Insolvent Retailers - Options Paper

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Submissions close: 11 February 2013

GAS INDUSTRY COMPANY LIMITED

About Gas Industry Co.

Gas Industry Co is the gas industry body and co-regulator under the Gas Act. Its role is to:

- develop arrangements, including regulations where appropriate, which improve:
    - the operation of gas markets;
    - access to infrastructure; and
    - consumer outcomes;
- develop these arrangements with the principal objective to ensure that gas is delivered to existing and new customers in a safe, efficient, reliable, fair and environmentally sustainable manner; and
- oversee compliance with, and review such arrangements.

Gas Industry Co is required to have regard to the Government's policy objectives for the gas sector, and to report on the achievement of those objectives and on the state of the New Zealand gas industry.

Gas Industry Co's corporate strategy is to 'optimise the contribution of gas to New Zealand'.

Authorship

This document was prepared by the Market Operations Group

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Executive summary

This paper canvasses options for instituting a system of transition arrangements for consumers in the event of a gas retailer becoming insolvent.

Examination of the problem

Work on this topic had its genesis in late 2010, when the E-Gas group of companies went into liquidation. In response, the Gas Governance (Insolvent Retailer) Regulations 2010 (GGIR Regulations) were put into place urgently, although they were never triggered. Following retrospective consultation,[1] Gas Industry Co recommended to the Minister of Energy and Resources (Minister) that those regulations should be allowed to expire, as they were targeted at a specific set of circumstances. Instead, Gas Industry Co recommended that a workstream be established to consider whether a generic regulatory solution is required to address retailer insolvency; and if so, the form that generic solution should take. The Minister accepted this recommendation.

As a first step in examining the issues associated with retailer insolvency, Gas Industry Co commissioned a report by Castalia Strategic Advisors (Castalia) to provide advice on whether normal insolvency processes can be relied on to produce acceptable outcomes in the event of gas retailer insolvency; and whether there are any market failures associated with the process. Castalia found that, while a gas retailer insolvency may involve some amount of inconvenience to other market participants and customers, the bilateral nature of gas contracts means that normal insolvency processes can apply. Indeed, gas market participants are able to use contracts to mitigate insolvency risks; for example, by using prudential securities. However, there are particular aspects of the gas market that can result in retailer insolvency leading to a market failure in the form of orphaned customers; that is, customers that remain physically connected to the distribution system and able to consume gas, but who have no gas retailer responsible for the gas they are consuming. Castalia found that such a situation would be a market failure, because the consumption of gas by orphaned customers at shared gas gates would be met by other gas retailers in the form of increased allocations of unaccounted-for gas (UFG) to those retailers. Submitters generally agreed with Castalia's findings and conclusions. No issues were raised by submitters that required additional attention.

Does the possibility of orphaned customers justify a regulatory intervention? Retailer insolvencies are rare events; the E-Gas liquidation was the first gas retailer insolvency since Gas Industry Co's inception in 2004. Further, a retailer insolvency will not necessarily lead to orphaned customers; in fact, experience with insolvencies and takeovers in the electricity and gas markets suggests that a retailer's customer base is a valuable asset that other retailers would be willing to purchase. Orphaned customers will therefore only result if the business is wound up prior to the sale of the customer base,

[1] When regulations are made under urgency there is a requirement to consult with stakeholders within six months of the regulations being made (and to recommend any changes that may be appropriate following that consultation).

or if customer contracts are disclaimed by the insolvency practitioner[2]. In other words, large-scale orphaned customers arising from an insolvency event would be a rare outcome of a rare event.

Further, there seems to be no reason why distributors and retailers could not negotiate a commercial solution to the prospect of retailer insolvency. Distributors could, for example, require retailers through their use of system agreements to have provisions in their retail contracts that would allow distributors to take action in the event of retailer insolvency, including access for meter reading and disconnection of orphaned customers. Also, retailers would appear to have incentives to win gas customers that have been orphaned, since they are already meeting the gas supply costs of those customers through UFG costs.

Still, it is possible that risks remain to third party retailers that they cannot manage through contracting.

Regulatory objective

Gas Industry Co's ability to put in place a regulatory response to the prospect of orphaned customers arising from a retailer insolvency is defined by the enabling provision in the Gas Act 1992 (Gas Act). Section 43G of the Gas Act provides that the purposes for which regulations may be made in respect of retailer insolvency are:

> Transition arrangements for insolvent gas retailers
>
> providing a system of transition arrangements for consumers in the event of a gas retailer becoming insolvent, and requiring industry participants to comply with that system, with the objective of protecting consumers or managing the liabilities of other gas retailers (emphasis added).

Gas Industry Co therefore cannot regulate for a potential or likely insolvency. Regulations may only be made which apply once a retailer is insolvent. The wording also suggests a Parliamentary intent that any regulations align with insolvency laws. Ideally, arrangements would also be compatible with insolvency arrangements in the electricity market, although it should be noted that the Electricity Authority has different statutory powers and objectives in relation to electricity retailer insolvency; and there are also important structural differences between the two markets. These differences mean it is unlikely that insolvency arrangements for electricity and gas can (or need to) be fully harmonised.

Gas Industry Co considers that its regulatory objective in relation to retailer insolvency is 'ensuring that there are efficient backstop arrangements in place if and when a gas retailer becomes insolvent.'

[2] In the E-Gas case the liquidator did disclaim a small number of customer contracts that the purchaser of the customer base did not wish to acquire. Each of those was a large (daily metered) customer and all of them were able to secure contracts with retailers within days.

Practicable options and assessment

The reasonably practicable options discussed in this paper are:

- no intervention;
- Gas Industry Co to facilitate a contractual remedy;
- establish parameters for urgent backstop regulations;
- compulsory disconnection of orphaned customers; and
- implement a permanent backstop regime.

Based on our assessment, there is considerable scope for the first two options to satisfactorily manage the market failures. Gas Industry Co must firstly consider whether non-regulatory solutions are feasible so those options must be fully explored. If a regulated solution is deemed to be necessary, the best option would be to establish parameters (in consultation with stakeholders) for urgent backstop regulations tailored to specific circumstance.

Next steps

Submissions are welcomed on this options paper by 5pm 11 February 2013.

Feedback on the options presented, which may include suggested additional options that could be analysed, will be integral in the next step for this workstream which is to design and implement the preferred approach.

Gas Industry Co will publish an Analysis of the Submissions shortly after the consultation period closes. That analysis will consider the feedback received and discuss Gas Industry Co's preferred approach. Additional consultation may be carried out if necessary.

The next step will depend on the preferred approach from the Analysis of Submissions but could include facilitating a contractual remedy at industry workshops through to the development of a full Statement of Proposal for a regulatory solution. Gas Industry Co will then be in a position to respond to the Minister as to whether permanent regulations are necessary to manage retailer insolvencies, and if so, what the form of such regulations should take.

Contents

1 Introduction

1.1 Background

In late 2010 the E-Gas group of companies went into liquidation. At the time, E-Gas' market share was approximately 3% of all gas customers and 9% by allocated volumes at shared gas gates. Due to concerns at the time, Gas Industry Co worked with the (then) Ministry of Economic Development and the Parliamentary Counsel Office to develop the Gas Governance (Insolvent Retailer) Regulations 2010 ('the Regulations'). The Regulations would have transferred the E-Gas customers to viable retailers if the liquidator had been unable to complete a sale process and then disclaimed all of the customer contracts as onerous property. The outcome was that the liquidator was able to sell the E-Gas customer base and the Regulations did not need to be invoked. In terms of gas governance arrangements, the E-Gas event has now been fully resolved.

The GGIR Regulations were made using the urgent regulation-making provisions of the Gas Act. Section 43P requires[3] the recommending body[4], within six months of making urgent regulations, to consult with the persons substantially affected by urgently-made regulations and to make a recommendation to the Minister as to whether those regulations should be revoked, replaced, or amended. In March 2011, Gas Industry Co issued a Statement of Proposal seeking submissions on the GGIR Regulations. That consultation process culminated in a recommendation to the Minister in May 2011 that the GGIR Regulations should be allowed to expire (be revoked as provided for in regulation 19) and that Gas Industry Co would establish a workstream to consider whether a generic regulatory solution is required, and if so the form of that regulatory solution, to address retailer insolvency.[5]

The Minister accepted Gas Industry Co's recommendation and endorsed further work being undertaken on the issue of retailer insolvency.

1.1 Recent work

As a first step in considering whether to develop a regulatory backstop for gas retailer insolvency, Gas Industry Co engaged Castalia to provide independent advice on whether normal insolvency processes can be relied upon to produce acceptable outcomes when a gas retailer becomes insolvent. Castalia

[3] By reference to section 43L and 43N of the Gas Act
[4] Although Gas Industry Co did not recommend the Regulations, the (then) Minister of Energy requested that we fulfil the requirements in the Gas Act to consult retrospectively on the Regulations.
[5] Relevant background documents are available at the Insolvent Retailer section of Gas Industry Co's website: http://gasindustry.co.nz/work-programme/insolvent-retailers

was asked to consider in particular whether there are any market failures present when a gas retailer becomes insolvent and whether those market failures are exceptional when compared with 'normal' insolvency processes. The Castalia Report finds that the presence of orphaned customers – that is, gas consumers who are physically connected and able to consume gas but have no viable retailer to pay for that gas – may constitute a market failure in the form of externalities imposed on third parties, but that it is not clear that the likelihood or scale of such a situation would mean that regulatory intervention is required.

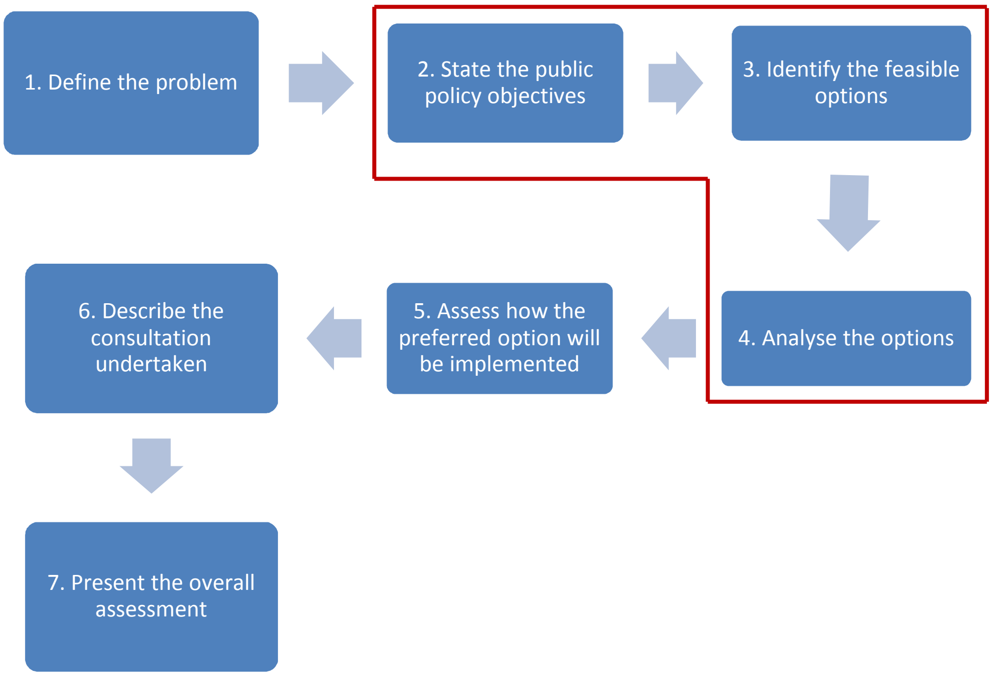
The Castalia Report, submissions received on the report, and Gas Industry Co's analysis of those submissions are available at: http://gasindustry.co.nz/work-programme/insolvent-retailers/consultation.

1.2 Options for addressing insolvency

This Options Paper is the next step in Gas Industry Co's insolvent retailer workstream. The paper builds on the Castalia Report and the submissions received on it.

The diagram below shows a 'typical' policy process and where Gas Industry Co is in regard to its insolvent retailer workstream. As indicated by the red rectangle, Gas Industry Co is at the stage of identifying feasible options and analysing those options according to the selected public policy objectives. This paper generally follows that outline:

- Chapter 2 discusses the problem definition and Castalia's findings;
- Chapter 3 examines the policy objectives;
- Chapter 4 identifies the reasonably practicable options;
- Chapter 5 analyses the options;
- Chapter 6 concludes the paper and discusses the next steps.



1.3 How to make a submission

Submissions are invited from stakeholders on this Options Paper. Submissions should be provided no later than 5pm on **11 February 2013** and preferably provided as soon as practicable. Please note that submissions received after this date are unlikely to be considered. Submissions can be made by logging-on to the Gas Industry Co website (www.gasindustry.co.nz), navigating to the Insolvent Retailer work programme and uploading your submission in the Consultation section. All submissions will be published on the website after the closing date.

The recommended format for submissions is attached as Appendix A and may be downloaded in MS Word format from the Consultation section of the Insolvent Retailer work programme that can be found on the Gas Industry Co's website.

Because submissions will automatically be made public on Gas Industry Co's website following the closing date, submitters should discuss any intended provision of confidential information with Gas Industry Co prior to uploading their submissions.

2 Problem definition

2.1 Experience gained from the E-Gas liquidation

Though this workstream began with the Minister endorsing Gas Industry Co's recommendation to investigate whether backstop insolvent retailer regulations are necessary, its origin was the voluntary liquidation of the E-Gas group of companies and the Government's decision to implement the GGIR Regulations under urgency. Key points to note from the E-Gas event, which may reasonably extend to future cases of gas retailer insolvencies, are:

- in the absence of any specific regulation addressing retailer insolvency, Gas Industry Co has only a limited regulatory role that applies before, during, or after a retailer becomes insolvent[6]. Relevant New Zealand laws around liquidation and receivership processes apply whenever a retailer becomes insolvent in the gas market, most notably parts 15, 15A and 16 of the Companies Act 1993 (Companies Act);
- the GGIR Regulations were never triggered, as the trigger point in the GGIR Regulations was the disclaiming of customer contracts by E-Gas's liquidator, which never occurred. However, some people have commented that the GGIR Regulations assisted the sale process by providing certainty as to what would happen if the receiver was unable to carry out a sale of the E-Gas customers;
- a successful sale process was carried out by the receiver which allowed E-Gas' former customers to be transferred to a new retailer at minimal inconvenience;
- while there were disruptions created during the E-Gas event and ultimately some costs borne by parties, insolvency events do not isolate market participants from these risks. A crucial point is that owing to the bilateral contracting which is prevalent in the New Zealand gas industry, counterparties have some ability to monitor and manage these risks contractually;
- much of the activity that occurred following the sale of the customer base, particularly work by distributors and Gas Industry Co, arose not from the liquidation per se but because it became clear that a number of E-Gas customers had 'slipped through the cracks' and were 'orphans' long before

[6] Gas Industry Co would have an interest in ensuring that the process of administration or liquidation did not prevent the company concerned from meeting its obligations under existing gas governance arrangements as long as it continued to trade as a gas retailer. In the case of the E-Gas group, Gas Industry Co worked with the liquidator to ensure that it understood the various obligations and would discharge those pending the sale of the customer base.

the voluntary liquidation. These were customers that E-Gas had gained (according to the gas registry) but had not migrated into its billing system and, therefore, were unknown to the liquidator and the acquirer of the customer base; and

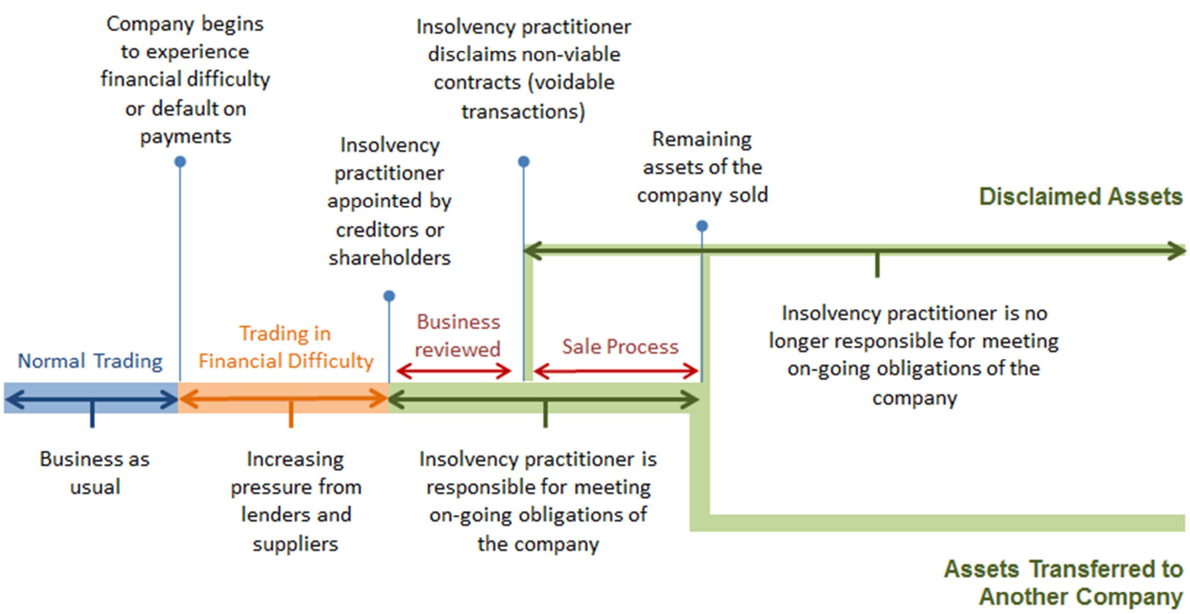
- the light-handed approach to regulating the gas market in New Zealand (for example, there is no licensing requirement) means that oversight by contractual counterparties is a necessary discipline on market participants.

2.2 Castalia's report

Insolvency timeline

The Castalia Report contains a timeline of how a standard insolvency would work:

Figure 1 Timeline of a standard insolvency (reproduced from p.4 of the Castalia Report)



Note the stage 'trading in financial difficulty'. This is an important stage in the normal operation of firms, particularly in New Zealand's gas market which extensively consists of bilateral contracts. If a firm is experiencing financial difficulty in the New Zealand gas market, it is highly likely that one of the firm's contractual counterparties will have visibility of that financial difficulty or may have experienced one or more missed or late payments. This bilateral contracting is significant because a standard feature of such contracts is that a secured creditor has the ability to petition the Court to appoint a receiver so that debts owing can be paid.

The next phase in an insolvency process is once the insolvency practitioner is appointed. This person will either be carrying out an administration, a receivership, or a liquidation process. Once the insolvency practitioner is appointed, s/he is responsible for meeting the ongoing liabilities of running the business until the business is either wrapped up or sold. This means that payments are made as normal to all contractual counterparties[7]. Gas market participants are able to use contracts to mitigate insolvency risks—for example, by using prudential securities—however, there is no guarantee contractual remedies will totally remove the risk of a market failure occurring or of participants experiencing loss.

Orphaned customers as a market failure

Castalia identified that a market failure exists when a gas retailer becomes insolvent if that insolvency results in customers becoming 'orphaned;' that is, they are physically connected to the distribution system and able to consume gas, but they have no gas retailer responsible for the gas they are consuming. This situation can arise because the physical delivery of gas is different from the contractual arrangements for gas delivery.

New Zealand's gas market is built on a series of bilateral contracts. Most end-users of gas have retail contracts with one of a number of competing retailers. However, those retailers do not have any physical connection to their customers' premises, so they must arrange contractually with distribution companies for customers to be physically connected to the distribution network. Distributors otherwise have little to do with the customers they are physically connected to; metering equipment and services are typically procured by the servicing retailer from third-party service providers. Similarly, the retailer is responsible for sourcing gas (from a gas producer or wholesaler) and for arranging its transport to the distribution system. These arrangements typically work well, but if a retailer becomes insolvent, the contractual links between the retailer, distributor, producer(s), wholesaler, transmission owner(s), and customer(s) are broken, even though the physical connection between the distributor, transmission owner(s) and customer remains whole[8].

Castalia found that such a situation would be a market failure, because the consumption of gas by orphaned customers at shared gas gates would be met by other gas retailers.[9] Orphaned customer consumption at direct-connect gas gates may also create the need for a balancing gas transaction, the cost of which would be borne by one or more TSOs. Therefore, orphaned customer gas consumption imposes a negative externality on other industry participants.

Retailer insolvencies are rare events; the E-Gas liquidation was the first gas retailer insolvency to have occurred since Gas Industry Co was founded. Further, orphaned customers do not necessarily result whenever a retailer becomes insolvent. If an insolvency practitioner decides to carry on trading the business (as occurred with the E-Gas event), then that insolvency practitioner will be responsible for meeting the ongoing costs of operating the business. Orphaned customers will only result when the

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[7] Albeit there may be some negotiation between the insolvency practitioner and the suppliers regarding the terms of any trade-on period.

[8] The producer(s) and wholesaler(s) would not continue to supply gas as the purchaser, the failed retailer, would no longer be paying for that service.

[9] Note that in the case of direct-connect customers their consumption would be identified by the relevant TSO and they would either need to sign up with a new retailer or risk disconnection. Such consumers are normally large and the TSO would not accept the risk associated with allowing supply to continue to such an orphan customer.

customer contracts are disclaimed. The market failure identified above will only occur as a subset of outcomes for a rare event.

Submitters generally agreed with Castalia's findings and conclusions. No issues were raised by submitters that required additional attention.

2.3 What are the risks posed by orphaned customers?

As discussed in our Analysis of Submissions on the Castalia Report, the risks posed by orphaned customer gas consumption are the creation of:

- UFG; and
- the need for balancing action(s).

Current industry arrangements for reconciling downstream gas consumption by consumers are provided for under the Downstream Reconciliation Rules. If orphaned customers continue consuming gas then their gas consumption will be treated as UFG under those Rules because, while the gas gate meter will measure the gas entering the network, there will be no retailer submitting consumption data to the allocation agent for such customers. The UFG will be allocated amongst other retailers trading at the gas gate(s) serving the orphaned customers and ultimately borne by those remaining retailers.

On the other hand, it is possible that some customers of an insolvent retailer are sole users of a transmission or distribution connection, i.e., they trade at a 'direct connect gas gate'.[10] These customers are generally large users of gas. If one of these customers became orphaned and continued using gas then technically the usage would show up as transmission UFG (because there are no other retailers at the gate to which the UFG can be allocated) and would become the responsibility of the relevant transmission system owner.

Because the insolvent retailer of orphaned customers has exited the market, no party will be purchasing upstream gas for consumption by these orphaned customers. The effect will be that orphaned customers extract other purchasers' gas from transmission and distribution pipelines or they consume linepack which may result in pipeline balancing actions being taken. The costs of any balancing actions would be passed on to Vector Transmission who would attempt to recover these costs from its shippers based on their daily allocations that were inflated due to the additional UFG at shared gas gates.

The effect of these risks on third-parties will differ depending on the types (volume) and on the numbers of orphaned customers. For example, a small number of orphaned residential customers will

[10] A direct connect gas gate is defined by exemption under the Gas (Downstream Reconciliation) Rules 2008 (Exemption DR10-03-S: Direct Connect Gas Gates) Notice 2010. This exemption was included in a review of the Downstream Reconciliation Rules and is subject to change, however there will be minimal change in practice from the exemption to any new rule.

have minimal effect on pipeline conditions vis-à-vis a small number of orphaned commercial or industrial customers, and that latter group are likely to be snapped up very quickly by competing retailers as was the case in 2011. In the case of direct-connect consumers, we believe the magnitude of the UFG they create would encourage the transmission system owner to require the customer to speedily enter into alternate supplier arrangements and/or to disconnect the customer from the transmission system. We also believe such customers would be keen to promptly manage the situation to avoid disconnection so would likely take the necessary steps shortly after learning their previous retailer had become insolvent.

2.4 How likely are orphaned customers?

Prior to the E-Gas liquidation, there were a number of occasions where gas and electricity retailers exited the market, as shown in the table below. Although not all of these cases were clearly linked with retailer insolvency, they still provide examples of customer transfers caused by retailer exit. In all of these cases, customers were transferred without the need for special regulatory intervention.[11] In the case of the E-Gas liquidation, the Regulations did not need to be invoked, although Gas Industry Co understands that some market participants welcomed the certainty that they brought to the market over a process that was fraught with unknowns.

Table 1 Exiting gas and electricity retailers, 1998 to present

Energy sector	Exiting retailer	Acquiring retailer	Date	Reason
Gas	Enerco Gas	Contact Energy	1998 (residential customers) 2000 (industrial customers)	Restructuring
Gas	Trans Alta	On Energy / NGC	2000	Exiting New Zealand
Gas	NGC	Genesis Energy	2002	Restructuring
Gas	Fresh Start	Genesis Energy	2003	Not announced
Gas	E-Gas	Nova Gas	2010	Retailer liquidation
Electricity	Empower	Contact Energy	2000	Access to capital
Electricity	Trans Alta	On Energy / NGC	2000	Exiting New Zealand
Electricity	On Energy / NGC	Genesis Energy (North Island	2001	Financial distress

[11] Note that some of the takeovers listed above obtained clearance from the Commerce Commission under section 66 of the Commerce Act 1986. However, this regulatory action concerns the competitiveness of markets after the proposed transfer, rather than assuring continuity of supply to customers and the integrity of the wholesale market settlement process, which are concerns relevant prior to the transfer of customers.

Energy sector	Exiting retailer	Acquiring retailer	Date	Reason
		customers) Meridian Energy (South Island customers)		
Electricity	Energy Online	Genesis Energy	2002	Restructuring
Electricity	Fresh Start	Genesis Energy	2003	Not announced

In the case of E-Gas, the issue of orphaned customers did not arise as a result of disclaimed retail contracts. On the contrary, the number of orphaned customers that came to light after the sale of the E-Gas customer base appears to have been the result of poor recordkeeping on the part of E-Gas, such that the customer list in their billing system did not match their customer list in the gas registry. This was not a result of the insolvency itself, but the issue came to light as a result of work undertaken following the insolvency.

2.5 Do these risks require a regulatory intervention?

At first glance, there seems to be no reason why distributors and retailers could not negotiate a commercial solution to ameliorate the problem above. Distributors and retailers have contracts in place with one another and retailers also have standard contracts with their customers. Distributors could, for example, as part of their agreements with retailers, require retailers to include in their customer contracts standard procedures for disconnection as a result of retailer insolvency. The costs of the disconnection could be met by the relevant customer(s) in the event of the customer(s) not switching retailers within a reasonable timeframe (e.g. 10 business days). Contract clauses could also require that distributor access to customer premises for the purposes of meter reading and disconnection survives the insolvency of a retailer.

However, because of the differing interests of distributors and retailers, when a retailer becomes insolvent, it appears as though a contracting failure could eventuate. Retailers will be frustrated that they will be billed for orphaned customer gas consumption in the form of UFG and, based on the submissions received on the Castalia Report, distributors will not immediately disconnect orphaned customers from their networks. The actions of distributors will not deal with the 'cause' of the market failure despite the distributors being responsible for providing the physical connection to the orphaned customer premises. Some retailers may not wish to deal with the 'effect' of the market failure by encouraging orphaned customers to switch, particularly if the orphaned customers will be a poor match for a retailer's average retail portfolio or if high costs will be incurred attempting to sign-up such customers. However, this may only be a significant problem if there were one or more market niches that were being served by only the failed retailer.

Since it is possible that risks remain to third party retailers that they cannot manage through contracting, it does appear as though there may be scope for some form of intervention – regulatory or otherwise.

2.6 Castalia recommendations

In its report, Castalia suggested that before Gas Industry Co recommended a regulatory solution for any identifiable market failure(s), Gas Industry Co should:

- be able to establish a clear purpose for regulating the market failure(s);
- be satisfied the gas industry's existing bilateral contracts were insufficient to manage those risks;
- tailor the regulatory responses so that they were commensurate with the rare event/low probability outcome of these market failures occurring;
- ensure regulations would not interfere with normal insolvency processes, including being consistent with the Companies Act 1993; and
- be satisfied the benefits of regulating outweigh the costs of regulating.

3 Policy objectives and regulatory solution space

3.1 Gas Act requirements

There is no specific requirement in the Gas Act for Gas Industry Co, as the approved industry body, to provide specific backstop insolvent retailer regulations. Section 43G of the Gas Act provides that the purposes for which regulations may be made in respect of retailer insolvency are:

> *Transition arrangements for insolvent gas retailers*
>
> providing a system of transition arrangements for consumers in the event of a gas retailer becoming insolvent, and requiring industry participants to comply with that system, with the objective of protecting consumers or managing the liabilities of other gas retailers.[12]

The empowering provision clearly limits the situations for which transition regulations may be made to address cases of retailer insolvency. Another key point to note is that transition arrangements may only be made for insolvent gas retailers. Gas Industry Co therefore cannot regulate to intervene in the event of a potential or likely insolvency. Regulations may only be made which apply once a retailer is insolvent. The wording also suggests a Parliamentary intent that any regulations align with insolvency laws Gas Industry Co does not monitor the solvency of retailers.

Any regulatory solution should also meet the principal objective of the industry body under the Gas Act which is to 'ensure that gas is delivered to existing and new customers in a safe, efficient, and reliable manner.' The Government Policy Statement on Gas Governance 2008 (GPS 2008) expects Gas Industry Co to pursue, for the benefit of consumers, the outcome that 'contractual arrangements between gas retailers and small consumers adequately protect the long-term interests of small consumers.'

Section 43N(1)(c) of the Gas Act also requires Gas Industry Co to 'ensure that the objective of the regulation is unlikely to be satisfactorily achieved by any reasonably practicable means other than the making of regulation'. With respect to this insolvent retailer workstream, this obliges Gas Industry Co in the first instance to consider whether non-regulatory measures, including ordinary insolvency

[12] Section 43G(2)(d) of the Gas Act

legislation, can satisfactorily manage retailer insolvency and, if not, to progressively consider other non-regulatory measures.

3.2 Consistency with other regulation

Insolvency legislation

Under current New Zealand law, insolvency arrangements are given legal effect through three Acts: Parts 15, 15A and 16 of the Companies Act, the Receiverships Act 1993, and the Corporations (Investigation and Management) Act 1989. These laws set out the processes for insolvent companies to meet their financial obligations to the extent possible, by realising the remaining value of a firm's assets.

Standard insolvency arrangements provide at least three important functions:

- Replacing existing management with professionals that have financial expertise and experience with insolvent companies (the administrator, statutory manager, receiver, or liquidator—in this report referred to as the 'insolvency practitioner').
- A critical review of the company's responsibilities and entitlements under existing contracts, and an assessment of which obligations should be disclaimed by the company (the insolvent practitioner's powers to disclaim obligations are prescribed under sections 292-296 of the Companies Act).
- A process to realise the value of any remaining assets, and pay liabilities according to a pre-determined order of priority.

Any regulatory arrangement that Gas Industry Co recommended to manage retailer insolvency would need to be consistent with these primary pieces of legislation.

Electricity Authority's workstream

The Electricity Authority (EA) has received advice from the Retail Advisory Group (RAG) proposing a scheme 'to facilitate the orderly resolution of a default situation should an electricity retailer become insolvent or otherwise rapidly exit the market.'[13] The RAG's most recent proposal would specify in the Electricity Industry Participation Code (the Code) what constitutes an event of default. If the EA was notified of a default event, the EA would investigate to determine whether the event was material. If the event was deemed material, the relevant retailer would be formally notified by the EA to rectify the situation within a specified timeframe. If the period lapsed without the default being rectified, the EA would notify the retailer's customers that they should switch from the retailer and if they did not

[13] Retail Advisory Group (2012), Proposed retailer default arrangements – submissions on discussion paper: a RAG briefing paper (24 October 2012), available from http://www.ea.govt.nz/dmsdocument/13872, accessed 27 November 2012.

do so by a certain period the EA would assign them to another retailer. The defaulting retailer would then be terminated from trading electricity under the Code.[14]

Should the gas and electricity schemes be aligned?

Some companies involved in both the electricity and gas markets have expressed a desire for regulatory responses to retailer insolvencies to be aligned. However, the gas and electricity markets are fundamentally different as are the regulatory powers of Gas Industry Co and the EA. A single solution is neither needed nor necessarily feasible. The fundamental features of the gas and electricity markets differ most notably with respect to contractual arrangements. The electricity market, while it contains some bilateral contracting, is dependent on the payments to and by the Clearing Manager. Electricity generators therefore have no financial oversight of individual electricity purchaser's payments to the Clearing Manager. This is not the case in the gas market. Gas producers (or gas wholesalers) enter bilateral contracts with gas shippers/retailers.

Based on the RAG's latest proposal, we do not consider it would be feasible to align a regulatory solution with the RAG's proposed approach, in particular the proposal to assign customers to other retailers. The trigger for a set of 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. Thus, the timing of any regulatory intervention under the Gas Act could only occur later than the intervention contemplated by the RAG proposal.

Notwithstanding the above, it remains to be shown that the gas market requires some form of regulatory intervention to manage retailer insolvencies. In addition, it is unclear at this point whether implementing a similar version of the EA's scheme for the gas market would meet the Gas Act's empowering provision objective of 'protecting consumers or managing the liabilities of other gas retailers' and the principal objective of the Gas Act.

Nonetheless, it is worth considering what the impact of different regulatory schemes would mean for dual-fuel consumers, assuming the EA implements the RAG's proposal or some close variant of it.

The table below summarises the energy retailers in New Zealand as of November 2012 and indicates which of those are dual-fuel retailers.

[14] Retail Advisory Group (2012), Arrangements for managing retailer default situations: discussion paper (14 August 2012), available from http://www.ea.govt.nz/dmsdocument/13547, accessed 27 November 2012.

Table 2. Energy retailers in New Zealand (as at November 2012, from Powerswitch website)

Retailer	Retail services			Gas producer	Electricity generator
	Gas	Electricity	Dual-fuel		
Contact Energy	✓	✓	✓		✓
Energy Direct NZ	✓	✓	✓		
Empower		✓			
Energy Online (Genesis subsidiary)	✓	✓	✓		
Genesis Energy	✓	✓	✓	✓	✓
Just Energy		✓			
King Country Energy		✓			✓
Greymouth Petroleum	✓			✓	
Mercury Energy (MRP subsidiary)	✓	✓	✓		✓*
Meridian Energy		✓			✓
Nova Energy (Todd subsidiary)	✓	✓	✓	✓*	✓*
Opunake Hydro		✓			✓
OnGas (Vector subsidiary)	✓				
Powershop (Meridian subsidiary)		✓			
Pulse Energy		✓			
Trustpower		✓			✓

* denotes subsidiary or parent/controlling company interest

Gas Industry Co notes that many of New Zealand's retailers have a 'natural hedge' as a gas producer and/or as an electricity retailer. The significance of this distinction is that with a natural hedge, while temporary or ongoing losses may occur to the retail arm of the business, there will be a partial or total offset gained in the production arm. There are six dual-fuel retailers. Of those six, all but one has a natural hedge.[15]

Of course, having a naturally hedged business does not ensure the business is removed from the prospect of becoming insolvent. Gas Industry Co considers that the most likely reason for a dual-fuel retailer to become insolvent is poorly managed exposure to high electricity spot prices, particularly if the dual-fuel retailer is a net retailer (i.e., its retail exposure exceeds its generation output/capacity). Under normal circumstances, we consider that a prospective purchaser of a retailer's assets would view the gas customers and the electricity customers as separate assets. This would certainly be the case for a retailer who only offered electricity or gas retail services. An insolvency practitioner is likely to be nonchalant about splitting the customer assets in this way as the practitioner's primary interest is

[15] That company's parent company owns a gas distribution network.

maximising the saleable value of the business – it does not matter how that is achieved. Further, the electricity registry and the gas registry do not contain information on whether a customer is a dual-fuel customer. In fact, some customers have two separate addresses (one in each registry) owing to the different physical location of meters which sometimes means a dual-fuel customer may not be identified as such by the retailer and be treated as two unique customers for the purposes of billing. This practicality means it would be a labour-intensive exercise to identify precisely which customers were dual-fuel customers.

If a dual-fuel retailer insolvency was to occur, our interpretation of the EA's proposal is that the retailer would have a short period of time in which to carry out a sale (or transfer) of the customers. This would provide a short period of time for gas (or dual-fuel) retailers to investigate purchasing the relevant customers. If a sale did not occur then the electricity customers would be transferred. Where dual-fuel customers are identified, this transfer may capture some dual-fuel customers so the EA may have to specify that dual-fuel customers of an insolvent retailer must be transferred to a viable dual-fuel retailer. Either way, Gas Industry Co could use public media avenues to notify gas customers what was occurring and what their options were. Gas customers that were not transferred under the EA scheme would be treated in exactly the same way as described in the normal insolvency process earlier. If any of those customers was subsequently orphaned, they would be treated in accordance with Gas Industry Co's selected option.

Therefore, while the two schemes may not be identical, the two schemes are compatible with one another and consistent with the regulatory powers of each agency.

Q1:	*Do you agree our assessment of the RAG's proposal?*

3.3 Regulatory objective

We consider our regulatory objective to be 'ensuring that there are efficient backstop arrangements in place if and when a gas retailer becomes insolvent.'

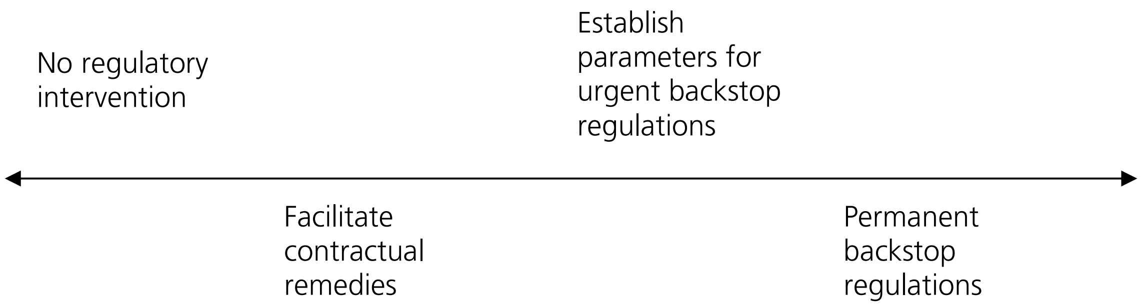
The remainder of this paper identifies and evaluates options for achieving this objective.

Q2:	*Do you agree with the stated regulatory objective?*

4 Identify the practicable options

In general, there is a spectrum of options available for dealing with the market failure discussed above. At one end of the spectrum is the option to leave the insolvency event to the market; normal insolvency arrangements for receiverships and liquidations would apply with all residual matters dealt with between industry participants. At the other end of the spectrum is the option to introduce dedicated regulations to manage retail insolvency, the most interventionist of which would be to introduce a 'retailer of last resort' scheme as used in some parts of the world including most of the states of Australia, Texas, the United Kingdom, and Ireland.

The spectrum of options available for Gas Industry Co is shown below.



It is important to reiterate the regulatory powers available to Gas Industry Co at this point. As we move from left to right on the spectrum we get closer to making a regulatory intervention. As discussed in sections 2 and 3, any option which involves making a recommendation to the Minister for regulations must be consistent with the purpose of 'protecting consumers or managing the liabilities of other gas retailers.' In other words, the options become more restricted in their scope as the regulatory intervention moves further to the right. Further, Gas Industry Co may only recommend regulations that take effect once a retailer is 'insolvent' and in considering any regulations, the rights and statutory responsibilities of the insolvency practitioner would need to be considered.

As discussed in section 3.1, Gas Industry Co has a positive obligation under section 43N(1)(c) of the Gas Act to ensure that the objective of the regulation is unlikely to be satisfactorily achieved by any reasonably practicable means other than the making of regulation. This implies we must first consider if the market failure discussed in section 2 can be met without regulatory intervention and, if not, to progressively consider whether the next option on the right of the spectrum is sufficient, and so forth.

Another useful distinction to make when thinking about reasonably practicable options is to consider the option as responding to the 'cause' of or the 'effect' of the market failure. Applied to the orphaned customer market failure, the 'cause' would be the physical connection being maintained between the distribution network and the customer while the 'effect' would be the externalities borne by other parties in having the physical connection maintained.

Any choice of regulatory instrument must have this distinction in mind because the choice made can have an impact on the transaction costs and/or regulatory costs imposed by the intervention. For example, in seeking to eliminate the cause by mandating (for instance) that all orphaned customers have their gas disconnected, would impose costs on the relevant gas distributor(s) or whoever was responsible for the physical connection to such customers. On the other hand, in seeking to address the effect, costs and uncertainties would apply in attempting to enforce payment from orphaned customers, and the empowering provision in the Gas Act does not appear to provide for this.

Option 1: No intervention

This option would involve Gas Industry Co not pursuing any intervention, regulatory or otherwise. In other words, an insolvency event would be solely dealt with under existing New Zealand laws but particularly the procedures for liquidation and receivership.

As discussed in section 2, there does appear to be a risk to the market if orphaned customers result from an insolvency event and there is no subsequent method for handling orphaned customer gas consumption such that it is absorbed by other retailers as an externality cost.

However, given that retailers bear the cost of the excess UFG that is created by orphan customers, those retailers also have an incentive to seek out and sign-up such customers. By doing so, they will:

- reduce the number of orphan customers and, therefore, the volume of the excess UFG created by orphan customers; and
- secure additional customers and the margins associated with that.

As a result, it would seem that 'mopping up' orphan customers is incentive compatible with reducing the excess UFG experienced by retailers. That process would be enhanced if retailers were to approach the insolvency practitioner at an early stage and arrange to have their details included in the communication sent out by the insolvency practitioner when s/he disclaims any customer contracts.

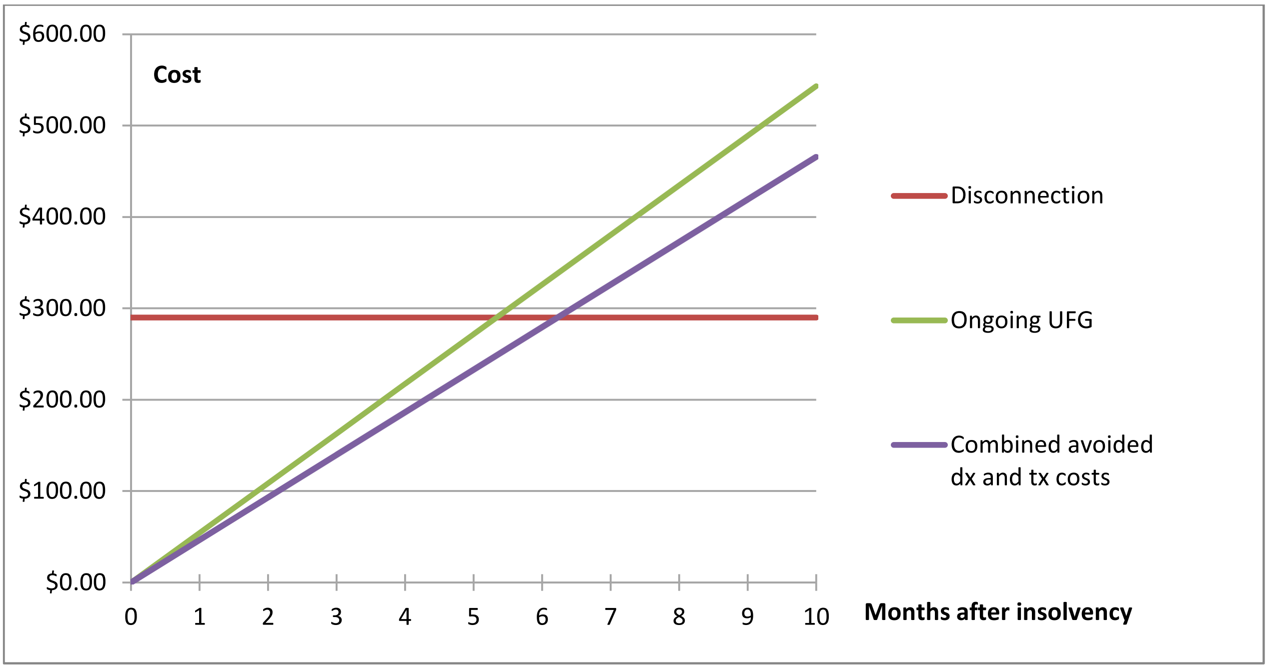
Gas Industry Co could still have a role to play in any retailer insolvency without making a formal intervention. It could assist the insolvency process if, say, Gas Industry Co was to identify the orphan customer sites as recorded in the gas registry as a means of identifying those sites that had not yet switched to a solvent retailer. That process worked quite well in the E-Gas case, with Gas Industry Co providing lists of orphan ICPs for distributors and retailers to follow up.

This option (no intervention) is not the same as doing nothing. Rather it is about allowing the market participants, assisted by the insolvency practitioner and Gas Industry Co, to capture the orphan customers. Accordingly, it is regarded as a practicable option but it must be acknowledged as suffering from the drawback that it is not time-bound insofar as it ultimately requires the willing co-operation of a number of parties, including the customers.

It would be theoretically tidy for orphaned customers to immediately have their gas disconnected as this will eliminate the market failure. However, this could impose costs on distributors that they may not be able to recover.

Assume that the one-off disconnection cost to a distributor is $290 per residential consumer and that the average monthly residential consumer consumption is 700 KWh. At a variable charge of $0.077/KWh (used as a proxy for the cost of UFG) and at a total (including transmission and distribution) daily fixed charge of $1.55/day, we get the following graph of costs per residential customer.[16]

Figure 2. Approximate costs of an average residential orphaned customer



Note: For simplicity the chart uses retail prices as a proxy for the 'costs'. Accordingly, the costs will be overstated.

[16] Pricing information taken from the Genesis Energy website for Central Wellington 'Lifestyle Plan', as of 27 November 2012 (http://www.genesisenergy.co.nz/genesis/index.cfm?3B5B030B-C09F-4299-6DD3-989D8258E04E)

The key lessons from the graph are:

- the daily cost of transporting gas to a residential orphaned customer is approximately $1.55. This cost may be avoided by disconnecting the customer;
- assuming an average consumption of 700 KWh/month, the cost to all other retailers of ongoing supply to an orphaned customer in the form of UFG is higher than the avoided total transport costs;
- the total industry cost of ongoing orphaned customer gas consumption is internalised by all other retailers. Once the cross-over occurs between total ongoing UFG costs and disconnection costs, the lowest cost option for the gas industry would have been to disconnect supply. However, up to this point (approximately 5-6 months in the graph above), distributors will take on a disproportionate share of the industry-related cost in carrying out disconnections, especially if they have no means of recapturing those costs;
- distributors ought to be indifferent between the cost of disconnection and lost transport charges (at least the distribution share of those charges). By choosing to maintain a physical connection, distributors permit the conditions whereby ongoing distribution charges are 'lost';
- on a per customer basis, the 'ongoing UFG' cost would be substantially higher for non-residential customers, e.g., commercial and industrial customers. The costs of ongoing orphaned customer gas consumption therefore varies with the size of orphaned customer(s) and the risk increases that a balancing gas transaction will be required to maintain pipeline integrity. The lowest cost option for the industry is likely to be to disconnect larger gas users if they become orphaned (and do not elect to switch to a new retailer).

There could be a contractual gap between retailers and distributors which cannot be closed without some form of intervention. Parties will be unlikely to want to meet either the costs of ongoing orphaned customer gas consumption or the costs of carrying out disconnections and this could represent a significant hurdle in contract negotiations. However, this option must at least be fully explored before we consider a more interventionist approach. We welcome feedback on this approach from the industry.

In conclusion, while the conditions are present for the market failure to be dealt with contractually, this may not occur in practice. In that case, we must therefore consider the next option along the spectrum from above.

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?*

Option 2: Gas Industry Co to facilitate a contractual remedy

For this option, Gas Industry Co could facilitate a contractual remedy to the orphaned customer risk by introducing new principles into its Retail Contract and Distribution Contract workstreams. The precise clauses could be negotiated at industry workshops, however they could involve requiring distributors to disconnect orphaned customers with the cost of that disconnection being met by the relevant customer. The agreed clauses would then be included in the relevant principles and Gas Industry Co would assess participant's contracts against those principles on an annual or biennial basis.

This option would be voluntary because Gas Industry Co's contract assessment workstreams are non-regulatory in nature. One benefit then is the lack of a need for a regulatory intervention and all of the associated costs in doing that. The obvious downside is that there is no way to ensure the relevant contractual changes will be made. One rebuttal to that argument is that over the relatively short time Gas Industry Co has overseen its contract principles workstreams, industry compliance with those principles has generally increased. The perceived reputational harm in not complying with the voluntary principles has no doubt driven an improvement in compliance.

We welcome feedback from submitters on whether they think voluntary contract principles can ensure the orphaned customer risk can be managed. We think this option is worth pursuing with the industry, certainly before making a more interventionist measure from option 3 onwards.

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

Option 3: Establish parameters for urgent backstop regulations

Assuming that Option 2 is found to be insufficient, the next option we would consider is to recommend urgent backstop regulations be made once a retailer becomes insolvent, as happened in response to the E-Gas liquidation. A key element to this option will be to allow the industry an opportunity to comment on the high-level design of the parameters that would apply in the event of a retailer becoming insolvent.

Shortly after the E-Gas Group of companies went into liquidation, the Government made the GGIR Regulations under urgency. While the GGIR Regulations were never invoked, they would have transferred the contracts of E-Gas's customers to other retailers according to the following allocation plan:

- Gas Industry Co to classify the insolvent retailer's customers into load groups, aggregated by transmission pipeline;
- 'recipient retailers' would be any retailer notifying Gas Industry Co that it wishes to be a recipient retailer and each retailer that has more than 10% of the total number of ICPs (with 'active-contracted' classification in the gas registry);

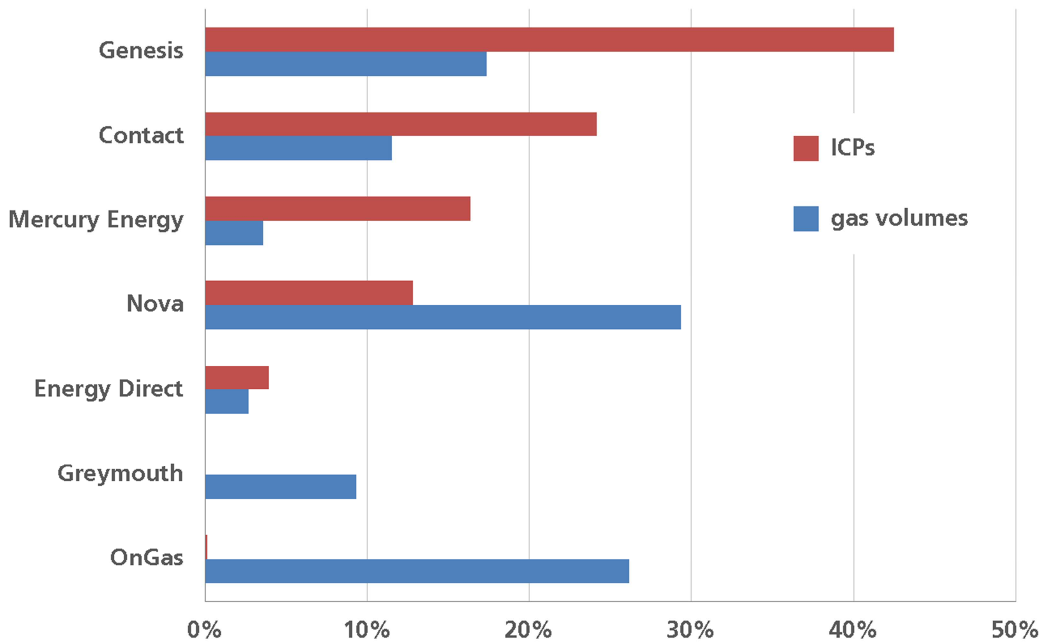
- customer contracts would then be allocated to the recipient retailers based on the customer load group classification by gas gate and a pro rata allocation to reflect the recipient retailer's market share of that load group classification at each gas gate;

- contracts disclaimed by the liquidator would be deemed to be not disclaimed and would be transferred to recipient retailers; and

- the 'trigger' for carrying out the transfer allocation was if Gas Industry Co was satisfied there was a real risk of gas not being supplied under a valid contract and if Gas Industry Co was satisfied the liquidator of the insolvent retailer had made reasonable efforts to sell or dispose of the customer contracts.

Consultation on the GGIR Regulations was carried out retrospectively. One of the key messages from that consultation was that the GGIR Regulations would not be appropriate as an ongoing tool to address the range of hypothetical future retailer insolvencies – the relative small size of E-Gas meant it would have been reasonably straightforward for other retailers to have absorbed a small increase in their respective customer numbers. New Zealand's gas market consists of a range of retailers with each retailer generally serving few large customers or many small customers. Figure 3 shows a recent breakdown of retailers according to their respective percentage shares of customer numbers (ICPs) and allocated gas volumes. Given the variations among retailer portfolios, insolvency of any of the current retailers would present its own unique challenge.

Figure 3. Gas retailer market share by number of ICPs (as of November 2012) and allocated volumes of gas (over the 12 month period Oct 2011-Sept 2012)



Based on the previous events of energy retailer insolvency in New Zealand, it is likely any future events will be settled commercially. However, due to the slight risk of orphaned customers resulting from retailer insolvency, there is some scope for considering the introduction of a low-cost regulatory measure which ought to not interfere with well-functioning commercial processes, but only if the previous options prove insufficient. Urgent backstop regulations would be such a low-cost measure, particularly if the parameters were designed in advance and provided the flexibility to deal with the full potential range of insolvencies. This option would eliminate the market failure because orphaned customers would have their contracts assigned to a viable retailer.

The parameters designed could include the method by which an allocation event would be triggered, a range of scenario responses for that allocation (possibly taking into account the relevant size of the insolvent retailer), whether there was a need for customer information sharing, various options for preparing allocation strategies[17] and so on. Gas Industry Co would then recommend to the Government that the appropriate parameters be included in urgent regulations as and when required. The regulations would therefore be flexible to the range of potential insolvencies. Such regulations would allow a normal insolvency process to run up until the point that customer contracts were disclaimed. Perhaps the most attractive aspect of this option is that, apart from the initial consultation, it incurs very little cost as the urgent regulations only need to be made when there is a reasonable likelihood they are actually required.

One downside to the use of such backstop arrangements is the impact they could have on parties negotiating a commercial sale. Retailers could be incentivised to not make offers to purchase the insolvent retailer's customers from an insolvency practitioner knowing that they may gain a proportionate share without cost if customers are assigned as per the backstop arrangement. Whilst one possible way around this is to include in the backstop arrangements a per-customer fee which the acquiring retailer(s) must pay to the insolvent retailer,[18] it must be acknowledged that such a solution may not be well-received. Another downside is that many customers will be assigned to a retailer they otherwise may not have chosen. However, we consider this to be a negligible harm given the ease and low cost of switching to a different retailer. The main cost to this option would be the time and resource spent in designing the framework for the intervention. We expect that this cost would be small.

Retailers will wear the costs of any orphaned customer gas consumption (at least until such customers are disconnected). The benefit to the option outlined here is that retailers will directly absorb such customers while gaining access to the revenue of those customers by establishing regular billing.

We consider that this option will meet the regulatory objective specified in section 3.4. Gas Industry Co has no evidence to suggest normal insolvency arrangements are inefficient so those arrangements

[17] The allocation strategy in the GGIR Regulations (*pro rata,* random allocation of customers by location and load group) is but one way of assigning contracts to retailers. Another suggestion is to assign customers to previous incumbent retailers at each gas gate.
[18] While the customers will be orphaned, the regulations would deem that the relevant contract was still valid.

should be allowed to play out as far as possible. However, there is a risk of orphaned customers resulting from normal insolvency arrangements. Assuming options 1 and 2 are found to be insufficient to manage these risks, the option to recommend urgent backstop arrangements, where the parameters have been designed in consultation with the industry, is an efficient and flexible response to retailer insolvency. This option would also fit within the empowering provision in the Gas Act because in eliminating the market failure it would manage the liabilities of other retailers. Customers would be protected too: orphaned customers would be transferred in an orderly manner but more importantly, the customers of viable retailers will not end up facing higher tariffs as a result of their retailers having to pay the costs associated with supplying orphaned customers.

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.

Option 4: Compulsory disconnection of orphaned customers

One solution that directly targets the cause of the market failure is to require compulsory disconnection of orphaned customers. The party obliged to disconnect orphaned customers would be the relevant distributor.

The disconnection could be mandated in permanent regulations and could compel distributors to begin carrying out disconnections after a specified period—perhaps 10 business days following the creation of orphaned customers— and to have completed all disconnections within a specified period. The regulations could also include a provision for the distributor to recover costs from orphaned customers for the disconnections carried out.

The main benefit to this option is that the source of the market failure would be totally eliminated over a relatively short period of time. One other benefit is that it encourages orphaned customers to promptly switch to viable retailers lest they risk having their gas supply terminated at their own cost.

This option would be costly to implement in practice because distributors would incur the costs of communicating with, and then possibly disconnecting (possibly a high number of) orphaned customers where the disconnection cost was estimated above at $290 per residential customer. Those costs may be difficult to recover from consumers. It is questionable whether Gas Industry Co could compel consumers to act in a certain way even where recovery provisions are included in the regulations.

It can be argued quite reasonably that this option is consistent with the empowering provision in the Gas Act. Clearly, disconnecting orphaned customers would manage the liabilities of other gas retailers because they would have no (or minimised) exposure to UFG and balancing gas costs. The other objective in the empowering provision is to 'protect consumers'. While some orphaned consumers may well be disconnected from their gas network, disconnecting such customers can be argued as offering a form of protection because those customers would avoid unlawfully taking gas to which they were not entitled. This option also protects all other consumers of gas because they will not have to wear the costs involved in meeting the ongoing supply of gas to orphaned customers. In any case, it seems more likely that the realistic threat of disconnection would be sufficient to incentivise orphan customers to promptly switch to a new retailer.

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

Option 5: Implement a permanent backstop regime

At this point, we do not see the need for a more interventionist approach than that outlined in option 3, but for the purposes of exploring all practicable options it is reasonable to consider what a more interventionist approach would look like. Permanent backstop arrangements could be designed which apply to the gas market at all times like many of the other rules/regulations governed by Gas Industry Co – obviously they would only be useful once an insolvency had occurred. The precise design of a permanent backstop arrangement would require more detailed investigation, including the development of a full Statement of Proposal, but any such option would need to fit within the empowering provision from section 3. We present some potential sub-options here and welcome additional suggestions from the industry.

The benefits of a permanent backstop regime include the increased certainty[19] it would provide to market participants, including for customers, in the event of retailer insolvency. Other benefits will depend on the specific scheme designed.

The costs of a permanent backstop regime include the inflexibility involved with specifying rules and processes (though some flexibility could be built into the scheme). Other costs will depend on the specific scheme design but may include the operational costs of maintaining the scheme. The greatest risk in permanent backstop arrangements is the signal they send to market participants: they may encourage riskier business endeavours and/or encourage customers to transfer to non-viable retailers. Crucially, permanent backstop arrangements may dampen the incentive of parties to negotiate, or totally remove the need for, commercial solutions. Such an intervention would jeopardise the well-functioning operation of normal insolvency arrangements.

[19] Such a scheme will not eliminate uncertainty as it would only be triggered by the insolvency practitioner disclaiming customers. However, customers would have the certainty of knowing who the retailer of last resort would be and, therefore, who they would be assigned to in that case.

There are many potential sub-options for a permanent backstop regime. We present a few possibilities here. The key feature for the design of this option is whether it will be consistent with the objective of protecting consumers or managing the liabilities of other retailers. While it would be reasonable to assume the option would solve the market failure, care must be taken to not create a new market failure or to introduce a regulatory failure.

Sub-option: Retailer of last resort (ROLR)

The idea of an operator of last resort is generally thought of with respect to banking. Central reserve banks often operate as the 'lender of last resort' and agree to extend credit to commercial banks that are at risk of becoming bankrupt. The rationale for a lender of last resort providing credit is that failure of strategically important banks risks panicking the public, leading to withdrawal of deposits, contagion throughout financial markets, and eventual financial collapse.

A similar idea can be applied to energy markets whereby a retailer acts as the supplier of last resort to customers impacted by the financial distress of their retailer.[20] ROLR schemes are relatively common internationally though in many jurisdictions they are necessary because retailers are required to fulfil licencing requirements. As part of those requirements, the retailer must meet certain financial obligations including remaining solvent. If minimum financial thresholds are breached, the retailer's licence will be revoked suddenly leaving their customers orphaned. No such licencing requirements apply for the New Zealand gas market.

The general principle of a ROLR scheme is that a retailer or retailers are appointed to step in to pick up any customers that may find themselves without a retailer if their original retailer experiences financial difficulty. The ROLR or ROLRs can either be specified in advance or appointed by a regulator on the occurrence of a predefined trigger event. Once the trigger event has occurred, the relevant retailer's customers are automatically transferred to the ROLR. This is usually followed by a requirement for the ROLR to contact any new customers and explain contract terms and the options for voluntarily switching to a different retailer. Often, the ROLR is able to recover whatever costs it incurs as a result of acquiring customers. More elaborate ROLR schemes could involve retailers tendering to become the ROLR and regularly reviewing the terms and conditions by which ROLRs will agree to take on customers.

ROLR schemes are less common for gas markets than they are for electricity markets. The main reason appears to be the perceived risk in otherwise disconnecting electricity customers given modern society's reliance on the utility derived from electricity supply.

Sub-option: Distributors are responsible to act as retailers for orphaned customers

This option involves distributors becoming responsible to act as retailers for orphaned customers and would work mostly the same as a ROLR scheme. Permanent backstop regulations would be designed

[20] Though the risk of market collapse is less obvious for energy markets

whereby the relevant distributor would be allocated all orphaned customer contracts on their network(s). Such arrangements are, or have been, in place around the world, including in the Tasmanian and South Australian states of Australia and Alberta in Canada.

The logic in making the distributor responsible for orphaned customers is that once a customer is an orphan, the only party with some form of connection to the customer is the distributor. The distributor then has the ability to contact the customers to explain the customer's options, including whether the distributor will continue supplying gas to the premises.

The main benefit to this option is that the party with the ability to remove the cause of the orphaned customer market failure would internalise that risk. The obvious downside is that distributors may not be sufficiently prepared to take on the functions required of a retailer. This downside could be negated by the regulations which could be designed to compel distributors to prepare to act as retailers for orphaned customers on their networks. The costs to this option then become those costs incurred by distributors in preparing to become retailers. Of course, distributors could have the option to sub-contract any obligations under such a scheme to one or more retailers.

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 any other options you think Gas Industry Co needs to analyse before moving to the next phase of this workstream?

5 Analyse the options

5.1 Evaluative criteria

These are the criteria by which the available options will be evaluated.

Regulatory objective

The regulatory objective expressed earlier was 'ensuring that there are efficient backstop arrangements in place if and when a gas retailer becomes insolvent.'

Primary objectives

The proposal must be consistent with Gas Industry Co's primary objective in the Gas Act.

Empowering provision

The proposal, if it is likely to involve making a recommendation to the Minister for regulations, must be consistent with the empowering provision in the Gas Act.

Barriers to competition are minimised

Another important consideration is one of the other objectives in section 43ZN(b)(ii) of the Gas Act which is that 'barriers to competition in the gas industry are minimised'. Insolvency events may provide an opportunity for potential new entrants to enter the market or for existing companies to increase their market share. Any intervention should be careful to not increase barriers for this competitive activity.

Likely to solve the market failure

There is a risk that the market failure identified by Castalia will result from an insolvency. The option must therefore be able to solve that market failure.

Benefits must exceed costs

The selected option must be expected to create benefits from a public perspective that exceed the costs of the option from a public perspective. The option must not create a new market failure or introduce a regulatory failure. We will provide a short assessment of the costs and benefits here. Gas Industry Co is only required to carry out a full assessment of the costs and benefits when making a Statement of Proposal.

Companies Act

The selected option must not be inconsistent with the Companies Act. This criterion is necessary because of the empowering provision which only permits a regulatory recommendation if a retailer is insolvent.

Consistency with gas safety regime

The selected option must maintain consistency with the Government's gas safety regime.

None of the options will impinge on the gas safety regime, so an assessment is not made for that criteria.

5.2 Assessment of the options

This section provides an assessment of the options from section 5 against the criteria listed above. The table below provides a summary of the assessment, which will be elaborated below.

✓✓	**Great**
✓	**Good**
×	**OK**
××	**Poor**

Table 3. Assessment of options

Option	Regulatory objective	Primary Gas Act objectives	Consistent with empowering provision	Barriers to competition are minimised	Will solve the market failure	Benefits exceed costs	Consistent with the Companies Act
1. No intervention	✓✓	×	✓✓	✓✓	×/✓	×/✓	✓✓
2. GIC to facilitate a contractual remedy	✓✓	✓	✓✓	✓✓	✓	✓	✓✓
3. Establish parameters for urgent backstop regulations	✓✓	✓✓	✓✓	✓	✓✓	✓	✓✓
4. Compulsory disconnection of orphaned customers	✓	✓	✓✓	✓✓	✓✓	××	✓✓

✓✓	Great
✓	Good
×	OK
××	Poor

Table 3. Assessment of options

Option	Regulatory objective	Primary Gas Act objectives	Consistent with empowering provision	Barriers to competition are minimised	Will solve the market failure	Benefits exceed costs	Consistent with the Companies Act
5. Implement a permanent backstop regime	×	✓✓	✓	×	✓✓	×	✓✓

Option 1

This option scores highly on the regulatory objective, consistency with the empowering provision, and consistency with the Companies Act criteria; the common reason being that this option would not require a regulatory intervention so would retain compatibility with the efficient processes for normal insolvencies. The main problem with this approach is the potential that it will not solve the identified market failure – though we note the chances of a commercial sale are good. Whether the benefits exceed the costs for this option largely depends on whether a sale of the customer base can be accomplished.

Option 2

This option returns favourable results against all of the criteria. Because we are required to firstly investigate non-regulatory solutions, our assessment of this option suggests that we ought to explore this option fully before moving on to a regulated solution. There is uncertainty as to whether this option will solve the market failure—the assessment of 'good' is based on the potential to solve the market failure—which could mean that one of the subsequent options is necessary.

Option 3

Based on our assessment, this option is the best overall option against the evaluative criteria provided the case for some form of regulatory intervention is justified. This is less favourable for the 'barriers to competition' criterion than options 1, 2, and 4 because orphaned customers may be transferred to existing retailers (depending on the design of the scheme) but it still rates as 'good' because a potential new entrant could be involved in commercial negotiations during the normal insolvency process.

Option 4

This option returns a favourable assessment against most of the criteria but owing to the high cost involved for distributors to disconnect orphaned customers, this option is inferior to options 2 and 3.

Option 5

This option does not perform well against the regulatory objective criterion because it is not clear that such an interventionist approach is necessary – it is less efficient than the preceding options. The potential costs of this option are relatively high, at least compared to options 2 and 3, but would largely depend on the precise design of the scheme. This option risks creating a regulatory failure; it may deter reliance on the normal processes for insolvency. It would also create a barrier to competition because potential new retailers may not be able to participate in any trade sale of the customer base of the insolvent retailer. The option otherwise performs well against the rest of the criteria and would solve the market failure.

5.3 Preferred approach based on the assessment

Based on our assessment of the options against the evaluative criteria, we consider that option 3 (establish parameters for urgent backstop regulations) represents the best approach. However, such an assessment assumes the need for a regulatory intervention. We welcome feedback on whether (and why) submitters believe option 2 is sufficient to manage the market failure.

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

6 Conclusion and next steps

This paper has presented the practicable options available for dealing with the market failure identified by Castalia. Feedback on the options presented, which may include suggested additional options that could be analysed, will be integral in the next step for this workstream which is to design and implement the preferred approach.

Gas Industry Co will publish an Analysis of the Submissions shortly after the consultation period closes. That analysis will consider the feedback received and discuss Gas Industry Co's preferred approach. Additional consultation may be carried out if necessary.

The next step will depend on the preferred approach from the Analysis of Submissions but could include facilitating a contractual remedy at industry workshops through to the development of a full Statement of Proposal. Gas Industry Co will then be in a position to respond to the Minister as to whether permanent regulations are necessary to manage retailer insolvencies, and if so, the form such regulations should take.

Table 4. Indicative workstream timeline

Milestone	Indicative date
Submissions due on Options Paper	1 February 2013
Analysis of Submissions published	1 March 2013
Development of preferred option	March-September 2013
Advice to the Minister	November 2013

Submission prepared by: (company name and contact)

QUESTION		COMMENT
Q1:	Do you agree our assessment of the RAG's proposal?	
Q2:	Do you agree with the stated regulatory objective?	
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?	
Q5:	Do you think voluntary contract principles can manage the orphaned customer risk?	
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?	

QUESTION		COMMENT
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.	
Q9:	Do you have any comments on the option requiring distributors to disconnect orphaned customers from their networks?	
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 any other options you think Gas Industry Co needs to analyse before moving to the next phase of this workstream?	
Q13:	Do you agree with Gas Industry Co's assessment of the practicable options?	