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30 July 2012

Ian Dempster
Gas Industry Company
PO Box 10 646
Wellington
New Zealand

[Submitted via Gas Industry Co website]

Dear Ian,

Powerco Submission on Insolvent Retailers Workstream: Castalia Strategic Advisors Report

Introduction

1. Powerco welcomes the opportunity to comment on Castalia Strategic Advisors (Castalia) report, *Discussion Paper on Gas Retailer Insolvency* (the Report), published on 22 June 2012. Powerco recognise that incidents of gas retailer insolvency are very rare in New Zealand, but due to the potential impact on the gas industry it is very important that the GIC further consider whether there is a case for regulatory intervention.

2. This letter summarises Powerco's key views on the Report. Our responses to the consultation questions in the submission template are in Annex A. None of the content of this letter or Annex A are confidential.

3. Powerco views the commissioning of the Castalia Report by the GIC as a positive step in progressing the matter of retailer insolvency. The Report provides a comprehensive analysis of the issues and details a series of recommendations that Powerco supports.

Certainty is essential for the development of the gas industry

4. The gas industry is battling with persuading people to connect, or stay on, reticulated gas. We must give consumers confidence that when they buy a gas appliance and make an investment for 10 or more years, they will continue to receive a high quality of service. The gas industry can not afford reputational damage and confidence in the gas industry being undermined. All risks must be carefully managed – and we see retailer insolvency as a very real risk.

5. The E-Gas situation highlighted the importance of having a regulatory back-stop, whether introduced under urgency or as permanent regulation. While the regulations enacted under

urgency for the E-gas situation were not required to be implemented, they helped provide assurance to impacted parties while the insolvency process was resolved. Providing certainty to industry participants and the public is essential in building the confidence levels and market development. It is recognised that standard insolvency arrangements or regulatory intervention do not eliminate all the risks or inconvenience associated with insolvency.

Requirement for regulatory intervention exists

6. The Report correctly outlines the unique characteristics of the gas supply chain and the associated market failures that justify the need for regulatory intervention. While a regulatory backstop would not address all market failures and issues due the complexities and parties involved, it would provide more certainty for the industry while an insolvency practitioner worked through the insolvency.

7. The Report accurately describes the market failures related to retailer insolvency experienced by distributors as a result of not operating in a competitive market. As the Report states, there are only two options available to distributors in the event of retailer insolvency and these both result in financial loss and create significant work for distributors. Gas distributors will always consider disconnecting customers as a last result due to gas being considered an essential utility, the reputation of gas as a secure and reliable energy source and the associated disconnection/reconnection costs . This leaves continuing to supply gas as the only other option available to distributors. While this is positive for the industry as it assists addressing the insolvency issue, it creates costs, uncertainty and risks for the distributor.

8. The justification for introducing back stop regulation is clearly outlined in the conclusion of the Report where it identifies that the parties imposing the costs on distributors have no motivation or incentives to avoid creating them. While this market failure cannot be removed under the current gas industry model due to the structure of the contractual relationships, regulation would provide a framework and certainty to deal with insolvency when it occurred.

9. The challenge of developing insolvency regulation that meets industry and customer needs, is ensuring that it is robust enough to provide certainty. Any regulation needs the flexibility enough to deal with the differences between retailers and benefits need to clearly outweigh the costs of creating and maintaining regulation.

Use of prudential requirements to manage risk

10. When considering the level of regulatory intervention required, consideration needs to be given to the use of prudential requirements in distributors' contracts with retailers. Prudential requirements are an important mechanism in managing distributor risk, allowing the industry the freedom to negotiate the level of protection creates more flexibility around how a distributor reacts to a retailer experiencing financial difficulty or defaulting on payments. Getting the balance right between setting prudential levels that encourage new

retailers to enter the market, but also provide distribution companies with necessary risk mitigation is the key factor in getting prudentials to operate effectively for the industry. Powerco considers a two to three month prudential achieves this.

Conclusion

11. Powerco is pleased that the GIC is investigating the issue of retailer insolvency and will continue to support the workstream where required by the GIC.

12. Thank you for the opportunity to make this submission. If the GIC wishes to discuss any aspects of this submission further, please do not hesitate in contacting me on 06 757 3397 or oliver.vincent@powerco.co.nz.

Yours sincerely,

Oliver Vincent
Regulatory Analyst
Powerco

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Submission prepared by: Oliver Vincent, Powerco Limited (contacts details in cover letter)

QUESTION		COMMENT
Q1:	Do you have any comments or concerns on the summary of standard insolvency arrangements provided in this section?	No. We agree with the summary, it is well written and the covers the key points, including that standard insolvency arrangements do not eliminate risk or inconvenience and that 'normal' insolvency may break down in monopoly markets.
Q2:	Do you have any comments on the summary of physical and contractual characteristics of the New Zealand gas market set out above?	No, both the physical and contractual characteristics have been described accurately.
Q3:	Are you aware of any reason(s) why a gas retailer may become insolvent in addition to those mentioned in this section?	No, we agree that the three main risks have been identified.
Q4:	Are there other likely scenarios of how a gas retailer insolvency might play out that have not been discussed above?	In general we agree that the scenario described is how retailer insolvency might play out. However, it is important to recognise that each party involved will respond differently to each insolvency scenario. Factors such as the size of the retailer, the contractual agreements in place (prudential requirements & customer agreements) and operating situations of other parties will affect responses. This could include a distributor triggering retailer insolvency by requesting payment to be made rather than hold off. Reasons for this occurring could be that a distributor perceives a retailer is a greater risk due to low prudential, high volume or how small business customers with contractual agreements understand their switching rights. An additional factor that should be considered is the type of customers that a retailer has, if they have a high number of large volume commercial customers they could be considered more attractive. While these contacts would be easily switched it could leave residential customers orphaned. The introduction of any regulation has to be flexible enough to address all the potential scenarios while providing an adequate framework.

QUESTION		COMMENT
Q5:	Do you agree with the description of customers' perceptions of the risk of insolvency, and the likely customer experience when their retailer becomes insolvent?	Yes. The high stability and low cases of retailer insolvency in the energy market means that the risk of insolvency is not of great importance to a customer when considering an energy retailer. The report aggregates residential and commercial customers within the report. This is fine when they are on equivalent contracts, but this is not always the case. The E-gas insolvency provided evidence that small commercial customers were unclear of their switching rights due to clauses in their contracts around length of agreements and when the agreements were no longer binding. Ensuring clarity around insolvency in these agreements and increasing the understanding of the risk should be more of a priority for residential customers.
Q6:	Do you agree with this discussion of the incentives that apply in an insolvency event?	Yes. Additionally, the gas industry can not afford reputational damage; therefore there is a strong incentive by all parties to reach a positive conclusion with as little disruption as possible. The E-gas insolvency demonstrated the industry's desire to work together and make compromises to resolve the situation. Any regulatory solution should be flexible enough for this to occur and encourage cooperation.
Q7:	Do you agree with the market failures identified?	Yes.
Q8:	Do you agree that the market failures identified will only eventuate if an insolvency practitioner disclaims customer contracts or if an acquiring retailer does not acquire the whole customer base in a sale process?	We agree that any scenario that leads to one or more customer being split from the customer base of an insolvent retailer is going to lead to market failure. We believe that ensuring customers are not hand picked from a customer base or orphaned is essential to the insolvency process. While there will be a desire by retailers to move quickly to attract consumers to switch and maximise the value of certain customers, any regulation should provide a framework to ensure that this does not happen from the beginning of insolvency proceedings. If a customer base is split it is more likely to take longer to resolve the transferring of all customers, create higher UFG and increase chances of orphaned customers. While all parties experience additional costs, distributors often end up shouldering the greater burden of managing orphaned customers and the workload associated with disconnections.
Q9:	Do you agree that contracts provide some ability for gas industry participants to manage the costs that they might bear if their counterparty becomes insolvent?	Yes, prudential requirements in contracts are a mechanism to manage the risk of retailer insolvency. Allowing retailers and distributors to negotiate the level of prudential requirements that is acceptable for both parties is important to encouraging new entrants and mitigating distributor risk.

QUESTION		COMMENT
Q10	Based on the issues discussed above and for the market failures identified, do you consider that there is a need for regulatory intervention beyond using the urgent regulation-making powers in the Gas Act?	Yes. We recognise that developing regulation would be complex and could be potentially addressed by non regulatory solutions but believe that greater certainty can be achieved through regulation. While the industry has proved that it can work together to resolve retailer insolvency, this may not always be the case. As the first few days of insolvency are critical we believe it is necessary to have regulatory back stop powers in place to ensure a process that will deliver the best outcome for the industry. We agree with the report's recommendations and encourage the GIC to consider these when progressing the retailer insolvency workstream.