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Submissions
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SUBMISSION ON ARRANGEMENTS TO MANAGE A RETAILER DEFAULT SITUATION

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the "Arrangements to manage a retailer default situation" consultation paper (the **paper**) released by the Electricity Authority (Authority) in June 2013.

Introduction

2 Our submission is in two parts:

- General comments on the paper, and
- Responses to the paper's specific questions as an appendix.

General comments on the paper

3 We generally support the proposals in the paper, and in particular the overall objective of shortening and clarifying the process for exiting a defaulting retailer.

4 Our comments relate primarily to:

- Concerns about the incentives on retailers to behave prudently,
- The way retailer default to distributors is handled,
- Some technical details of the proposal,
- Possible legal considerations, and

- The inclusion of a tender process.

Prudent behaviour by retailers

5 We agree with the conclusion that mass disconnection of a defaulting retailer's customers is impractical, and probably undesirable. However, it should be acknowledged that this has some downside. In particular it potentially reduces incentives on retailers to behave prudently and on consumers to consider the financial robustness of retailers when choosing them. This may be reflected in retailer offerings to consumers, making them "too attractive".[1]

6 This downside could influence the design of retailer default arrangements in a number of ways:

- *Less concerns about the rights of consumers regarding assignment*: The counterfactual to assignment is disconnection. In any case, can the Code override consumer contracts? We think it would be useful if it can. We also note that, while retailer mass market terms and conditions are largely posted terms, which can be changed on reasonable notice, contracts with larger "TOU" customers are more likely to be individual contracts requiring consumer agreement to the change, a much more time-consuming and less certain process. Can the Authority require retailers to insert terms in agreements that can themselves only be changed by agreement? And if it can, should it not simply deem them?

- *Less concerns about the terms and conditions, in particular price, that consumers face in the event that their retailer is forced to exit and they are allocated to another retailer*: Again the counterfactual is disconnection, and the proposed process protects consumers from that. Placing limitations on the terms offered by recipient retailers as well strikes us as going too far, and effectively requires good retailers to underwrite bad ones. It also increases the risk that recipient retailers are themselves financially stressed by the process. Moreover if, as seems likely, the default is due to high wholesale market prices (for example we might be in a shortage situation that has triggered scarcity pricing), then the loss generators will be facing from default results from not getting that high spot price, and being required to sell, via its retail business, at a possibly much lower 'standard price' may not reduce that risk much.[2] (This is also discussed in the section on the tender process below). We also note that a defaulting retailer's customer base may not be average, and there is a reasonable chance that it will be of relatively poor credit quality.

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[1] Which was arguably part of the problem with a number of finance company collapses over the past decade even though investors bore most of that risk.

[2] For example, if the wholesale price is $10,000 per MWh, then there is not much difference between getting nothing for the energy from the Clearing Manager, and getting $100 per MWh from the consumer. And we note that, in times of market stress, it is not uncommon for the standard offering to 'TOU' customers to be a spot price contract.

- *Less concerns about communication with consumers*: In the circumstances and given the very tight time frames it should be acknowledged that many and perhaps most consumers will not know what is going on until after it has happened.

- *More consideration of a 'licensing' regime for retailers*: We note that the proposal to rapidly, and with limited customer impact, exit a defaulting retailer may encourage the retailer to just 'walk away' from its payment obligations, with the risk of starting a cascade of financial difficulties for others, while at the same time taking the favourable hedge settlements that would result when spot prices are high - a likely cause of retailer stress in any case. We note there is a prudential and licensing regime for banks *even though* consumers are the final risk bearers. A licensing regime might be able to include features which reduce this 'walk away' risk, and the associated reputational risk that the whole market faces.

- *Structuring prudentials so as to reduce the risk of 'walk-away' by retailers*, for example by having the prudential calls more closely reflect high spot price conditions.

- *Considering whether and how the process should accommodate scarcity pricing situations*: Do the retailers that end up with the exiting retailer's customers inherit the Code obligations to make payments under the customer compensation scheme?

Retailer default to distributors

7 We welcome the inclusion of an option for default to a distributor to trigger the exit mechanism. However, some aspects of the design make it less likely that distributors will use this process, in particular the requirements that the use of system agreement must have been terminated, that the termination must be due to a "serious financial breach", and that there must be no outstanding disputes.

8 If the rationale for including default to distributors in the Code process is to help ensure consistency, and in particular maintenance of supply, then it would seem appropriate to make it relatively easy for a distributor to trigger the process. If it isn't reasonably easy, distributors may well find it preferable to pursue their own remedies, which could involve application to appoint a receiver and, indeed, disconnection. We note that, by the time a retailer has not paid a distributor, the distributor is already facing a significant loss: in most cases at least six weeks of charges[3]. The distributor will be keen to pursue whatever process promises rapid and effective resolution.

[3] Charges for the previous month plus accrued charges for the current month not paid on 20th, plus at least a week or so of the current month to go through the UoSA pre-termination process less maximum two weeks prudentials allowed. If the retailer has an acceptable credit rating there will be no security to call on so it will be more like two months' worth of charges. This is in stark contrast to the Clearing Manager's position where the prudentials will be (or

9 The proposal highlights a significant difference between the prudential requirements that distributors may require of retailers, and those that retailers (purchasers) must meet in the wholesale market under the Code. This difference has never been adequately explained by the Authority. Likewise the proposal requires the "serious financial breach" to a distributor to meet the MUoSA criteria of $100k or 20% of charges, whichever is the greater, whereas not paying a single dollar to the Clearing Manager is a trigger.

Technical details

10 We consider that a key attribute in how smoothly the exit process will work will be the size of the defaulting retailer. We are not sure if the proposal is supposed to deal with a problem of any size, but it is probably good if it is. And if it is, consideration might be given to having the process reflect the size.

11 A number of concerns get more and more material the larger the defaulting retailer is, most particularly the risk that the reallocation of customers creates financial difficulties for recipient retailers, particularly if the terms and conditions of the reallocation are constrained.

12 We agree with the paper that there should not be a *de minimus* if the process gets to the stage of mandatory allocation. Not only might this create perverse incentives around retailer market share targets, there is a real risk that as competition increases, few retailers may reach the threshold, meaning presumably that an even greater proportion get allocated to those retailers still above the threshold. This will inevitably concentrate any financial stress on those remaining retailers, and increase the chance that they too claim that they cannot absorb the consumers.

13 The Authority will need to be very careful in how it deals with retailer claims that they are not financially able to absorb the allocation of further customers. There are significant tensions in both directions:

- Depending on the state of the wholesale market, it is quite conceivable that a further allocation of customers will indeed place a retailer in financial distress, but
- The more it recognises this concern for some retailers the greater the chance that the remaining retailers will face distress.

14 In the end the Authority will need to decide whether it can, via the Code, *require* retailers to take on more customers.

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will be expected to be) sufficient to cover any outstandings provided the exit process is indeed completed within the 17 days.

15 At least some parts of the process imply mass communication with customers, and that this will occur in very short time frames. As a practical matter, it will probably be difficult to phone customers, and normal mail is likely to be too slow. Email may work in some cases but we are not sure how widely this is used. Mass media publicity might be more effective. Whatever methods are used there is clearly a significant administrative overhead. Given the tight timeframes it is probably best if the Authority knows how it is going to organise all of this before the event, and perhaps have arrangements in place with service providers that can be triggered at short notice. To the extent that communication is effective, it will likely generate customer enquiries, and there will need to be a way to deal with these.

Possible legal considerations

16 Can the Authority deem terms into retailer contracts with consumers (like it can with UoSAs) or alternatively simply override consumer contracts? Given the consequences, and desirability from a consumer perspective, of having an assignment process, it seems painful and expensive to go through the contract revision process that most consumers will not notice anyway?

17 If the process gets to mandatory allocation, can the Authority actually do this in the face of claims of financial distress on the recipient? Where does the liability lie if the transfer goes ahead and the recipient defaults?

18 Is it likely or possible that the process will be derailed by legal action of the owners / receivers of the failed retailer? For example, a tender process not designed to maximise value for the owner/receiver may be legally challenged.

Tender process

19 We are not sure that it is necessary or practical to include the tender process as described in the paper, for the following reasons:

- We doubt that it can be completed in the time available, both from an Authority perspective, and more importantly from a retailer perspective

- One way or another there should already have been efforts – for example by a receiver - to sell the customer base *before* the Authority's tender process. Moreover, other retailers can or will already have been promoting themselves and their offerings as they see fit.

- The indicated requirements around what prices and terms and conditions are being offered seem unnecessary, and will only complicate the process:

    (a) It is not a trivial exercise to determine which retailer's offerings are best for particular consumers.

(b) 'Standard' prices can usually be changed on 30 days' notice, and indeed what the current 'standard' offering is can be changed without notice. Such changes in prices could well be happening quite naturally if the market is under stress, which seems to be the most likely cause of retailer default.[4] And in fact another retailer's default might itself be a reason for a retailer to review its standard prices.

(c) Retailers' 'standard' prices might reflect a particular acquisition process that would possibly not be able to be followed in this case, particularly in the area of targeting, credit quality and credit checking.

(d) Some retailers, particularly in times of high spot prices, will only take on new 'TOU' customers on spot price arrangements, which is effectively their 'standard' offering at that time.

(e) For all of these reasons, what the customers end up on could well be very different to, and much less favourable than, what they were on, but that is understandable and reasonable.

- If the tender response is partial (not all the consumers are allocated), does that effect the tender winning retailers residual allocation?

- If a tender process is included in the overall process, we suggest that it be limited to only one phase. This will save time and effort and avoid flogging an already very tired horse.

Concluding remarks

20 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 Bruce Rogers (Pricing Manager), DDI 03 363 9870, email bruce.rogers@oriongroup.co.nz.

Yours sincerely

Bruce Rogers
Pricing Manager

[4] And indeed for a number of years one major retailer had the right to change prices at 48 hours' notice in such circumstances.

Appendix: Responses to specific questions

	Question	Response
1	Has there been any development since submissions were received on the problem definition developed by the RAG that might warrant the Authority reconsidering its view as to the nature of the problem?	No.
2	Do you agree with the objectives of the proposed amendment? If not, why not?	Not all of them. We think the main reason to seek to avoid disconnection is the practical one that mass disconnection is very difficult to implement. Arguing that customers of a defaulting retailer should never be disconnected *as a matter of principle* at the very least raises moral hazard issues with respect to retailer behaviour. Specifically they might make price offerings that are 'too low' knowing, and perhaps telling customers, that a process is in place to protect them if it all goes bad. This process is effectively a cost to all other participants and consumers. While we are always careful with analogies, we note that, despite there being a prudential supervision regime in place for banks, depositors remain the residual risk bearers if a bank fails. Finally it seems at least possible that the process will not find a home for all consumers due to the inability of other participants to absorb them financially. In that event, disconnection would seem to be the only option left.
3	Do you agree with the proposed Code amendment which would introduce a new category of default when the following conditions are satisfied:	Yes, but some of the conditions are problematic. Generally speaking it is not clear whether the inclusion is designed to ensure that distributors *do not* follow their own process – which may well result in disconnection of customers – or whether it is designed to allow this

	Question	Response
		process as an option. If the former it should be made as easy as possible for a distributor to use it, and it is not. The condition of having no "unresolved disputes between the retailer and distributor" is too high a threshold. Parties in distress often use all measures available to prevent their demise, providing a range of excuses for missing payments and using other delaying tactics. This condition simply provides the opportunity for a defaulting retailer to raise an unrelated or unreasonable dispute to avoid triggering the default procedure. The condition should be qualified with "the Authority is satisfied that no relevant and material disputes remain between the retailer and the distributor". The inclusion of a serious financial breach condition is clearly intended to align with the MUoSA, but it can't help but highlight the serious asymmetry that has emerged between the still quite stringent prudential requirements applied to retailers (purchasers) in the wholesale market, and those Code limited requirements that distributors can apply to retailers via UoSAs. This difference has never been explained, but in the current context we note that the proposed exit process: • Is designed to protect the Clearing Manager from virtually any default risk, yet the distributor will experience many weeks of loss by the time the process *begins*, and • Requires the distributor to accept significant loss via the serious financial beach condition before the process is triggered, yet non-payment of a single dollar to the Clearing Manager will trigger the process. While we do not agree with the condition, as a technical matter many existing use of system agreements will not define a serious financial breach, so the condition in 14.55(h) would need to be amended to say "or in the absence of such a definition, where the termination results from the retailer's failure to pay an amount exceeding the greater of $100,000 or 20% of the retailers normal monthly charges, or the retailer's material failure to comply with any prudential requirements"

	Question	Response
4	Do you agree that the proposed Code amendment should apply not only to the network or networks across which the event of default has occurred? If not, why not?	Since the proposal is to use this as a trigger for the process to exit the retailer from the market, it would be difficult to apply locally. In any case, we doubt there will be many situations where a retailer defaulting to one distributor is not also having difficulties making payments to other distributors, suppliers and the Clearing Manager.
5	Do you agree that the trigger for the actions to be undertaken by the Authority should be limited to a breach of sub-clauses 14.55(a), 14.55(b), 14.55(f), and (the new) 14.55(h)? If not, why not?	No comment.
6	Do you agree that the process for managing a retailer default should ensure that responsibility for all ICPs of the retailer in default, active and inactive, are transferred to another retailer? If not, why not?	Yes. By definition transfer of an inactive ICP should not impose material risk on the recipient retailer, as such an ICP has already been disconnected. We note that the paper suggest such ICPs might be associated with customers who are poor credit quality. Our understanding is that retailers seldom change the Registry status when they disconnect for non-payment. An inactive ICP is much more likely to be vacant, meaning any incoming customer will have to find a retailer which may or may not be the recipient.
7	Do you agree that the process should accommodate situations where the default might not be resolved but an acceptable resolution has been agreed and all payments that should have been made have been made? If not, why	Yes.

	Question	Response
	not?	
8	Do you agree with the judgement arrived at by the RAG that a total period of 17 days for managing an event of default would provide a reasonable balance between the costs of too short a period and the costs of an extended period? If not, why not?	The shorter the better, but we understand that there are practicalities. 17 days is much better than the current rather open-ended situation. For the Clearing Manager, we note that the timeframe will determine the overall level of prudential security that needs to be provided, so in a sense the wholesale market is indifferent. There is no such link for distributors. Either way the Authority should resist the likely calls for the process to be extended. To the extent the proposal to include a tender process pressures the timeline we think the tender process should be the first part to be produced.
9	If a period of 17 days is maintained, should this time be allocated as follows: seven days for a retailer to resolve the dispute or transfer its customer base, seven days for customers to voluntarily switch to another retailer, and a maximum of three days for communication with customers and ensuring all switches are processed?	We are not convinced that the three days at the end of the process is enough time to carry out the tasks, particularly the tender process and communication in any meaningful sense. We recommend that communication with all parties, and in particular consumers, start as early as possible.
10	Do you agree that the Code should be amended to require a retailer in default to provide information on its customers to the Authority and for the Authority to obtain this	We support the inclusion of the requirement in the Code for the distributor to provide customer information if they have it. Without such a requirement, the potential financial impact of the action and distributors confidentiality obligations under their UoSAs, as well as Privacy Act requirements might prevent distributors from reasonably releasing it.

	Question	Response
	information from distribution networks and the registry if the information is not forthcoming from the defaulting retailer? If not, why not?	
11	Do you agree that the Code should be amended to provide for the registry to complete the switch of any customer of a retailer in default that chooses to switch to another retailer, if the retailer in default does not meet its obligations under the switching rules? If not, why not?	Yes, although if the defaulting retailer does not meet its obligations, can the switch be completed as a technical matter?
12	Do you agree that the Code should be amended to provide for the Authority to direct the registry not to complete the switch of any customer *to* a retailer in default after the Authority has advised the customers of that retailer that their retailer is in default and they should transfer to another retailer? If not, why not?	Yes. Again there will be technical considerations around who is doing the notifying. A customer in the process of switching may not be included in any targeted communications so could be left in limbo. Perhaps the losing retailer should have some rights/obligations in these cases?

	Question	Response
13	Do you agree that the Authority should advise retailers and other interested parties that an event of default has occurred, and if it considers appropriate, identify the entity in default, to enable these parties to make necessary preparations? If not, why not?	Yes. We think there would need to be a good reason not to identify the party in default.
14	Do you agree that the Code should provide for the Authority to communicate directly with the customers of the retailer in default, including via mass media? If not, why not?	Yes, as it is unclear who else would. It may be useful to decide on aspects of the communication approach and content before the event as there will be little time to do so once the clock starts ticking.
15	Do you agree that the Code should provide for the Authority to provide customer information to the retailers to whom it transfers customers, should a mandatory transfer be required? If not, why not?	Yes, and the requirement should extend to distributors – where they have the information - to obviate concerns that they may otherwise be contractually unable to release the information. See response to question 10 above.
16	Do you agree that the Code should be amended to require that contracts between the retailer and its customers provide for the	If it is required, yes. However the Authority should first determine whether it must do this, and then if it must, whether it can simply deem the terms to be in consumer contracts. We note that the consumer counterfactual is disconnection. It might be that, provided the Authority

	Question	Response
	Authority to assign the contract to another retailer if an event of default is unresolved after 17 days? If not, why not?	communicates its intention to assign, and consumers are entitled to explore alternatives to assignment, and if still unhappy with it, accept disconnection, no contractual changes are required? In any case what is being 'assigned' is not the customer along with the terms and conditions, but just the customer, so is assignment even the right term? If anything needs to be added to consumer contracts it might be something more along the lines of an acknowledgement that, should the retailer fail, the connection might be subject to a regulatory process that meant the customer's retailer could change.
17	Do you agree that the terms offered by recipient retailer (who is assigned customers by the Authority) should be those terms (including price) normally offered by the recipient retailer at the date the Authority was notified of the default? If not, why not?	This is a complex and problematic area. On balance we do not think this is appropriate, and it may well not be effective. In times of market stress, retailers take a range of approaches, including halting acquisition, and offering only spot based contracts (to 'TOU' customers). Indeed the notification of the default may of itself be sufficient for retailers to review their offerings. More fundamentally the retailer default process is designed to protect consumers from disconnection. It is unnecessary, and probably unwise in terms of the objective of continued supply, to protect them from all of the consequences of their choice of retailer. However, we do think the Authority should avoid arrangements that, with little or no involvement from the consumer, lock the consumer in for extended periods with a new retailer, see next question.
18	Should the arrangements for managing an event of default provide for the Authority to tender the remaining customer base of the retailer in default after the Authority had exercised its rights to assign the contract on the terms of the recipient retailer? If not, why	We take it this question relates to the fixed term offerings tender described in para 3.2.44. The Authority needs to be careful that consumers do not end up locked in to what they might come to consider are very unfavourable terms, particularly since they might have little awareness of what is going on at the time. We note the two week 'cool down' period, but we suspect consumer awareness might take longer to dawn, and might be triggered by the first bill. On this basis it is preferable to move straight to mandatory allocation after the first tender is complete.

	Question	Response
	not?	
19	If a tender arrangement is provided for, should the Authority invite tenders on the basis of the prices that would be charged to the customers by the recipient retailer (but no higher than standard terms offered by that retailer) with the Authority assigning the customers on the basis of the lowest priced retailer? If not, why not?	This seems like a reasonable method in principle. However, we are not sure that a tender is a practical solution in the time available. We note above (response to question 17 and the body of submission) the difficulty in defining 'standard terms' particularly as this regards price.
20	Do you agree that, should the Authority be required to allocate customers of the retailer in default, it should do so on the basis of market share in the relevant networks but without any de minimus threshold? If not, why not?	Yes. We presume this is referring to mandatory allocation rather than allocation by tender?
21	Do you agree that the arrangements for managing a retailer default should provide an opportunity for any retailer that is assigned customers to object on the basis that the assignment	Yes. However, this raises the risk that many or perhaps even all retailers make this claim. How would the Authority go about establishing this is not the case, and if it overruled it, and the retailer failed, where would that liability lie? On the other hand accepting this claim from one retailer potentially changes the position for all others. We think this confirms that, no matter how the allocation is carried out, the Authority should not, or should place

	Question	Response
	would threaten its financial viability, with the onus on the retailer to substantiate such a claim? If not, why not?	less weight on an, attempt to get favourable terms for consumers. The counterfactual for the consumer is disconnection. The arrangement they were on with the exiting retailer is off the table. Can the Authority, even under the Code, allocate customers to retailers without the retailers' consent? Would directors be able to allow this to happen if they thought it would place the recipient retailer at risk of failure?
22	Do you agree that the Code should require that the recipient retailer is responsible for notifying their assigned customers that they were now a customer of the recipient retailer, and advising the terms and conditions of their new contract? If not, why not?	Yes. This seems to sensibly leverage existing practice and process.
23	Do you agree that the Code should require that contracts between retailers and their customers should include provisions that: provide for the retailer to give customer details to the Authority in the event of a default; allow the contract to be assigned by the Authority in the event of default, with the terms and conditions to be replaced by the recipients retailers terms and conditions; provide for	As noted in our answer to question 16 above we are not sure assignment is the right term, and if a contractual change is required.

	Question	Response
	the retailer to assign the contract? If not, why not?	
24	Do you agree the proposed amendment is preferable to the other options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act? If not, why not?	In terms of avoiding disconnection yes. We do not think that the statutory objective requires control of the terms of the recipient retailers. Whether the long term interests of consumers are served by what is effectively an incentive for a retailer to act imprudently, with that cost socialised across all consumers, is less clear.
25	Do you agree that a period of 17 days strikes the right balance to achieve the benefits of an arrangement for managing an event of default while minimising the costs of achieving those benefits? If not, what period of time should be specified and why?	It should not be longer, and probably cannot be much shorter.
26	Do you agree that the benefits of the proposed arrangements would exceed the costs? If not, why not?	The costs are low, and since we are avoiding disconnection, the VoLL and other avoided disruption benefits will be high. The long term benefits are much more difficult to gauge.
27	Do you agree that the proposed arrangements meet the Authority's Statutory Objective? If not, why	Yes, but to some extent we believe they go beyond them.

	Question	Response
	not?	
28	Do you have any comments on the drafting of the proposed amendment?	No.