



Insolvent Retailers Options Paper - Analysis of Submissions

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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

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Executive Summary

This paper provides an analysis of the submissions received on the Insolvent Retailers Options Paper (Options Paper) which was released for consultation by Gas Industry Co on 17 December 2012. We are required to report to the Minister of Energy and Resources on whether a generic regulatory solution is required for retailer insolvency. Our analysis, including consideration of submissions received, leads to a recommendation to the Minister that:

- permanent backstop regulation is neither necessary nor efficient for managing gas retailer insolvency because commercial arrangements are an acceptable way of managing retailer insolvencies;
- however, to address the unlikely risk of orphaned customers persisting after a commercial sale process, it would be prudent for Gas Industry Co to develop drafting instructions for backstop regulations that could be tailored and implemented for any individual insolvency.

Background

The Options Paper discussed the options available for managing the market failure risk posed by orphaned customers—customers physically connected and able to consume gas but with no responsible retailer to pay for that consumption—that may result from retailer insolvency. This potential market failure had been identified in a report carried out by Castalia Strategic Advisors (Castalia) in 2012 which itself represented the first step in Gas Industry Co's workstream to assess whether a generic regulatory solution was required for retailer insolvency in the wake of the liquidation of the E-Gas group of companies in late 2010. Orphaned customers are an unlikely subset of insolvency and the evidence supports this; the most frequent outcome of energy retailer insolvencies in New Zealand has been a commercial sale of customers. The orphaned customer risk is therefore a low probability outcome of an already rare event.

The five options discussed for managing the orphaned customer risk, by increasing degree of regulatory intervention, were:

- no intervention;
- Gas Industry Co to facilitate a contractual remedy;
- establish parameters for urgent backstop regulations;
- compulsory disconnection of customers without a retailer; and
- implement a permanent backstop regime.

Six submissions were received. Submitters generally agreed that normal insolvency arrangements are sufficient for managing retailer insolvencies. There was majority support for Gas Industry Co to pursue the establishment of parameters for backstop regulations which could be quickly implemented in the unlikely event of commercial arrangements not managing an insolvency event. Such backstop regulations would be tailored for the specific insolvency: one of the key problems identified with the Gas Governance (Insolvent Retailer) Regulations 2010, which were implemented shortly after E-Gas went into liquidation in late 2010, was that they would not be flexible enough for all potential insolvencies. Most submitters agreed that the development of permanent regulations for retailer insolvency is not needed. We will therefore pursue our preferred option of developing drafting instructions for backstop regulations that can be tailored and implemented in the rare event of an individual insolvency. This course will ensure that:

- in the first instance all parties will be able to pursue commercial outcomes which is most likely to be efficient;
- in the unlikely event that intervention is needed, the drafting instructions can be recommended under urgency (incorporating any changes tailored to the particular situation); and
- customers will either be purchased by retailers in a commercial manner or transferred by regulation so that all of the failed retailer's customers continue to have a gas retailer.

In this way we can provide a regulatory backstop without the costs, inflexibility and potential inefficiencies of permanent regulations.

Next steps

Gas Industry Co has been asked to advise the Minister on whether a generic permanent backstop arrangement is necessary to manage situations of retailer default. Based on our analysis, including consideration of the submissions received, we will report to the Minister that permanent regulation is not necessary for managing the risk of orphaned customers. Normal insolvency arrangements and commercial incentives offer an efficient way of managing retailer insolvency and for dealing with the rare-event/low-probability outcome of orphaned customers. Permanent regulations risk compromising a commercial sale of customers and would block industry efforts to negotiate a contractual remedy for any residual risk retailer insolvency.

We propose convening an industry working group who will discuss parameters for drafting instructions for backstop regulations that could be used in the unlikely event of orphaned customers persisting after a commercial sale process and after any industry efforts to remedy a retailer insolvency have failed. Such regulations could be made urgently and tailored for each unique insolvency that may occur.

Assuming the Minister accepts this advice we will work with the industry to design the relevant parameters and associated drafting instructions for backstop regulations.

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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 GGIR Regulations'). The GGIR 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 or some of the customer contracts as onerous property. 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 requires¹ the recommending body², 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.³

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

1.2 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

¹ By reference to section 43L and 43N of the Gas Act

² 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.

³ 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 found 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>.

In the Options Paper, we explained that:

- it was not feasible for Gas Industry Co to align its scheme with the Electricity Authority's (EA), at least based on the EA's most recent proposal;
- the Gas Act only permits transition arrangements to be made for insolvent gas retailers. Gas Industry Co cannot recommend regulations that would intervene in the event of a potential or likely insolvency;
- the Gas Act also requires Gas Industry Co to consider in the first instance whether non-regulatory measures could solve the market failure

The Options Paper built on the Castalia Report and presented a range of options available for managing the orphaned customer risk. Those options were:

1. No intervention;
2. Gas Industry Co to facilitate a contractual remedy;
3. Establish parameters for urgent backstop regulations;
4. Compulsory disconnection of orphaned customers; and
5. Implement permanent backstop regulations.

The options increase in terms of regulatory intervention. We found that the conditions are present for the market failure to be dealt with contractually but that there may be a contractual gap between retailers and distributors which may prohibit a successful outcome. The same was likely of option 2 but to a lesser extent: we would need to consider the feasibility of this option before moving to a more interventionist approach.

Option 3 was our preferred solution assuming options 1 and 2 were deemed insufficient. There was no need for a more interventionist approach than option 3.

Six submissions were received, once each from:

- Contact Energy Limited (Contact);
- Genesis Power Limited (Genesis);
- Greymouth Gas New Zealand Limited (Greymouth);
- Mighty River Power Limited (MRP);
- Powerco Limited (Powerco); and
- Vector Limited (Vector).

The next section of this paper summarises the submissions received in according with the consultation questions. Section 3 discusses the key points from submissions. Section 4 discusses the next steps for this workstream.

2

Summary of submissions received

2.1 General comments

The following table summarises the points made by submitters in their submission cover letters.

Submitter	Response
Contact	Gas Industry Co needs to be prepared for retailer insolvency but a RoLR ⁴ scheme is not necessary. The key issue is the lack of a mechanism to stop the financial loss of orphaned customer gas consumption. The E-Gas event took around 12 months to clean up owing to problematic registry population.
Genesis	Supports reliance on urgent regulations if required. Notes that several E-Gas customers were not recorded accurately in the registry. Offers some suggested high level parameters for urgent backstop regulations.
Greymouth	The E-Gas event should not overly influence the preferred option. Other important considerations are: power companies should not disconnect customers as this is not a good look; Gas Industry Co has higher priority workstreams so should not devote resources to the development of regulations; and it would be problematic relying on voluntary principle workstreams.
MRP	Support option 3. The key issue for MRP is how to deal with an insolvent retailer's orphaned customers that show on the registry as active/vacant. Another key idea is credit risk – recipient retailers should have the ability to screen orphaned customers they may be allocated. States that the disconnection costs used for Figure 2 should be lower (\$105-150) which makes this option more attractive.
Powerco	Support option 3 but confident existing insolvency law would handle retailer insolvency. Gas Industry Co can play a useful role in a future insolvency. Customer disconnection should be seen as a last resort.
Vector	Prefers a solution that is permanent yet flexible. States the options paper underestimated, if not discounted, the importance of certainty. The proposed options were insufficient.

Gas Industry Co's response

Several submitters make reference to cleaning-up active/vacant customers in the registry with reference to experiences from the E-Gas insolvency. This is a key issue which is deferred to section 3 of this paper.

⁴ Retailer of Last Resort

By way of response to Contact, we note that retailers have an ability to limit the financial loss arising from orphaned customer gas consumption by encouraging orphaned customers to switch.

We note the suggested parameters put forward by Genesis to apply in the case of urgent backstop regulations. We will consider these further at the next stage of this workstream.

MRP's point about credit risk is with respect to being allocated orphaned customers that a retailer may otherwise not wish to offer services to as per options 3 and 5. This is a key point to keep in mind if designing urgent or permanent backstop regulations. However, the nature of a blunt contract transfer is likely to mean a recipient retailer (of orphaned customers) will have to maintain the same terms and conditions of the insolvent retailer until the orphaned customer agrees to new terms. Such issues will be a key component of the next stage of this workstream.

We note Vector's point regarding the importance of certainty as a result of an insolvency. We think that a regulatory response, if any, should not add to uncertainty. However, we disagree with the idea that permanent regulation is necessary in itself in order to achieve certain outcomes. As identified in the Castalia Report, an insolvency event does not guarantee that all participants will avoid harm. Standard insolvency arrangements are an efficient, low-cost way of dealing with firm failure. Businesses are exposed to insolvency risks but this is not abnormal. Contractual tools, like prudential requirements, are available and used specifically for these risks.

2.2 Do you agree with our assessment of the RAG's proposal?

In the Options Paper we presented our assessment of the Retail Advisory Group's (RAG) proposal for managing events of retailer default in the electricity market. We stated that based on the RAG's latest proposal, it would not be possible to align our regulatory response (if any) with the RAG's because the Gas Act only allows a regulatory response once a retailer has become insolvent; the RAG's proposal is to intervene prior to a retailer becoming insolvent.

We also showed that a minority of electricity retailers are dual-fuel retailers and of the dual-fuel retailers, all but one has a 'natural hedge' as either a gas or electricity producer. Assuming the RAG's proposal was implemented, we did not find a problem in not having our regulatory response not aligned with the Electricity Authority's (EA): some dual-fuel customers may find themselves transferred to a different supplier under the RAG's scheme but at all times would have the option of switching to their preferred retailer. Any resulting orphaned gas customers would find themselves captured by Gas Industry Co's regulatory response.

Submitter	Response
Contact	Believes the assessment is accurate though recommends checking this with the RAG.
Genesis	Believes that because the majority of gas retailers are dual-fuel retailers, a consistent regulatory approach is desirable. Says the RAG's approach does not provide a reasonable length of time for standard insolvency arrangements to work and having separate schemes may complicate matters for an insolvency practitioner.
MRP	Yes.
Powerco	Yes.
Vector	Does not completely agree with the assessment. Believes that commercial relationships in the gas sector being governed by multilateral agreements complicate Gas Industry Co's assumption that bilateral oversight enables effective counterparty oversight. Notes that the RAG's final recommendations were updated from those used in the Options Paper.

Gas Industry Co's response

As discussed in the Options Paper, our response to retailer insolvency is constrained by the Gas Act. In particular:

- before making a regulatory intervention, we must first ensure the regulatory objective could not be met by any other means than the making of regulation;
- we can only make a regulatory intervention that will apply after a gas retailer has become insolvent; and
- the objectives of any regulatory intervention must be either to protect consumers or managing the liabilities of other gas retailers.

We will need to ensure that our regulatory response is consistent with this. Our approach may differ from the EA's selected option but this is appropriate given the respective regulatory powers of and differences in markets governed Gas Industry Co and the EA.

We do not entirely agree with Vector's point about multilateral transmission contracts constraining bilateral counterparty oversight in the gas industry. As discussed in our [Analysis of Submissions](#) (published in August 2012) on the Castalia Report, the multilateral codes in the gas industry are entered into on a bilateral basis. These arrangements mean that a TSO has the ability to cancel the contract of an insolvent retailer or, as a creditor to a shipper, to petition to have the insolvent or financially distressed party placed in liquidation or receivership. Prudential requirements are clearly set out in both the MPOC and VTC indicating that these may be used to manage insolvency risks.

2.3 Regulatory objective

Within the context of our Gas Act and Government Policy Statement requirements, we identified the following as our regulatory objective for this workstream:

‘ensuring that there are efficient backstop arrangements in place if and when a gas retailer becomes insolvent.’

Submitter	Response
Contact	Agreed.
Genesis	Agreed.
MRP	Agreed.
Powerco	Agreed.
Vector	Agreed, but believes Gas Industry Co must consider a wider framework such as reliability of supply and the protection of consumers.

Gas Industry Co’s response

All submitters agreed with the regulatory proposal.

However, Vector also believed that Gas Industry Co should consider a wider framework for its regulatory objective including reliability of supply and protection of consumers. As noted in the Options Paper, our regulatory objective is largely constrained by Gas Act and Government Policy Statement objectives. We do not consider that the ongoing supply of gas to orphaned customers is necessarily consistent with the reliability objective or the protection of consumers. In fact, it is better for all other consumers to have orphaned customers disconnected because their consumption pushes externality costs onto non-orphaned customers. We do agree that orphaned customers should be clearly communicated with and be given a reasonable amount of time to arrange an alternate retailer. Provided this is done, the alternative of maintaining reliable supply to (and thereby ‘protecting’) orphaned customers would only serve to exacerbate the market failure. This is discussed further in section 3.4.

2.4 Whether the orphaned customer risk could be managed contractually

Gas Industry Co is required under section 43N(1)(c) of the Gas Act to ensure that the objective of the regulation cannot be achieved by any reasonably practicable means other than the making of regulation. The Options Paper discussed that there is no reason why retailers and distributors could not negotiate a commercial solution to the orphaned customer risk. We asked submitters whether they thought a contractual solution was feasible for managing this risk.

Submitter	Response
Contact	The E-Gas event showed that orphaned customer risk cannot be managed contractually due to the presence of active/vacant customers discovered on the registry. Is doubtful orphaned customers/vacant ICPs could be managed contractually. Suggests Gas Industry Co designs a framework and assesses whether the desired approach could be implemented through contracts, regulation, or a combination of options.
Genesis	Believes there is scope for use-of-system-agreements within the gas industry to minimise counterparty risk.

Submitter	Response
MRP	Agrees with Gas Industry Co's assessment.
Powerco	Believes that a commercial solution will not provide the level of certainty a regulated solution would.
Vector	This would represent an extension of the status quo, i.e. there would be residual risks from insolvency events such as the industry having to deal with customers with an inactive registry status.

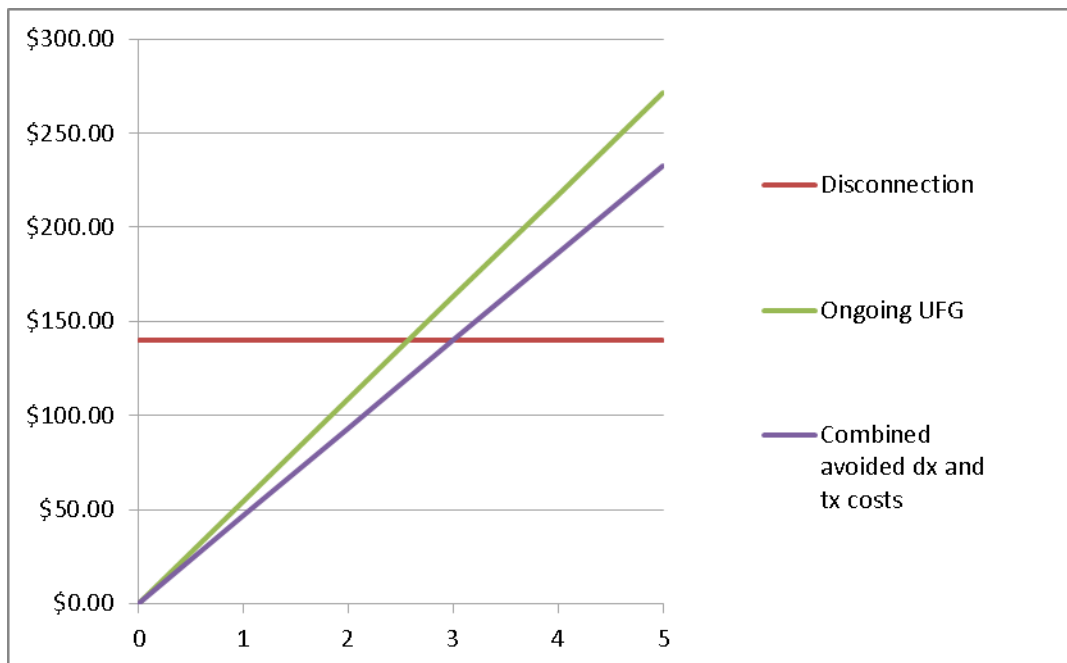
Gas Industry Co's response

The issue of active/vacant customers is discussed in section 3.

We note that Genesis believes there is scope for use-of-system agreements to minimise the orphaned customer risk. We welcome any industry effort on such solutions.

In its cover letter, MRP stated (in response to a figure used in the Options Paper) that it is aware of disconnection costs being in the range of \$105-150 rather than the \$290 figure used in the Options Paper. Accordingly, we reproduce the figure from the Options Paper below using an updated estimate of the disconnection cost for an average residential orphaned customer.

Figure 1. Approximate costs of an average residential orphaned customer (updated from Options Paper)



The key point to note from this figure compared with the one used in the Options Paper is that disconnection of orphaned customers becomes the optimal industry outcome after approximately

3 months, rather than the 5-6 months quoted in the Options Paper. This is an important clarification for the purposes of this workstream and will have implications if designing a regulatory backstop.

Both Powerco and Vector believe that a commercial solution is unlikely to satisfactorily manage the orphaned customer risk. A more permanent solution will ensure certainty and deal with the risk of active/vacant customers. We note that a commercial solution was reasonably successful with respect to the E-Gas liquidation.

2.5 Whether Gas Industry Co can add value to normal insolvencies

During the E-Gas event, Gas Industry Co communicated and disseminated information relevant to the insolvency. We asked submitters in the Options Paper whether Gas Industry Co could add value in this way for any future insolvency.

Submitter	Response
Contact	Agrees Gas Industry Co can add value to an insolvency process by publishing a list of orphaned customers. Gas Industry Co could also work with participants to ensure all ICPs previously the responsibility of the insolvent retailer became the responsibility of a new retailer or were disconnected.
Genesis	Yes – this was beneficial during the E-Gas event. Gas Industry Co could play a role in freeing up pipeline capacity for retailers.
MRP	Yes.
Powerco	Agree though note this does not provide a certain outcome for the industry.
Vector	Suggests that information sharing (facilitated by Gas Industry Co) could form a part of any permanent regulations.

Gas Industry Co's response

We note the industry support for Gas Industry Co assisting throughout a retailer insolvency and we intend to assist as far as possible in any future insolvency.

We responded to a similar point made by Genesis on freeing up transmission capacity in our Analysis of Submissions on the Castalia Report. In short, any trades of capacity must be agreed by Vector as per the VTC.

2.6 Can voluntary contracting manage orphaned customer risk?

The next option along the spectrum of feasible options would be for Gas Industry Co to facilitate a contractual remedy backed with the introduction of new principles for the Retail Contract and Distribution Contract workstreams.

Submitter	Response
Contact	Possibly – it would need to be supported by all parties and deal with orphaned ICPs in the wider context.

Submitter	Response
Genesis	Question the value in pursuing this. These developments can proceed without Gas Industry Co involvement.
MRP	Believe this would create more problems than it would solve, particularly around allocating the costs of managing disconnections etc.
Powerco	Powerco believes that while the majority of retailer defaults would be dealt with by the industry, a regulated backstop may be the only way to reach a guaranteed resolution if the insolvent retailer is of a significant size or other complexities arise.
Vector	This approach could help address residual risks to some extent but is likely to be insufficient due to the fragile constitution of voluntary arrangements.

Gas Industry Co's response

We note the responses from submitters on this. The general theme seems to be that while this is possible, it is unlikely to reach an agreeable outcome due to the competing interests of retailers and distributors.

One possibility might be to add a clause to the Distribution and/or Retail Contract workstreams along the lines of: 'appropriate arrangements are in place in the event of market participant insolvency.' This would leave open to the industry the optimal contractual remedy without the need for regulating or prescribing certain arrangements in the Principles workstreams. Compliance with this would be folded into the relevant workstreams.

This can be considered at the next stage of this workstream.

2.7 Whether urgent backstop regulations would be an efficient response

The three questions referred to in the headings of sections 2.7-2.9 here were all asked in response to the option of establishing parameters for urgent backstop regulations. This option would involve drafting instructions for regulations that would be tailored in response to an individual insolvency and would only be effective once an insolvency practitioner had disclaimed the contracts of an insolvent retailer. The first question asks whether submitters think urgent backstop regulations would be an efficient response to retailer insolvency, particularly if a commercial outcome has been unsuccessful.

Submitter	Response
Contact	Yes but only if other low cost options do not result in orphaned customers and energised ICPs becoming the responsibility of a viable retailer.
Genesis	Agree – this is Genesis' preferred option.
MRP	Agree.
Powerco	Yes. Urgent backstop regulation is a justifiable and cost-effective solution.

Submitter	Response
Vector	Creating urgent regulations does not guarantee a satisfactory backstop. They are not necessarily low cost. The main problem with the GGIRR was that they only covered contracted customers; inactive customers, especially those continuing to take gas, caused most of the difficulties in the response to the E-Gas event. Regulations made in urgency are not as robust as those that go through a more considered process.

Gas Industry Co's response

Contact is comfortable with this option provided that other 'low cost options' do not achieve the objective of dealing with orphaned customers.

We note Genesis, MRP, and Powerco support this option.

Vector does not agree with the urgent backstop option as it believes permanent regulations will be more robust in terms of guaranteeing a satisfactory backstop, will provide certain outcomes, and may be just as flexible as urgently made regulations.

We do not find a solid case for pursuing the option of permanent backstop regulations. Insolvencies are rare events and orphaned customers are only one outcome (and an unlikely one) of standard insolvency arrangements for the gas industry. Permanent backstop regulations may interfere perversely with the incentives of market participants. Permanent backstop regulations risk creating a regulatory failure where the outcome becomes more costly than if the regulatory intervention had not been made at all. We therefore find the temporary and 'tidy-up' nature of backstop regulations that will only be used as required more favourable than permanent backstop regulations. Such regulations would not interfere with industry attempts to find a commercial solution to the risk of insolvency.

2.8 Any comments on the parameters that could apply for urgent regulations?

Submitter	Response
Contact	Suggests establishing a cross-party working group to get the parameters right.
Genesis	(As per cover letter) Enable a normal insolvency process and commercial arrangements to play out as far as possible; provide disclaimed or unallocated customers a period of time in order to switch; allow retailers the terms and conditions for accepting new customers; and allocate customers in a way that preserves existing market shares across different allocation groups at the relevant gas gates. Suggests that a technical working group would be useful for the detailed design of the regulations.
MRP	Reiterates concern about having to maintain insolvent retailer's pricing structure and associated credit risk of absorbing allocated customers.
Powerco	No comment at this stage but willing to engage in the development.
Vector	No suggestions offered.

Gas Industry Co's response

We note the suggested parameters and comments offered by Genesis and MRP. These will be carried forward to the next stage of the workstream.

We discuss the suggestion to establish a cross-party working group in section 3.

2.9 If option 3 (urgent regulations) was selected, do you consider there would be any residual risks?

Submitter	Response
Contact	Supportive of developing parameters for urgent regulations but only if it is shown the issues cannot be addressed through contracting.
Genesis	No.
MRP	Accept the need to try and ensure continuity of supply but this should be limited to customers actively using gas. Do not think it is reasonable to assign the responsibilities of paying fixed daily network and metering charges to another retailer.
Powerco	No. However, Powerco's support of the urgent backstop option is contingent on having any urgent regulations put swiftly in place. If this cannot be guaranteed then Powerco supports permanent backstop regulations.
Vector	As per response for question 6.

Gas Industry Co's response

We agree with MRP that while it is acceptable to try and ensure continuity of supply, such efforts should be limited to those customers actively using, and paying for, gas.

As noted in response to Vector's submission in section 2.7, we are not convinced of the case for permanent backstop regulations.

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

The fourth option considered in the Options Paper was the compulsory disconnection of orphaned customers. This would deal directly with the cause of the market failure, however would come at high cost to distributors because they would be required to carry out disconnections.

Submitter	Response
Contact	Would like to see a clear process/timeframe for distributors to disconnect orphaned customers and vacant ICPs. Note that distributors have little incentive to disconnect customers at present. Understand that prudential cover of around three months provides some protection for gas distributors to recover ongoing costs.
Genesis	Believes this is the most direct way of dealing with the orphaned customer problem but accept Gas Industry Co's concerns that the costs of this option would be high.
MRP	Sees this as the option of last resort.

Submitter	Response
Powerco	This provides a focused and targeted approach but results in the worst case scenario for the gas industry – customer disconnections. Customer confidence and reputation of the gas industry must be maintained.
Vector	Vector is disappointed this option was contemplated by Gas Industry Co. Disconnections compromise customer safety and the reputation of the industry. Reliability implies that the flow of gas to customers would not be hindered by the failings of a particular industry participant. Disconnecting orphaned customers would be very costly for distributors.

Gas Industry Co’s response

Provided that reasonable steps are pursued, we see no harm in disconnecting orphaned customers who enjoy the consumption of gas while not having payment arrangements in place for that consumption. In our view, reasonable steps would include explaining the situation to orphaned customers, providing an appropriate amount of time to switch to a viable retailer, and setting out a clear procedure for disconnection if a switch is not arranged.

A credible threat of disconnection sends a clear signal to orphaned customers that they must initiate a switch or they risk losing their gas supply.

As noted by Contact, prudential requirements ought to provide some cover for distributors that may have to incur some costs in disconnecting orphaned customers. Distributors are responsible for the physical connections on their networks.

If option 3 were implemented, it is unlikely that viable customers would find themselves orphaned. However, if viable customers did find themselves orphaned as a result of their retailer becoming insolvent, as per the discussion above, they should be given sufficient time to arrange an alternate supplier.

There is a strong case for disconnecting orphaned customers that do not make arrangements for supply from a viable retailer despite being given ample opportunity to do so. It is these types of orphaned customers that Gas Industry Co sees as candidates for disconnection.

We note that en masse disconnections of orphaned customers shortly after their retailer becomes insolvent would be both unpopular and costly for certain parties. However, our objective is to ensure the most efficient possible outcome from retailer insolvency and, as shown above in figure 1, the most efficient outcome may involve disconnection of orphaned customers (who have not arranged alternate supply arrangements) after a certain amount of time.

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

The next two questions were for the option of implementing permanent backstop regulations. The Options Paper discussed that we did not see the need for a more interventionist option than that of

option 3 and certainly not for a more interventionist approach than option 4. We therefore asked submitters for their rationale if they thought a permanent backstop was necessary.

Submitter	Response
Contact	No comment.
Genesis	Genesis does not support the need for permanent regulations.
MRP	It is neither practical nor necessary to have permanent regulations.
Powerco	The options would provide the highest degree of certainty but its negatives outweigh its positives, particularly the signals it would send to the market, the costs of development, and the inflexibility to deal with the full range of possible insolvencies.
Vector	Permanent backstop regulations are necessary to guarantee the reduction/avoidance of residual risks (as recognised by the RAG).

Gas Industry Co's response

None of Contact, Genesis, Greymouth, MRP, or Powerco supported permanent regulations (though we note Powerco's support for permanent regulations if none of the other options can guarantee an acceptable outcome).

Vector believes that permanent backstop regulations are necessary to guarantee the reduction or avoidance of 'residual risks' which we assume are the market failures imposed on others by orphaned customers. We disagree with Vector. The E-Gas event showed that residual risks can largely be dealt with using standard insolvency arrangements backed with, at most, tailored (and temporary) backstop regulations.

By continuing to allow gas to flow to orphaned customers, other retailers will wear an increase in their UFG allocations. Distributors are likely to miss out on revenue that would otherwise have been received had a viable retailer been in place and making payments. However, unlike retailers, distributors at least have the tools (prudential requirements) in place to be able to mitigate this lost revenue.

2.12 Do you have comments on any of the sub-options for a permanent backstop regime?

The two sub-options discussed for the permanent backstop regime were a retailer of last resort scheme or a distributor of last resort scheme.

Submitter	Response
Contact	No comment.
Genesis	Does not support a permanent backstop regulation but if this option was selected, Gas Industry Co would need to consult on the design.

Submitter	Response
MRP	Would not support a RoLR against the wishes of the retailer to be appointed as a RoLR due to different target customers of retailers. A RoLR scheme might work if the RoLR was applied for and tendered for by retailers.
Powerco	Do not consider either sub-option appropriate because they are both heavy-handed regulatory interventions for addressing a rare scenario which impose unnecessary costs on participants. Does not see the need to investigate further sub-options.
Vector	Neither option holds much appeal. The RoLR sub-option would leave one or more retailers exposed; the option of a distributor acting as the RoLR is not feasible.

Gas Industry Co's response

Neither of these sub-options were supported by submitters.

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

Having assessed the options identified, we asked submitters if they thought we needed to consider any other options before progressing to the next stage of this workstream.

Submitter	Response
Contact	No comment.
Genesis	No.
MRP	No.
Powerco	No.
Vector	Recommends the establishment of an industry working group on retailer insolvency to facilitate further development of sub-options under option 5.

Gas Industry Co's response

We do not agree with Vector's suggestion to establish an industry working group specifically to develop further sub-options for option 5. There is not a case for making permanent regulations. Further deliberating on sub-options for this option would be an inefficient use of Gas Industry Co and industry resources.

Section 3 discusses the merits in developing an industry group for this workstream more generally.

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

Our assessment showed that option 3 was the best solution available. However, this assumes the need for a regulatory intervention at all.

Submitter	Response
Contact	The scope needs to be widened in order to cover the issues surrounding vacant ICPs.
Genesis	Yes.
MRP	Yes, provided the concerns around active/vacant properties and credit risk are considered.
Powerco	Yes.
Vector	The value of certainty and durability in maintaining market confidence when a retailer becomes insolvent has been discounted in the assessment. Vector believes introducing permanent backstop regulations best meets the Gas Act principles of promoting efficiency, ensuring security of supply, and the regulatory objective of protecting consumers.

Gas Industry Co's response

We discuss the issue of active/vacant customers in section 3.

We have largely responded to the points made by Vector throughout the previous sections of the document. Some of these are discussed in the next section.

3

Analysis of key issues

3.1 Vacant ICPs

Several submitters commented on problems from the E-Gas insolvency caused by customers given a registry code of ACTIVE-VACANT (ACTV), INACTIVE TRANSITIONAL (INACT) or INACTIVE PERMANENT (INACP). Under the Gas (Switching Arrangements Rules) 2008, an ICP status of ACTIVE-VACANT may only be assigned by a responsible retailer if gas is able to flow to the consumer but the responsible retailer does not have a current contract to supply gas to that consumer. The responsible retailer must continue taking actual meter readings for ACTV customers. Similarly, INACT and INACP sites should not have gas flowing to customers and it appears that there were a number of sites that had these status codes applied inappropriately as gas was still able to flow.

During the clean-up of customers after the E-Gas event, several ACTV, INACT, and INACP customers were discovered to be consuming gas. These customers were orphaned customers and their gas consumption was being paid for by other retailers via UFG. Because these customers appear to have been lost from the E-Gas billing system, they were not purchased by Nova Energy – they remained orphaned customers after the commercial sale. We understand that distributors contacted these customers to explain the situation and provided instructions on how to switch to a viable retailer. A very limited number of disconnections occurred.

We do not believe that the orphaned customer risk posed by ACTV customer gas consumption was related to the E-Gas insolvency. Rather, this was a situation that had existed for some time as there would be no sound reason for E-Gas to 'lose' customers from its billing system. There are many thousands of sites on the gas registry with ACTV, INACT or, INACP status and there is no guarantee that none of these sites has a customer taking gas. We do not imply that anything untoward is occurring with these customers but simply recognise that mistakes can occur (i.e. inaccurate registry population). In the event that customers do slip through the cracks, it is possible that at least some of them have little incentive to follow that up with their retailer.

The problem of orphan customer gas consumption is not necessarily related to insolvencies in general, or only to the E-Gas event. With respect to ACTV customers, it is not clear they pose more of a risk during or after an insolvency. In fact, it could be argued that an insolvency presents an opportunity to clean-up ACTV customers in the registry. Given that orphaned customers resulting from retailer insolvency will be transferred in one way or another, the remaining ACTV customers of the insolvent

retailer will be candidates for the relevant distributor and/or other retailers to contact and identify whether they wish to maintain their gas connection. Gas Industry Co can co-ordinate such a process.

We anticipate that methods for identifying and managing orphan customers will be one of the key issues to consider in the next stage of this workstream. Gas Industry Co undertook a good deal of work to identify remaining E-Gas sites where gas appeared to be being consumed and to then encourage distributors to ascertain the status of those sites. It seems likely that, unless more comprehensive auditing of all inactive and vacant sites is undertaken by gas distributors, orphan customers will come to light following any future gas retailer insolvency (albeit not caused by the insolvency).

3.2 Prudential cover and credit risk

As Contact notes in its submission, distributors require retailers to meet prudential requirements in order to use distribution networks. Such requirements may include payment of cash bonds. Prudential requirements are a common business risk management tool used to avoid or mitigate potential losses that may arise from things like counterparty non-payment or insolvency.

Gas Industry Co does not mandate minimum or maximum levels of prudential requirements and we are unaware of there being any problems with the current levels of prudential requirements in the gas industry. However, we would expect that distributors have prudential requirements in place precisely for retailer insolvency risks. We cannot make regulations to manage distributor related risks that may arise from retailer insolvency. Additionally, distributors are able to make claims against the failed retailer for costs incurred as the result of insolvency by virtue of being a contracted counterparty. Our view is that these are commercial matters between distributors and retailers.

3.3 Gas Act objectives and GPS outcomes

While Vector largely agrees with Gas Industry Co's proposed regulatory objective and accepts our regulatory constraints, Vector says in its submission that Gas Industry Co ought to take a broader view of retailer insolvency and should include such factors as the restoration of market certainty.

While restoring market certainty is a fine goal, Gas Industry Co has no mandate to make regulations to achieve this. The empowering provision in the Gas Act clearly limits the purpose for which regulations can be made for transition arrangements for insolvent gas retailers to protecting consumers or managing the liabilities of other gas retailers. Our view is that market certainty can be achieved within the scope of this empowering provision.

3.4 Disconnections

Vector states that it is 'disappointed' Gas Industry Co considered this option at all in the Options Paper. Gas Industry Co is required by the Gas Act to consider all reasonably practicable options. We noted in our assessment of the options that carrying out disconnections would be costly, particularly for distributors, and therefore it was an inferior option to option 3 (urgent regulations).

In arguing against this option, Vector also says that the Gas Act empowering provision of 'protecting consumers' should see that disconnections do not occur. We agree with submitters who said that disconnections ought to be a last resort. However, it may be necessary to carry out some disconnections as a result of retailer insolvency. To be clear, we do not expect paying customers will be disconnected, particularly if a transitional scheme envisaged by option 3 is implemented. Paying customers are more than likely to be purchased by a viable retailer, voluntarily switched, or may find themselves transferred in any regulatory transfer. However, it may be discovered that as a result of a retailer becoming insolvent, there are some customers no retailer wishes to sign-up, i.e. some customers may have been avoiding bill payments for some time and/or refuse to be switched. We think it is entirely reasonable that such customers are disconnected. This is in fact consistent with the empowering provision because all other customers would be protected from these consumers.

3.5 No disclaimed customers

Vector states that the Options Paper mentioned there were no disclaimed contracts in the E-Gas liquidation. The Options Paper clearly states (in footnote 2 of the Executive Summary) that the liquidator did disclaim a small number of contracts.

3.6 Working group

Several submitters stated that a good way to progress the workstream would be to convene an advisory group similar to how the Downstream Reconciliation Advisory Group was established to assist Gas Industry Co's review of the Gas (Downstream Reconciliation) Rules 2008.

We think this would be an efficient way to progress the preferred option.

4

Conclusion and next steps

Based on our analysis, including consideration of the submissions received, our preferred option remains to allow a normal insolvency event to run its course as far as possible. Normal insolvency arrangements and commercial incentives offer an efficient way of managing retailer insolvency and for dealing with the rare-event/low-probability outcome of orphaned customers. Permanent regulations risk compromising a commercial sale of customers and would block industry efforts to negotiate a contractual remedy for any residual risk retailer insolvency.

We think it is efficient to develop backstop regulations that will apply if an insolvency practitioner disclaims contracts. It is important that such a backstop is not permanent because this would compromise the flexibility of the response and may risk altering the incentives to negotiate a commercial solution. This approach leaves open the possibility for industry participants to negotiate a contractual solution for potential insolvencies.

We will now write to the Minister of Energy and Resources with our advice that a generic regulatory response is not necessary for retailer insolvency.

Assuming the Minister accepts our advice, Gas Industry Co will form a terms of reference and call for nominations for a technical advisory group. The purpose of the group will be to identify the relevant parameters to apply for urgent backstop regulations and develop the drafting instructions. At the completion of that goal, the draft regulations will be 'shelved' and can be used as required in future.