Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarket
Auckland 1149,
New Zealand
www.vector.co.nz

Corporate Telephone
+64-9-978 7788

Corporate Facsimile
+64-9-978 7799

21 September 2012

Retail Advisory Group
c/o Electricity Authority
PO Box 10043
Wellington 6143

Sent by email to: rag@ea.govt.nz

Submission on arrangements for managing retailer default situations

1. Vector welcomes the opportunity to respond to the Retail Advisory Group's consultation paper entitled *Arrangements for managing retailer default situations* (the "consultation paper"). No part of this submission is confidential and Vector is happy for it to be made publicly available.

2. Vector's contact person for this submission is:

   Ian Ferguson
   Senior Regulatory Advisor
   09 978 8277
   ian.ferguson@vector.co.nz

Overall comments

3. Vector strongly supports the work done by the Retail Advisory Group ("RAG") on managing potential retailer defaults. This is an important initiative for ensuring the efficient operation of the industry. In an environment where consumers are not practically able to be disconnected and distribution prudentials are severely restricted, it is essential that parties have assurance that losses will be minimised in an event of default.

4. The consultation paper proposes a framework to address situations of retailer default by providing:

   a. a set of definitions of default; and

   b. a set of actions the Authority can undertake to address the default, including the transfer of customers of failed retailers to other retailers.

5. The RAG's proposal would be, in principle, a substantial improvement in the electricity market rules. Embedding the Authority's ability to transfer

remaining customers of the defaulted retailer in the Electricity Industry Participation Code ("Code") provides certainty and clarity for both distributors and customers (among others), while improving the overall robustness of the regulatory regime. Vector's past experience with the default of E-Gas (as described in our previous retailer default submission dated 16 March 2012) demonstrates just how costly the negative impacts of a retailer default can be for distributors, customers and other industry participants. Vector therefore firmly believes that the interests of all industry participants need to be recognised, particularly the interests of end users. The industry needs to ensure that the actions employed in a default situation are in the best interests of customers. We also consider that triggers for intervention by the Authority in events of default are well informed and well defined, and do not unduly interfere with standard commercial practices during receivership/liquidation. Our views below are based on these principles.

6. The following section provides Vector's views on the RAG's key proposals. Appendix A addresses the specific questions posed in the consultation paper.

Comments on proposals

7. Overall the proposals provide the basis for a robust regulatory proposal. However, some elements are unrealistic, impractical or based on incorrect assumptions. These elements are set out below.

Definition of event of default

8. The RAG proposes to define events of default as including failure to pay the Clearing Manager or meet security requirements of the Clearing Manager under Part 14 of the Code, plus events external to the Code such as the termination of a use-of-system agreement (UoSA) by a distributor.

9. Vector supports the view that the definition of event of default needs to include defaults relating to industry participants other than the Clearing Manager. However, the termination of a UoSA is not the correct trigger for an event of default as this will occur too late in the defaulting process. Further, there will be situations where although a retailer has shown likely signs of default (e.g. serious financial breach or failure to pay/meet prudential requirements), a distributor may not wish to terminate the contract as some contracts will contain powers and remedies for distributors, such as the power to appoint a receiver/liquidator.

10. The trigger for the event of default should instead include a breach of prudential requirements under both Part 14 and Part 12A of the Code – to include prudential requirements for Distributors as well as the Clearing Manager. Payments under Part 12A should be given as much weight as Part

14. The status quo currently incentivises retailers short on cash to prioritise payments to the Clearing Manager.

11. The trigger for the event of default should also include serious financial breaches and undisputed payments or failure to meet prudential requirements required under the Code (however, minor non-payments should be excluded). The final Model Use-of-System Agreements include clauses allowing distributors to notify the Authority of any serious financial breaches.[1]

Use-of-system agreements (UoSA)

12. The RAG suggests that an option for distributors to manage the risk of a retailer default would be to shift retailers to a conveyance UoSA. For the reasons set out below, Vector does not agree that this is a practicable option. While there are additional protections for a distributor if a retailer defaults under a conveyance UoSA, it may not be practicable to 'shift' a retailer from an interposed UoSA to a conveyance UoSA. Billing methods cannot be easily or quickly changed, nor is a different billing method/type of contract (e.g. a mixed method) on the same network realistic.

13. Furthermore, there is an assumption that under a conveyance UoSA, funds collected for distributors are "*generally* held in trust" and "*may not* be available to other creditors" (see paragraph 3.4.9 of consultation document, emphasis added). This cannot be guaranteed to be the case, hence the equivocal language.

Notification of default

14. Distributors should be able to notify the Authority of an event of default before/without the termination of contract. Where defaults occur events can move very quickly and it is important that the Authority and other participants are ready to act to manage the situation. To ensure quick reactions, the systems and processes put in place through any Code changes should be regularly tested.

Termination of a UoSA

15. Vector does not agree that, where termination of a use of system is the event of default, the Authority should be automatically authorised to investigate whether a default in fact exists. This is because the termination of the use of system would have been a contractual issue addressed by the parties' respective legal counsels. However, Vector does recognise the need to provide the Authority with sufficient information to establish that there was a 'real' default. The Authority may need to request additional information to

[1] Clause 20.4 of Interposed MUoSA and clause 12.3 of Conveyance MUoSA.

confirm that a default has occurred. In the event of a receivership/liquidation, we would expect the Authority to maintain and work closely with the receiver/liquidator to ensure that the impact across the industry is minimised.

Timing of events

16. The RAG proposes that the Authority would intervene at the point that a default occurs and, after perhaps eight working days, contact the customers of the retailer. Then, after a further ten working days, assign the remaining customers to other retailers within the same network areas. Vector supports this proposal in principle but we do not believe the proposed triggers are quite right.

17. Vector submits that the Authority should have powers to intervene at two stages within the process:

    a) When an event of default occurs and is not remedied but the industry participant does not have powers to appoint a receiver/liquidator; and

    b) When the receiver/liquidator decides that the default situation cannot be rectified and that they will be ceasing to trade.

18. These points are discussed in more detail below.

19. Some industry participants have the power to appoint a receiver/liquidator. However, where a retailer has defaulted and the existing contractual arrangements do not allow the affected participant(s) to appoint a receiver/liquidator, the Authority should be mandated under the Code to appoint such.

20. When a receiver/liquidator has been appointed, it is important that they can continue trading (when they have the support of the distributors and the Clearing Manager) without third party interference. At this stage they would be assessing the viability of the business and it would be counterproductive for the Authority to intervene, until such time as the receiver/liquidator *cannot* rectify the situation. Therefore, where a receiver/liquidator has been appointed, the Authority ought not to put a time limit on the receiver/liquidator to rectify the situation. This could put undue pressure on trading by the receiver/liquidator and inhibit, rather than ease, the process. However, the Authority should work closely with the receiver/liquidator to provide information and ensure that the impact on the industry is minimised.

21. The Authority should only contact customers to provide a notice of transfer after it has been established that the attempts of a receiver/liquidator to rectify the situation have failed and that the receiver/liquidator is not continuing to trade. This contact should occur within three working days of the receiver/liquidator stopping trading.

22. Vector acknowledges the need for a balance to be struck to ensure a reasonable time for the voluntary transfer of customers while maintaining minimal loss of revenue for industry participants. However, the proposed 10 working days seems slightly excessive and could be reasonably cut down to one week – 5 working days – from the date the Authority notifies the customers that they are required to switch retailers. One week is enough time to allow customers to receive and digest the information and choose whether to voluntarily transfer to a new retailer. Thus, in summary, under Vector's proposal the Authority would have three working days to contact customers to advise them to switch retailers and would then transfer any remaining customers five working days after that.

Transfer of customers

23. The consultation paper assumes that a sale of customers will be likely to be a 100% transfer of the defaulting retailer's customer base. Though the proposals include a reference to the anomaly of the E-Gas default, the Code and industry should be prepared for changes to past practice and the possibility that the E-Gas situation could set a new precedent.

24. Anyone buying a customer base will undertake due diligence. It is likely that they will only want to purchase contracts which are profitable and will not want to be locked into unprofitable contracts. Despite this 'unwanted customers' need to be dealt with as they continue taking supply. Further, any transfer of customers should include those classed as "inactive", as it cannot be presumed that "inactive" customers are not in fact still using the service – as was discovered with the E-Gas situation (see paragraphs 29-31 of previous submission dated 26 March 2012 for more on the E-Gas default).

25. Vector does not support the proposal to invite retailers to tender to provide contracts for the customers of the defaulting retailer, as it contradicts the pursuit for a swift and easy transfer that maintains certainty and minimises costs. It is also unnecessary as this step will be undertaken by the receiver, who will have more expertise in such matters than the Authority. Vector sees this proposal as inviting delays and uncertainty for both distributors and customers.

Access to customer information

26. The RAG proposes the Code be amended to allow the Authority to access information held by distributors to reconstruct a customer database (if necessary). This presupposes that those entities have complete, up to date and accurate information. In reality, customer information is not always provided or complete – e.g. customer information is more likely to be collected under a conveyance UoSA than an interposed UoSA. Nonetheless, it is likely that participants will have access to customer information that is

useful to the Authority and should in any case work closely together to build an accurate customer database, as much as possible. The Code should be amended to allow the Authority access to the defaulting retailer's customer base, even in the event of receivership/liquidation. This would facilitate the receiver/liquidator being able to provide customer information without fear of contravening any Privacy Act 1993 obligations, and ensuring readiness to transfer any customers when required.

Alignment with the GIC's work on gas retailer insolvency

27. Vector notes that Option 3 includes reference to suggestions for aligning proposals with the Gas Industry Company's ("GIC") work on gas retailer insolvency. The RAG's proposal does not comment on how exactly it will ensure this will occur or what the timeframes will be.

28. A number of scenarios could arise from separate regulatory arrangements for electricity and gas, for example:[2]

    a. an energy retailer that is in financial difficulty could have its electricity customers transferred but retain its gas customers;

    b. if the gas retailer insolvency rules are more liberal, energy retailers may have less incentive to pay their gas pipeline charges than their electricity line charges; and

    c. dual-fuel customers may find themselves in the confusing situation where they are transferred to another retailer for one energy service but remain with the defaulting retailer for the other.

29. Vector considers that a combined gas and electricity default scheme is preferable. However, this should not prevent the Authority from implementing its own Code amendments in advance of a combined solution being developed with the GIC.

Yours sincerely,

Bruce Girdwood
Manager Regulatory Affairs

2 http://www.vector.co.nz/sites/vector.co.nz/files/PUBLIC%20Vector%20Submission%20Castalia%20Report%20on%20Retailer%20Insolvency.pdf, page 5

APPENDIX A: ANSWERS TO SPECIFIC QUESTIONS

Question 1: Do you agree with the summary of the options available to a distributor in the event of a default by a retailer, or are there other remedies available to a distributor?	Vector does not view the options identified in the consultation paper as practicable options for a distributor. It may not be practicable to 'shift' a customer from an interposed UoSA to a conveyance UoSA. Billing methods cannot be easily or quickly changed, nor can a mixed method be used. Furthermore, there is an assumption that retailers on a conveyance UoSA hold the funds in a Trust to ensure distributors are paid in a default situation. However, this cannot be guaranteed (see paragraph 3.4.9 of the consultation paper and paragraph 13 above). To be clear, Vector does not view disconnecting customers as an acceptable option. It is not a practicable solution to a default situation and does not promote consumer confidence in the electricity market. Therefore, our views on any options to address retailer default start from this perspective.
Question 2: Do you consider that a distributor could be sufficiently concerned about the prospect of a default by a retailer to insist on a conveyance use-of-system agreement for the use by retailers of its network, and if so, would this be an undesirable outcome?	See above answer to Question 1.
Question 3: Should a distributor, after terminating a use-of-system agreement with a retailer as a result of an unresolved serious financial breach by that retailer, have an option of advising the Authority that it considers an event of default exists and that this event should be subject to the proposed arrangements under the Code to manage an event of default?	Yes. However, this raises concerns around: 1. unnecessary interference with an appointed receiver/liquidator (see above, paragraphs 16-22); and 2. notification of default without termination of contract (see above, paragraphs 9-11, and 14).
Question 4: Are there any other events not currently captured by clause 14.55 that should be defined as an event of default and if so on what rationale?	Yes. The definition should not be limited to situations where a termination of contract has occurred. Similarly, events of default should include serious financial breaches and failure to provide payments required under Part 14 *and* Part 12A of the Code (see above paragraphs 8-11). It is not an equitable outcome for retailers facing payment issues to not face consequences when they continue to pay the Clearing Manager but not their distributor.

Question 5: Should the Code provisions governing the notification of a default be broadened to require all participants and service providers to notify the Authority as soon as that entity has reasonable grounds to believe that an event of default is likely to occur, or has occurred?	Yes, Vector holds the firm view that all participants of the industry should be able to notify the Authority. While the Authority may not need to act (if a receiver/liquidator has been appointed) the Authority will need to monitor the situation, work closely with the receiver/ liquidator, and prepare to act quickly if it is required to contact and transfer customers.
Question 6: *Should the clearing manager have an obligation to advise an entity if it has not complied with a requirement of Part 14 of the Code and that this non-compliance is an event of default?*	Yes. This also gives the entity the opportunity to correct any non-compliance in the event of possible oversight.
Question 7: *Should the Code be clarified and simplified by bringing the actions that may be taken by the clearing manager in the event of a default into one sub-part and re-drafted to stipulate, to the extent practical, the actions the clearing manager would take in relation to a shortfall in payment or a failure to meet a call?*	Yes if it means that it would provide greater clarity and certainty. Care would be required to ensure that re-drafting would not change the meaning and scope of such actions.
Question 8: *Should the Code stipulate that on being notified of an event of default, the Authority would immediately investigate and determine:* *a. whether an event of default exists; and* *b. if an event does exist whether that event is a minimal risk event arising from a technical or administrative failure that has or will be corrected within one business day or a commercial disagreement that doesn't affect the retailer's long-term ability to trade?*	Yes, subject to our comments on Q8 below, the Code should include provision for the Authority to investigate upon notice of default regarding whether one exists – (links to Q3 and 5). Clause (b) looks like it is trying to flesh out the cause and impact of the default; however, this should be set out more clearly. We suggest something along the lines of: i. What level of risk does the event of default have? ii. Did the event of default arise out from a technical, administrative, commercial or other type of failure/issue? If so: A. will the failure or event be corrected in one business day? If not, when will it be corrected? B. does the failure or event affect the retailer's long-term ability to trade?

Question 9: *Should any assessment by the Authority of whether the event is a minimal risk include a materiality threshold, equivalent to the serious financial breach threshold under the draft model use-of-system agreement?*	Yes. However, the definition of 'serious financial breach' needs to be clarified. In footnote 8 of the consultation paper it is stated to be "the **lesser** of $100,000 or 20% of the monthly lines charges", while in paragraph 4.2.4 it is "the **greater** of $100,000 or 20% of the monthly lines charges" (emphasis added). Vector recommends the definition of serious financial breach is "the **lesser** of $100,000 or 20% of the monthly lines charges". For some small retailers, it can take several months to build up $100,000 of unpaid bills.
Question 10: *If distributors are provided with an option of notifying the Authority that they had terminated a retailer's use-of-system agreement as a result of an unresolved serious financial breach, should the Authority be tasked with assessing whether the distributor had complied with the notice terms of* *the use-of-system agreement and, in the absence of action by the Authority, would be entitled to notify consumers that they would be disconnected unless they switched to an alternative retailer?*	Termination of a UoSA is a contractual legal matter which would be likely to involve lawyers from both sides. There would not be much value in involving the Authority; however the Authority would need to be provided with sufficient evidence to demonstrate an event of default has occurred. If the Authority finds the information insufficient, they could request further information (see above paragraph 15).
Question 11: *Should the Code stipulate that on determining that an event of default of more than minimal risk exists the Authority would advise the retailer and its agent(s) that unless the default is rectified within a specified number of days, the Authority would:* *a. communicate with all of the retailer's customers advising them that their retailer had defaulted and that the customer should switch to another retailer and that if they did not switch by a specified date the Authority would assign them to another retailer; and* *b. proceed to terminate the retailer's rights to trade electricity under the Code?*	Yes; however, the Authority should only intervene if an appointed receiver/liquidator has failed to successfully rectify the situation or where a default has occurred and not been rectified and no retailer or liquidator has been appointed (see above paragraph 16-22).

Question 12: *Should the Code require that retailers include an assignment clause in their customer contracts?*	Yes – relates to Q21.
Question 13: *What period of time, measured in days, is necessary to allow sufficient time for a retailer to transfer responsibility for its customers to another retailer or to rectify the default?*	Where a receiver/liquidator has been appointed, it is important that they can continue rectifying the default situation without third party interference. Therefore, the Authority ought not to put a time limit on the retailer to rectify the situation. This could put undue pressure on trading by the receiver/liquidator and inhibit, rather than ease, the process. However, if there has not been a receiver/liquidator appointed the Authority should have the powers to step in and appoint one, rather than step in to transfer customers as a first step. Customer transfer will be required only where the receiver/liquidator decides to cease trading. (See above, paragraphs 16-22.)
Question 14: *Should the relevant period of time be specified in working days or in calendar days?*	Working days – calendar days are not reasonable.
Question 15: *Should a mechanism exist to extend the number of days provided to the retailer in default to rectify the event of default, including any interest payable, if that extension of time is approved by the parties who would bear the financial risk of an extended time period?*	This will be addressed by the receiver/liquidator working with the creditors and assessing the business. There should not be any need for the Authority to intervene. However, the Authority should be working closely with the receiver/liquidator.
Question 16: *Should any extension of time for rectifying the default require approval of a majority in number representing 75% in value of the money owed or some other threshold?*	Yes, 100% is likely to be impossible but a clear majority is acceptable. There are also provisions under other Acts, e.g. the Companies Act 1993, which cover what the receiver/liquidator can do. Vector recommends these are considered by the Authority to ensure the Code does not conflict with existing legislation.
Question 17: *Should the Code provisions that provide for generators to be assigned or subrogated to the rights of the clearing manager be removed from Part 14?*	Yes.

Question 18: *If, at the end of the eight-day period, the defaulting retailer has not satisfied the Authority that it (the retailer) is no longer in default, or has not transferred all of its customers to another retailer, should the Authority have the ability to communicate with the retailer's customers advising those* *customers that their retailer had defaulted, that they should switch to another retailer and, that if they did not switch by a specified date, the Authority would arrange for them to be transferred to another retailer?*	Refer to answers for Q13 and 15.
Question 19: Should the Authority be able to facilitate this voluntary transfer by providing the customer list of the retailer in default to competing retailers so that they may make their own approaches to the customers of the retailer in default?	No. If this is coupled with the proposal for tenders, it will most likely lead to customers being bombarded by competing retailers. This is arguably a bad thing as people usually do not like to be contacted by sales-people. Furthermore, there are probably restrictions on the use of customer's personal data and privacy implications, in relation to its use by numerous retailers. In addition, those retailers will have had the opportunity to purchase the defaulting retailer's customer base from the receiver/liquidator.
Question 20: *What period of time, measured in days, should be provided by the Authority to the customer of the retailer in default to voluntarily switch to an alternative retailer?*	On balance, we are of the view that 5 working days is reasonable.
Question 21: *Should the Code impose on retailers an obligation to have the following provisions in their contracts:* *a. in a default situation, the Authority may terminate the contract between the retailer and its customer; and* *b. if the Authority terminates the contract under (a), the customer would become bound by a contract with another retailer stipulated by the Authority?*	Yes but subject to the contractual conditions/operation between the retailer and the distributor – e.g. this step should not be taken while a receiver/liquidator is still trading (relates to Q12).

Question 22: *Should retailers in the same network area be required by the Code to enter into contracts with customers of the defaulting retailer whose contracts have been terminated by the Authority?*	Yes, as customers will continue to use electricity unless transferred (or disconnected, which is not practicable) – for example, in the E-Gas default some customers classed as "inactive" on the Registry, were still using gas despite being classed as "inactive".
Question 23: *Should the Code provide for the Authority to invite other retailers to tender to provide contracts to the customers of the failed retailer whose contracts the Authority has terminated?*	No. Inviting tenders is time consuming (involves more steps in the process) and may lead to consumers being bombarded by competing retailers. Customers of the defaulting retailer need to be moved as quickly and seamlessly as possible – inviting tenders is not conducive with achieving this goal. In addition, as discussed above, those retailers will have had the opportunity to purchase the defaulting retailer's customer base from the receiver/liquidator.
Question 24: *Should the Code enable the Authority to allocate, as a last resort, any remaining customers of the retailer in default amongst retailers on the affected network on a pro rata basis based on a historic retail volume measure?*	Yes, but this should include any customers classed as "inactive" (refer Q22).
Question 25: *If you do not agree with a pro rata basis, what method should the Authority use to allocate any remaining customers of the retailer in default amongst retailers on the affected network?*	NA
Question 26: *Should responsibility for the customer, caused to be transferred by Authority, change to the new retailer on the date of the switch?*	Vector considers the responsibility of the new retailer should include payments for the default amount relating to the acquired customers – e.g. the new retailer should be responsible from the date of default, adjusted for any prudentials held by the industry participant. The new retailer's responsibility should be backdated so that the customer is paying a retailer for electricity on each day and the retailer in turn is paying the other industry participants. If this is not done, affected participants will not be kept whole through the process. While this requirement may appear onerous for the acquiring retailers, it is directly linked to the prudential requirements. If sufficient prudentials were in place to manage the default risk, then responsibility for the customer as at the date of the switch would be reasonable. As long as the current distribution prudentials remain in force, the responsibility should be backdated to the date of default.

Question 27: *Should the Code be amended to require a retailer in default to provide the Authority with the information it would need to write to all of the retailer's customers advising them that the retailer is in default, and if necessary, to cause any remaining customers to transfer to another retailer?*	Yes – this will ensure the swift and efficient transition on the part of the Authority. Ideally, this information sharing will occur concurrently with other actions during a default, to ensure the Authority's "readiness". However, this could be limited to "orphaned" customers only (both active and inactive ICPs on the Registry) – as the need to transfer will only arise for the Authority in situations where customers have not voluntarily switched, and/or have been transferred/sold by a receiver/liquidator.
Question 28: *Do you agree that to address the potential for information difficulties the Code should provide for the Authority to:* *a. advertise to advise customers of the retailer in default that they should choose an alternative retailer;* *b. access information held by the Registry and distribution utilities to reconstruct a customer database if necessary; and* *c. instruct the Registry to act as counterparty for customers switching voluntarily from the retailer in default, if required?*	Yes. Distributors' customer information is likely to be incomplete and subject to restraints regarding its use. The Code should be amended to override any such restraints so that parties can work together to build a customer database and ensure readiness of transfer (see above paragraph 26).