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Dear John

Submission on the Insolvent Retailers – Options Paper (Public Version)

Introduction

1. Vector Limited ("Vector") welcomes the opportunity to make this submission on the Gas Industry Company's ("GIC") *Insolvent Retailers – Options Paper*, dated 17 December 2012 ("Options Paper").
2. Appendix A of this submission is provided to the GIC on a **confidential** basis and should not be made publicly available. Vector has accordingly provided public and confidential versions of this submission.
3. Vector's contact person for this submission is:

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4. Vector reiterates its position that permanent backstop regulations should be introduced to address the risk of future gas retailer insolvencies.¹ The outcomes of stakeholder consultations on this issue, following the E-Gas insolvency in 2010, could not be any clearer:

¹ This view was expressed in previous Vector submissions, <http://www.vector.co.nz/sites/vector.co.nz/files/8%20%2020110415VectorSubmission-InsolvencyRegulations.pdf> and <http://www.vector.co.nz/sites/vector.co.nz/files/PUBLIC%20Vector%20Submission%20Castalia%20Report%20on%20Retailer%20Insolvency.pdf>.

- there are risks over and above those in other markets that are more pronounced than, if not unique to, gas retailer insolvencies (“residual risks”) which should be addressed, i.e. stopping the financial losses incurred by third parties, particularly distributors and meter service providers;
- any proposed arrangement that compromises the safety of consumers is unacceptable. Consumer safety is upheld in other regulations, such as the *Gas Governance (Critical Contingency Management) Regulations 2008*, and should be the case in any insolvency arrangement;
- during a retailer insolvency, there is a common desire by industry participants to restore normalcy in the shortest time possible for the benefit of consumers and to protect the reputation of the gas industry as a reliable supplier of energy. This was evidenced by industry participants’ cooperative behaviour in the development of urgent regulations during the E-Gas insolvency (the *Gas Insolvent Retailer Regulations 2010* – “GIRR”), which have since lapsed;
- while industry participants generally prefer non-regulatory approaches to resolving industry issues, they overwhelmingly prefer more permanent arrangements to address residual risks in an efficient manner, particularly to ensure that customers who are connected to the network but do not have a retailer (‘orphaned’ customers) are transferred to other retailers without interruption of their gas supply;
- any proposed arrangement should be efficient. It should 1) minimise or stop costs being incurred by those who did not cause the residual risks, 2) not introduce further risks/inefficiencies, and 3) be low-cost, e.g. discourage litigation; and
- any proposed arrangement should be enduring. There should be no need to revisit the regulations unless there are compelling reasons to do so, for example, regulatory or commercial changes that significantly alter industry participants’ incentives. Enduring regulations are low-cost regulations.

Permanent and flexible arrangements required

5. Permanent backstop regulations would guarantee that residual risks are mitigated, if not avoided, and market confidence would be restored immediately, following a retailer insolvency. The residual risks represent failings of the market and using pure market mechanisms (non-regulatory options) to correct them would fall short of this guarantee.
6. The Options Paper alludes to permanent regulations compromising flexibility. It fails to consider the benefits and flexibility of regulations as a backstop. While the

Options Paper acknowledges that some submitters commented that the GIRR assisted the resolution of the E-Gas insolvency by providing certainty as to what would happen if the receiver was unable to carry out a sale of E-Gas customers (page 4), the benefit of this certainty is not discussed in the analysis of Option 5 (implementing a permanent backstop regime).

7. Flexibility should not be a trade-off for certainty and market confidence during a disruptive period, such as a retailer insolvency. However, Vector cannot see any reason why it would not be possible to develop permanent and flexible regulations.

Proposed options insufficient

8. The contractual options proposed in the Options Paper (Options 1 and 2) cannot provide the certainty required to address retailer insolvencies. The costly and drawn-out processes of designing contractual agreements to correct clearly identified market failures are too well known to industry participants; it only takes one party reneging to make any agreement ineffective. Addressing the breakdown of voluntary agreements could well require regulations eventually.
9. The proposal to draft urgent backstop regulations only after a retailer insolvency has occurred (Option 3) suffers from the problems of hastily crafted regulations, i.e. the long-term consequences of decisions are not given proper consideration and are not subject to meaningful consultation. Such an approach would also not guarantee full compliance because of the fragility of voluntary agreements. However, the parameters that are proposed to be defined in advance under this option could inform the development of permanent backstop regulations.
10. Vector would not support any option that involves the mandatory disconnection of customers (Option 4). Disconnection is a detrimental outcome for customers and puts the reputation of the gas industry on the line. This approach is effectively a (potential) disruption of supply, which in other cases, such as critical contingency events, are covered by permanent regulations.
11. The Options Paper has not sufficiently explored sub-options under Option 5 (permanent backstop regime), given the certainty such a regime could provide in situations of a market failure. The argument that permanent regulations could deter reliance on normal insolvency processes (page 30) is unrealistic. Deterrence would be weak as insolvency legislation needs to be adhered to.
12. Vector finds the sub-options proposed under Option 5 unacceptable and impractical, particularly the sub-option of making distributors act as retailers. This would require distributors to source gas and establish systems, e.g. billing, which would be impossible to set up in a short time. This is a much greater cost to industry than having existing retailers take on some new customers that are similar to their existing customer base. Vector supports requiring recipient

retailers to have at least 10% of the number of ICPs in the Gas Registry to avoid failure cascading to other retailers.

Benefits of certainty and costs of uncertainty underestimated

13. The Options Paper underestimates, if not discounts, the importance of certainty in meeting the Gas Act 1992 (“the Act”) principal objectives of efficiency in the delivery of gas and reliability of supply. The occurrence of a retailer insolvency shakes up market confidence, and the role of any arrangement should be to restore that confidence without further distorting the market. This would enable industry participants to resume trading and investing with confidence, and consumers to regain confidence on gas as their fuel of choice.
14. Regulations are not only introduced (or retained) to address market failures but also to maintain or enhance market robustness, i.e. providing even greater certainty, to ensure that markets keep functioning, if not functioning more efficiently.² While the GIC has a specific regulatory objective in respect of retailer insolvency (ensuring efficient backstop arrangements), it has wider objectives under the Act. Options to address regulatory issues should therefore be assessed within a wider context, including considering their interrelationships with other work streams.
15. Risk management is not only about addressing problems or avoiding/preventing them; it is also about not missing out on opportunities that would better meet Gas Act and regulatory objectives and have a stabilising effect on the gas market.

Responses to specific questions

16. Vector’s responses to the specific questions in the Options Paper are set out below.

Q1: Do you agree with our assessment of the RAG’s proposal?

17. Vector does not completely agree with the assessment.

² For example, the Electricity Authority interprets its role of “promoting competition”:

...to mean exercising its functions to facilitate or encourage stronger competition...

Promoting competition does not mean achieving a certain level of competition. Even in markets where the Authority considers competition is already strong, the Authority interprets its statutory objective as requiring it to adopt proposals that would further strengthen competition if such proposals have positive net long-term benefits for consumers.²

18. The GIC argued that retailers and distributors in the gas sector, whose commercial relationships are governed by bilateral contracts, have more control over their contractual relationships than in electricity and could therefore respond to retailer insolvencies more flexibly. As indicated in Vector's submission on the *Castalia Discussion Paper on Retailer Insolvency*, gas contracts are constrained by multilateral agreements such as the Vector Transmission Code, the amendment of which can be costly and time-consuming, and in some circumstances, almost impossible.
19. The Options Paper made references to the Retail Advisory Group's ("RAG") report to the Electricity Authority, dated 14 August 2012. The RAG has since made final recommendations in a report dated 28 November 2012, recommending a regulated approach to address retailer default, which was subsequently adopted by the Electricity Authority. The report emphasises the importance of providing certainty and considers that mandatory disconnection of customers is neither practicable nor tenable.³

Q2: Do you agree with the stated regulatory objective?

20. Vector agrees with the stated regulatory objective of "ensuring that there are efficient backstop arrangements in place if and when a gas retailer becomes insolvent".
21. As stated above, however, the GIC has to consider options to address retailer insolvency within a wider framework. It has to consider the principal objectives of the Act, which include ensuring reliability of supply, and section 43G (purpose of regulations in respect of retailer insolvency), which includes the "protection of consumers".

Q3: Do you consider that the orphaned customer risk could be managed contractually?

Q4: Do you think Gas Industry Co can add value to a normal insolvency process by, for instance, providing lists of orphan customers to market participants?

22. Continuing to rely on contractual mechanisms would essentially be no different from the status quo. Different results cannot be expected by doing the same things over and over again. The purpose of permanent backstop regulations is precisely to address residual risks, or part of those residual risks, that cannot be resolved by contractual arrangements or normal insolvency processes.
23. Vector's experience with the E-Gas insolvency showed that orphaned customer risk was not able to be fully managed contractually. Many of the customers Vector dealt with had an inactive status on the Gas Registry. This meant they should not

³ RAG Final report on retailer default, <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, sections 3.1.2 and 3.1.3

have been taking gas, but a number, in fact, were. This imposed undue costs on Vector's distribution business, which was inefficient.

24. The GIC providing a list of orphaned customers to industry participants could potentially facilitate commercial decision making, though that list is likely to be taken from the Gas Registry, which other industry participants already have access to. A potential problem would arise if the ICP address is different from the postal address, and this information would presumably be available only from the Insolvency Practitioner. This type of information sharing could complement, if not be a component of, permanent regulations.

Q5: Do you think voluntary contract principles can manage the orphaned customer risk?

25. The GIC facilitating the introduction of new principles to retail and distribution contracts would help address the residual risks to some extent but this approach, in itself, is insufficient due to the fragile constitution of voluntary arrangements. In addition, orphaned customers do not have incentives to pay, and disconnected customers even less so.
26. As the RAG proposed a regulated approach for the electricity industry, which provides an essential service (i.e. interruption of service and payment for service cannot be tolerated), the case is even more compelling for the gas industry, where customers have the option to switch to another energy source.
27. Voluntary contract principles, however, could provide a good starting point for the development of more robust permanent backstop regulations. A working group on retailer insolvency can look into linking the GIC's retailer insolvency work stream with its assessment of distribution agreements against the Distribution Principles it developed with industry, for example, to ensure sufficient prudential requirements.

Q6: Do you agree that relying on urgent backstop arrangements that would apply after an insolvency process, where the parameters would be developed in consultation with the industry, is an efficient response to the orphaned customer risk?

Q7: Do you have any comments on the parameters that could apply for those regulations?

Q8: If Option 3 were selected, do you consider there to be any residual risks that would justify a more interventionist approach? If so, please elaborate on those risks.

28. The Options Paper does not clearly demonstrate that Option 3 would provide an adequate backstop. Creating urgent regulations on an "as and when required" basis does not provide a satisfactory backstop, or even a backstop, to address the issue of orphaned customers. Though urgent regulations were enacted during the E-Gas insolvency, it does not follow that it should create a norm.

29. The E-Gas regulations involved retrospective consultations and urgent amendments, which were not ideal, and did not help create any certainty. The GIC should use this opportunity to help ensure that such a process is not followed again; Vector cannot see how it can do this with Option 3.
30. Urgent regulations are not necessarily low-cost; their development can be resource-intensive and prone to political pressures. It would be less costly to establish regulations once after going through all the proper channels in a more considered and comprehensive fashion.
31. The problem with the GIRR was that it only covered contracted customers. There was nothing to cover the inactive customers. The liquidator of E-Gas disclaimed 11 contracts, which were manageable on a manual basis. The issue was around inactive customers, some of whom were still taking gas. These customers all required site visits, with the disconnected customers having their gas meters removed and status changed to disconnected. The rest were still taking gas and needed to move to another retailer. This created issues as it is usually the retailer losing the customer who finalises the switch. This could not happen as E-Gas was not trading.
32. Regulations made under urgency are not as robust as those that go through a more considered process, with the benefit of hindsight. Permanent backstop regulations, considered and drafted without undue haste, would provide greater certainty and ensure compliance. While flexibility should not be a trade-off for certainty and market confidence, it does not mean that parameters cannot be set up front to ensure future flexibility is not compromised, i.e. permanent regulations need not be incompatible with flexibility.

Q9: Do you have any comments on the option requiring distributors to disconnect orphaned customers from their networks?

33. Vector is disappointed that the GIC contemplated the mandatory disconnection of paying customers as an option (Option 4). This would breach Gas Act and regulatory objectives of ensuring reliable supply and protecting consumers.
34. Disconnecting orphaned customers compromises customer safety and is unacceptable to Vector. Customer safety should be a non-negotiable outcome. The gas industry would not want to bear the brunt of public outrage for incidents that could have been avoided.
35. Distributors do not have visibility of the nature of orphaned customers, given that it is retailers, not them, who have the contractual relationships with customers. Some orphaned customers could be 'vulnerable', most notably the terminally ill and those providing essential services, who could not tolerate a disruption of gas

supply. Any untoward outcome as a result of even a single disconnection, despite being mandated by regulations, would be detrimental to the reputation of the gas industry. This is inconsistent with the industry's wider and long-term interest.

36. Gas is a discretionary fuel and competes with alternative fuel sources. Sending the signal that customers could be disconnected should their retailer become insolvent would not be attractive to existing and potential customers, and could discourage existing customers from increasing their gas consumption. Reliability implies that the flow of gas to customers would not be hindered by the failings of a particular industry participant.
37. Disconnecting orphaned customers *en masse* would be very costly for distributors. The Option Paper's suggestion to recover disconnection costs from orphaned customers is inefficient. The customers do not cause, nor contribute to, the residual risks, but suffer from disruption and anxiety associated with it. They have no incentives to pay for disconnection and inconvenience. While disconnecting customers targets the most visible residual risk, making them bear the costs of supply disruption not of their own making creates another one. As the Options Paper itself indicated (page 17), it appears that the empowering provision in the Act does not appear to provide for enforced payment from orphaned customers.
38. In addition, given that each property for disconnection has to be physically visited, this could take some time as there is limited qualified resource available to do this type of work. This defeats the purpose of stopping 'un-billable' consumption in an expeditious manner.

Q10: If you consider that a permanent backstop arrangement is necessary please provide full supporting reasons.

Q11: Do you have comments on any of the sub-options for a permanent backstop regime? Are there other sub-options you believe warrant further investigation?

Q12: Are there other options you think Gas Industry Co needs to analyse before moving to the next phase of this work stream?

39. Permanent backstop regulations are necessary to guarantee the reduction, if not avoidance, of residual risks. This is well recognised in the RAG's final report on retailer default to the Electricity Authority.⁴
40. A retailer becoming insolvent, while rare, affects the entire industry and consumers.⁵ Normal insolvency processes are effectively already regulated

⁴ RAG Final report on retailer default, <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, sections 3.1.1-3.1.5

⁵ Retailer insolvencies can be seen as "black swan" (or "mini-black swan" events) - rare and hard-to-predict events that are beyond the realm of normal expectations and play vastly large roles than regular occurrences

processes, being governed by insolvency legislation. Sector-specific permanent backstop regulations are not intended to intervene in this process but to address residual risks and complement, if not reinforce, its efficacy.

41. The risk of deterrence to normal insolvency processes was not borne in the E-Gas insolvency, where there was active cooperation by industry participants in crafting urgent regulations (with nary a complaint) which would have taken effect had the sale of E-Gas customers not materialised. As the Options Paper itself indicated, “the trigger for...regulated transition arrangements under the Gas Act to become effective would be once a retailer becomes insolvent and, even then, it is most likely that customer contracts would need to be disclaimed before they could be compulsorily assigned to other gas retailers”. Permanent regulations targeting residual risks ensure that any impact on prior contractual arrangements would be minimal, i.e. the risk of deterrence is mitigated.
42. Permanent regulations, which provide certainty and durability, could cost less than establishing urgent regulations which require conducting retrospective consultations. A voluntary arrangement would “not deter opportunistic behaviour or obviate costly self-protective measures”.⁶ An established permanent arrangement decreases “inefficient searching for...other risk instruments”,⁷ decreasing cost for industry. For example, retailers contemplating market entry would be certain of the implications of a retailer insolvency to their cost structure and operations.
43. There should be permanent arrangements to ensure the efficient transfer of orphaned ICPs to other retailers. The reason the liquidator of E-Gas could not sell all the contracts was that the due diligence by the purchasers showed some of the contracts were not viable (an unsurprising outcome in an insolvency). The liquidator also had no knowledge of the real status of the inactive ICPs.
44. The Options Paper mentions there were no disclaimed contracts in the E-Gas liquidation. This is incorrect as shown in Appendix A.

Option 5 sub-options

45. Neither sub-option holds appeal. The retailer-of-last-resort sub-option would leave one or some retailers disproportionately exposed, which does not reduce residual

(http://en.wikipedia.org/wiki/Black_swan_theory).⁵ The rarity of such events does not mean they would not be catastrophic; in fact, they often are. Retailer insolvencies can occur for various reasons, even in the best of economic times, for example, due to poor business judgments or fraudulent activities. Permanent regulations should be seen as an ‘insurance’ against events of this nature that industry participants do not want to use ever, but which provides them with certainty that disruption would be fleeting and not costly to them and their customers.

⁶ RAG Final report on retailer default, <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, section 6.5.2

⁷ Ibid., section 6.2.2c

risks. The nature of various retailers' businesses (e.g. customer base or market share) also changes over time, not making this arrangement stable.

46. The sub-option of distributors acting as retailers for orphaned customers is not feasible; distributors do not have supply contracts with customers and are not well placed or geared for this function. Distributors would have to buy gas, establish billing systems, obtain meter reads, comply with all the reconciliation rules and regulations, etc. This arrangement would add to the confusion, not to mention cost, in an uncertain time.
47. Vector supports retaining the provision in the GIRR requiring recipient retailers to have at least 10% of the number of ICPs in the Gas Registry. This would avoid the risk of failure cascading to other retailers who are forced to take large numbers of customers from the insolvent retailer. Vector notes this is consistent with the RAG's recommendation.⁸
48. Further analysis is required around Option 5, particularly in identifying more sub-options (or various 'permutations') that would deliver permanent and flexible regulations. Potential sub-options could incorporate elements of Option 2 and 3 or a combination of other elements.
49. The allocation of orphaned customers across recipient retailers on a pro-rata basis could be considered. This means that retailers could determine price in accordance with their other customers, and the customers could easily opt to switch to other retailers.
50. Applying regulations only to domestic customers, not commercial customers, could also be considered, to encourage early commercial negotiation and settlement (an approach Vector does not currently have a view on).

Working group on retailer insolvency

51. Vector **recommends** that the GIC establish an industry working group on retailer insolvency, whether advisory or technical in nature (or a combination or sequence of both), to facilitate the further development of sub-options under Option 5. Continued industry discussion would enable issues that have not been contemplated or considered extensively to be brought to the surface and given proper consideration. This is not possible with intermittent formal submission processes.
52. The GIC and industry's experience with the review of the *Gas (Downstream Reconciliation) Rules 2008* being informed by the Downstream Reconciliation Advisory Group shows how valuable a group of this nature could be. The

⁸ RAG Final report on retailer default, <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, section 5.7.6

establishment of the RAG also appears to have expedited the Electricity Authority's work on retailer default.

53. The working group could explore and develop proposals for the following, among other measures:

- a general framework for establishing permanent and flexible arrangements to address residual risks, including third-party risks;
- aspects of the above framework that need to be codified in regulations;
- issues that require prescriptive provisions and those that require mere guidance (to embed flexibility in the regulations);
- trigger(s) for the regulations to take effect;
- incentives for industry participants to act efficiently to reduce residual risks;
- processes and timeframes for the efficient transfer of orphaned customers;
- switching incentives for orphaned customers, which may require amendments to the *Gas (Switching Arrangements) Rules 2008*. The RAG considers that switching-related problems are likely to be the key cause of any breakdown in confidence;⁹
- process for information sharing and communication responsibilities, including communication to orphaned customers, industry participants and, where required, the public; and
- consideration of aligning the GIC's retailer insolvency work with other work streams, specifically with 1) the GIC's assessment of retailers' contracts against benchmarks, 2) the GIC's Gas Distribution Contracts Oversight Scheme, and 3) the Electricity Authority's work on retailer default, e.g. adopting useful features of the EA's *Guidelines for Managing Retailer Default Situations*, which was informed by the RAG's proposed process.¹⁰ While the RAG indicates there is no requirement for its approach to be aligned with the GIC's work, there is no reason why the GIC could not align aspects of its work with the Electricity Authority's.

⁹ RAG Final report on retailer default, <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, section 5.7.4

¹⁰ <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, page 5

Q13: Do you agree with Gas Industry Co's assessment of the practicable options?

54. The comparative assessment of options (Table 3) underestimates, if not discounts, the value of certainty and durability in maintaining, if not immediately restoring, market confidence when a retailer becomes insolvent. See response to Q10-12.
55. As stated above, Vector does not agree with the assessment that disconnecting paying customers meets Gas Act and regulatory objectives. See response to Q9.
56. Vector believes introducing permanent backstop regulations best meets the Act's principal objectives of promoting efficiency and ensuring security of supply, and the regulatory objective of protecting consumers. Developing the 'rules of the game' ex-ante boosts market confidence and could encourage market entry, i.e. due to costs/risks being known up front. The motivations of industry participants in the event of a retailer insolvency may be too complex to analyse quantitatively (which the RAG points out)¹¹, let alone predict. In periods of great disruption, sometimes confidence is all it takes to keep markets functioning.

Yours sincerely



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Manager Regulatory Affairs

¹¹ RAG Final report on retailer default, <http://www.ea.govt.nz/our-work/programmes/market/consumer-rights-policy/assuring-supply/>, section 6.2.1

Appendix A – []
(Confidential)

