rating (currently A-) has effectively given the holder unlimited wholesale credit, while the next best rating provides no advantage in terms of quantum. However, this is not in our view a reason to lower the standard, but to define it more clearly. Even very good credit ratings do not give the holder unlimited access to funds via capital markets, so it is unusual that they give virtually unlimited access to credit in the wholesale market and indeed with respect to distributors.

10 The nature of uncapped wholesale electricity markets is that even large vertically integrated entities that are normally able to command adequate resources can find themselves in significant short-term difficulties, and that the consequences of the financial failure of a large player could be catastrophic. We would suggest

that no credit rating is sufficiently good to entitle the holder to unlimited credit, and that some sort of graded approach would be superior. We note that no current participant has an acceptable credit rating under the Code.

11 In addition, and as the paper notes, the quality of an entity's credit rating will inevitably be reflected in the cost of, and ease with which, it can procure security. This is as it should be.

12 Finally on the subject of credit ratings, we note that the approach taken with respect to distributor prudentials is to increase the unlimited security afforded by the (in that case now relatively poor) credit rating. We do not consider that this approach is appropriate for distributor prudentials and would strongly caution against extending it to wholesale market prudentials.

The respective roles of the Authority, the Clearing Manager and banks

13 We agree that the authority needs to be cautious in extending either its role or the Clearing Manager's role into territory normally occupied by banks[1]. So long as generators are the residual risk bearers in the wholesale market, the ability of other parties - such as the Authority or the Clearing Manager - to exercise discretion that changes the nature and quantum of that risk needs to be carefully constrained since, as the paper notes, those parties have no financial skin in the game, whereas banks do. It is not just about "new skills or systems"[2].

14 We also agree that, if there is a perception that banks do not understand the electricity market, education is the appropriate course[3]. Our own view here is that banks understand the market and risk very well, and are understandably wary of participants with limited assets to back up significant wholesale market obligations that can build up and change very quickly.

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[1] Para 7.5.2(f), pp57 and 58.

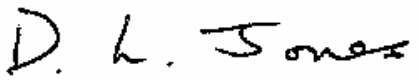
[2] Para 5.3.3, pp43 and 44. Alternatively, although we would not recommend the approach, the Authority could consider 'underwriting' new entrants and socialising the cost of this and any failures via its levies. This would at least be transparent.

[3] Para 7.5.2(f), pp58.

Concluding remarks

15 Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely



Dennis Jones
Industry Developments Manager

Appendix: Responses to specific questions

	Question	Response
Q1	To what extent have we defined the regulatory failures appropriately, and what other problems are there, if any?	The failures have been appropriately defined.
Q2	What, if any, material issues have been missed from the description of current arrangements?	Although probably more appropriately addressed by the Authority rather than WAG, we would have thought the paper could have discussed the relevance of the recent Code changes that have reduced distributors' ability to impose prudential requirements on retailers.
Q3	To what extent is this an accurate description of the failures around current arrangements? If not, what have we missed, how would you describe it and why is the issue material?	We consider this to be an accurate description.
Q4	Have we identified the right measures of risk? If not, what would you use?	We believe so. Care needs to be taken to avoid the line of reasoning that *because* there has been no material default, the existing requirements are excessive or overly conservative.
Q5	Do you agree with the assessment of the appropriate level of security? If not, what information do you have to support an alternative level of security?	Yes. The sensitivity to the assumed exit period is noted.

Q6	Do you agree we have described the right set of solutions? Have we outlined the right mechanisms that highlight the different options? Are there other mechanisms?	At a high level, yes. Obviously as these solutions are investigated in more detail further issues and options may arise.
Q7	To what extent do you agree with the proposed path for moving forward? Should other options be explored, and if so, why?	We are comfortable with the proposed path.