



# Insolvent Retailers workstream: Castalia Strategic Advisors report

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**Submissions close: July 30 2012**







## **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'.



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# 1

## Introduction

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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. Due to concerns at the time, Gas Industry Co worked with the 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. The outcome was that the liquidator was able to sell the E-Gas customer base and the Regulations did not need to be used. In terms of gas governance arrangements, the E-Gas event has now been fully resolved.

The Regulations were made using the urgent regulation-making provisions of the Gas Act 1992 (section 43P). Section 43P requires<sup>1</sup> the recommending body<sup>2</sup>, 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 of Energy and Resources 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 Regulations. That consultation process culminated in a recommendation to the Minister of Energy in May 2011 that the Regulations should be allowed to expire (revoked) 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.<sup>3</sup>

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

### 1.1 Castalia Strategic Advisors report

As a first step in considering whether to develop a regulatory backstop for gas retailer insolvency, Gas Industry Co has engaged Castalia Strategic Advisors (Castalia) to provide advice on whether normal insolvency processes can be relied upon to produce acceptable outcomes when a gas retailer becomes insolvent. Castalia was asked to consider in particular whether there are any market failures present

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<sup>1</sup> By reference to section 43L and 43N of the Gas Act

<sup>2</sup> 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.

<sup>3</sup> Relevant background documents are available at the Insolvent Retailer section of Gas Industry Co's website: <http://gasindustry.co.nz/work-programme/insolvent-retailers>

when a gas retailer becomes insolvent and whether those market failures are exceptional when compared with “normal” insolvency processes.

Gas Industry Co is releasing the Castalia report for public consultation. The Castalia report is an independent document and does not necessarily represent the views of Gas Industry Co.

## **1.2 Workstream Process**

At present, Gas Industry Co has no regulatory role or process that applies before, during, or after a retailer becomes insolvent. Similarly, any prudential or other credit-support arrangements are a matter between counter-parties contracting in the market. That means when a retailer becomes insolvent in the gas market and in the absence of any regulations made under urgency, the relevant New Zealand law around liquidation and receivership processes applies. One of the key issues Gas Industry Co intends to clarify its view on as a result of calling for submissions on the Castalia report is whether these standard arrangements are sufficient to manage all cases of gas retailer insolvency, particularly from an economic efficiency viewpoint.

It is standard practice in the design of policy to firstly consider whether there are any market failures that justify regulatory intervention. Gas Industry Co intends to use the Castalia report and submissions received on it to identify the market failures present (if any) when a gas retailer becomes insolvent. If market failures are identified then Gas Industry Co intends to progress this workstream according to its Gas Act requirements by identifying all reasonably practicable options to address those market failures and the costs and benefits of those options in an Options Paper.

## **1.3 Link with the Electricity Authority’s workstream**

Gas Industry Co notes that the Electricity Authority has developed a similar workstream that will consider the issue of retailer insolvency. Gas Industry Co has and will continue to engage with the Electricity Authority as the two workstreams develop. However, Gas Industry Co considers that there are fundamental differences in the regulatory roles of Gas Industry Co and the Electricity Authority and in the gas and electricity markets themselves which dictate that a unified policy response may not be required. Most notably, unlike the electricity industry which relies on a series of multilateral contracts, the gas industry is construed of a series of bilateral contracts, giving market participants a good deal of control over the pace and management of a gas retailer insolvency.

## **1.4 Submissions**

The Castalia report is attached as Appendix A. Submissions are invited from stakeholders on this report. Submissions should be provided no later than 5pm on **Monday 30 July 2012**. Please note that submissions received after this date will not be considered. We request that submissions be focussed solely on the issues identified in the Castalia report.

Submissions can be made by logging on to the website ([www.gasindustry.co.nz](http://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. Submitters should discuss any intended provision of confidential information with Gas Industry Co prior to uploading their submissions

The recommended format for submissions is attached as Appendix B and may be downloaded in MS Word format from the Consultation page on the website

# Appendix A. Castalia report

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# **Discussion Paper on Gas Retailer Insolvency**

**Report to Gas Industry Company**

**June  
2012**

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## Executive Summary

We have been asked by the Gas Industry Company (GIC) to prepare a discussion paper on whether any market failures exist when gas retailers become insolvent. **Our scope of work focuses on the problems** that may need to be addressed in the gas industry when a gas retailer becomes insolvent.

This work was prompted by the insolvency of E-Gas in 2010. Although a sale of most of the E-Gas customers was carried out, the Government implemented temporary backstop regulations (the Gas Governance (Insolvent Retailers) Regulations 2010), which would have transferred the E-Gas customers to other retailers had a sale not occurred. At the time E-Gas became insolvent, the Government felt urgent regulations were necessary to meet the objectives of protecting consumers and/or managing the liabilities of other retailers in the event the liquidator was unable to sell the E-Gas customer base. As it turned out, those Regulations were not required to be implemented as the liquidator was able to complete a sale process.

The Regulations had a sunset clause that meant they revoked themselves six months later. The GIC consulted industry participants prior to the regulations being revoked on whether they thought more work needed to be done to assess if more permanent regulatory arrangements were required and, if so, what form they should take. Most submitters agreed that more work should be done on the issue, although there was no agreement on whether regulatory intervention was necessary or what the form of any intervention would be. The Minister endorsed the GIC investigating this issue further.

**The purpose of this paper is therefore to consider whether there is a case for regulatory intervention in the event of a gas retailer becoming insolvent.** The paper seeks to achieve this by assessing whether there are features of the gas market that mean normal insolvency arrangements are unlikely to produce acceptable insolvency outcomes; in other words, if there are instances in which retailer insolvency could lead to a market failure. If there are, then there may be a case for considering regulatory options or interventions.

In order to assist with the identification of market failures, this paper contrasts what could be expected to occur under standard insolvency arrangements with what is likely to occur in gas market retailer insolvencies. The Companies Act 1993 relies on contractual arrangements for triggering an insolvency, and the insolvency practitioner is given wide powers to realise and distribute the assets of the insolvent company. Under standard insolvency arrangements, once an insolvency practitioner is appointed, it will make one of two decisions – to continue operating the business or to wrap-up the business. If a decision is made to continue operating the business, then two outcomes are possible – one is that the insolvency practitioner trades out of difficulty; the other is that the insolvency practitioner carries out a sale process. If the insolvency practitioner decides to wrap-up the business, then it will attempt to sell the assets of the business; any assets or contracts that are not sold they are likely to be disclaimed as onerous property.

As is the case in many markets, the gas market is made up of a series of bilateral contracts that include risk management provisions, such as prudential requirements. As a result, a gas retailer insolvency would progress in most instances in a similar way to expectations of a standard insolvency. Insolvencies are normal occurrences in commercial markets and there is no reason to expect standard insolvency processes to result in zero inconvenience or minimal risk for all parties. The issue here is to consider whether the gas industry poses different risks to those in other sectors, if those risks are acceptable, and if not, whether regulatory intervention would be justified. The table

below compares insolvency in other markets (“standard insolvency”) with the insolvency of a gas retailer.

Insolvency phase	Standard insolvency	Gas retailer insolvency
Normal trading	Business as usual	Business as usual
Financial difficulty	Company under increasing pressure from contractual counterparties	Gas retailer under increasing pressure from contractual counterparties
Insolvency practitioner (IP) appointed	IP reviews company	IP reviews company
(a) IP decides to trade on	<ul style="list-style-type: none"> <li>▪ IP responsible for ongoing costs and may be able to trade out of difficulty</li> <li>▪ Suppliers have incentives to trade with IP</li> <li>▪ Customers unaffected</li> </ul>	<ul style="list-style-type: none"> <li>▪ IP responsible for ongoing costs and may be able to trade out of difficulty</li> <li>▪ Suppliers of gas retailer (gas wholesalers, transmission companies, distribution companies) have incentives to trade with IP</li> <li>▪ Customers unaffected (but can always switch to another retailer unless contractually bound)</li> </ul>
(b) IP decides to sell assets	<ul style="list-style-type: none"> <li>▪ IP will try to maximise value of assets</li> <li>▪ Customers may be affected, depending on whether company is sold as going concern</li> </ul>	<ul style="list-style-type: none"> <li>▪ IP will try to maximise value of assets. Customer base is likely to have positive net value and is likely to be sold</li> <li>▪ Competing retailers have incentives to buy the customer base</li> <li>▪ If customer base is sold, customers will be minimally affected, as they will be transferred to another retailer. Customers retain the option of switching to any retailer they select.</li> <li>▪ Any customers that are not included in the sale become “orphaned”</li> </ul>
(c) IP disclaims contracts	<ul style="list-style-type: none"> <li>▪ Company is closed.</li> <li>▪ Customers no longer able to access goods or services from that provider</li> </ul>	<ul style="list-style-type: none"> <li>▪ Customers still physically connected and can draw gas, even though they do not have a retailer. Some of these customers may switch retailers; others may not and become “orphaned”</li> <li>▪ Other retailers incur costs through UFG</li> <li>▪ Distributors can stop gas flowing to customers without a retailer, but may not recover the costs of disconnections</li> </ul>

### **The gas market does present some challenges due to orphaned customer risks**

As shown in the table above, gas retailer insolvencies are likely to proceed along similar lines to other insolvencies in most cases. The exception is the case of “orphaned customers,” which arises because the physical flow of gas differs from the contractual flow and associated payment arrangements in the New Zealand gas market. As outlined in the table above, the significance of this is that in the event that a retailer becomes insolvent, some customers may become “orphaned” by virtue of being physically connected and able to consume gas but having no viable retailer to pay for that gas.

It appears that current industry arrangements would treat the consumption of gas by orphaned customers as unaccounted-for-gas (UFG), with the costs of UFG being socialised amongst remaining viable retailers. **This is a market failure because bilaterally contracted or physically connected parties may impose an externality on third parties.** Further, such customers will not have their access to gas disconnected unless action is taken by their distributor. The high cost to distributors of *en masse* disconnections – and the fact that distributors may not be able to recover those costs – makes it unlikely that access will be terminated. The means that conditions are present to allow orphaned customers to continue using gas for some time after their gas retailer becomes insolvent, particularly if they do not actively seek to switch to a viable retailer.

There is another related risk (albeit smaller) that orphaned customers create the need for a pipeline balancing action where the costs of that action would likely be passed on to remaining viable retailers.

### **The nature of the gas industry in New Zealand means retailer insolvencies are rare**

The nature of the gas industry is such that unexpected and immediate insolvencies are unlikely. The gas market relies on a series of bilateral contracts whereby counterparties are likely to monitor the ongoing financial viability of retailers. Gas prices are also established under relatively long-term contracts, so there is little potential for the spot price shocks that can happen in the electricity market. If a gas retailer insolvency occurs again, history suggests that the insolvent retailers’ customer base would have a positive net value and a retailer’s gas customers are likely to be picked up by a competing retailer. Selling the customer base is consistent with the insolvency practitioner’s incentives of realising the maximum return possible from the insolvent retailer’s assets; it is also consistent with the incentives of competing retailers, who may seek to increase their customer base and to avoid paying the costs of orphaned customers.

### **Comparison with the New Zealand electricity market**

There are important differences between electricity and gas that affect how insolvency events may be addressed from a policy perspective. Importantly, exchanges between electricity generators and retailers are facilitated through a spot market where a clearing manager aggregates generation and centrally coordinates dispatch. Unlike the gas market (which relies on bilateral contracts), electricity market arrangements mean that participants do not have contractual counterparties against which to enforce payment. We are aware that the Electricity Authority is currently considering this issue, including whether there is a need to regulate. However, the issues arising in the gas market are clearly different.

### **Insolvent gas retailers: the customer’s experience**

Insolvencies do not guarantee a seamless experience for customers in most markets. However, owing to the presence of well-functioning switching arrangements in the gas market, there is no reason for customers of an insolvent retailer to experience

unnecessary inconvenience. At any point during an insolvency process, customers are able to switch to a viable retailer. If their insolvent retailer was a dual-fuel retailer, then they may switch to a viable dual-fuel retailer or they may select to sign-up with two new retailers – one for gas and another for electricity. If an entity decides to purchase the assets of the insolvent retailer, then customers will likely be automatically transferred to the purchaser if they have not already switched. Customers of dual-fuel insolvent retailers therefore do not present unique policy challenges.

### **Contracts provide avenues to mitigate risk, but residual problems remain**

While the presence of orphaned customers may constitute a market failure in the form of externalities imposed on third parties, it is not clear that regulatory intervention is required. The chance of customers becoming orphaned depends on the insolvency practitioner either winding up the business and customers not actively switching or being purchased by a viable retailer, or, in the case of a sale, if the purchasing retailer decides not to purchase all of the insolvent retailer's contracts.

Previous cases of retailer insolvency in New Zealand have resulted in the purchase of most (if not all) of an insolvent retailer's customers under an insolvency practitioner sale process. This outcome that is consistent with the incentives of both the insolvency practitioner and competing retailers. As insolvency events themselves are rare, and given the incentives of the relevant parties, it is therefore a low probability outcome of a rare event that a situation will materialise whereby significant numbers of customers find themselves orphaned.

If the GIC decides to regulate for the market failures identified in this paper, we recommend ensuring that the GIC:

- Is able to establish a clear purpose for regulating these market failures
- Is satisfied the gas industry's existing bilateral contracts are insufficient to manage these risks
- Tailor regulatory responses so that they are commensurate with the rare event/low probability outcome of these market failures occurring
- Ensure that any regulations will not interfere with normal insolvency processes—the market failures identified in this paper will only eventuate as one possible outcome of a standard insolvency process
- Are satisfied that the benefits of regulating outweigh the costs of regulating.

# 1 Introduction and Background

The Gas Industry Company (GIC) is responsible for the governance of New Zealand’s wholesale and retail natural gas markets, gas processing facilities, and gas transmission and distribution pipelines. As part of this governance role, the GIC will report to the Minister of Energy and Resources on whether permanent regulations are needed to deal with gas retailer insolvencies. To help inform its report to the Minister, the GIC has engaged Castalia to prepare this discussion paper on whether any identifiable market failures exist when gas retailers become insolvent.

The GIC has the principal objective of ensuring that gas is supplied in a safe, efficient, and reliable manner (section 43ZN of the Gas Act 1992). Any regulatory measures to deal with gas retailer insolvencies should therefore work towards better achieving this objective.

## **This work was prompted by the insolvency of E-Gas in 2010**

In October 2010, the gas retailer “E-Gas” entered into voluntary liquidation<sup>1</sup>. The E-Gas insolvency gave rise to concerns about how customers would be treated if the liquidator moved quickly to stop the company trading, and who would bear the costs resulting from supply to E-Gas customers once their retailer was no longer responsible for their supply.

The liquidator was able to agree terms with the various counterparties (distributors, transmission owners, and the gas producer) that allowed the company to continue to trade pending a sale of the customer base. Those arrangements allowed for an orderly transfer of the E-Gas customers.

To ensure that customers were protected, and to reduce the risks facing other industry participants, the GIC helped the Government to implement the Gas Governance (Insolvent Retailer) Regulations that were made under urgency in November 2010. These regulations were tailored to the circumstances of the E-Gas insolvency, and had the specific objective of ensuring that E-Gas’s 7,000 customers would be transferred to other retailers in the event that it was not possible for the liquidator to sell the customer base.

The Gas Governance (Insolvent Retailer) Regulations operated as a “backstop”—they would only be invoked if the liquidator’s sale process was unsuccessful and the GIC was satisfied that the E-Gas customers would not be transferred to another gas retailer. In fact, the liquidator announced that the E-Gas customer base had been sold to Nova Gas around 10 days after the regulations were passed. The regulations were allowed to lapse in May 2011 after consultation with industry stakeholders.

As part of the consultation before the Gas Governance (Insolvent Retailer) Regulations lapsed, the GIC asked industry participants whether they believed that generic regulations should apply when a gas retailer becomes insolvent. The responses from industry participants varied—some strongly supported regulatory intervention, while others expressed concern about the possible consequences of generic regulatory intervention.

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<sup>1</sup> The E-Gas Group operated two retailing companies: E-Gas Limited and E-Gas 2000 Limited. For convenience we use E-Gas in this document to refer to the Group.

## **This report focuses on whether a generic regulatory intervention is warranted**

This report focuses on whether a generic regulatory solution is justified to address the concerns that arise when a gas retailer becomes insolvent. This requires us to ask whether any market failures exist that would justify a regulatory response, and whether any regulation is likely to provide net benefits when compared to the status quo.

Market failure in this report refers to the conventional definition used by economists. We find that the relevant type of market failure for the purposes of this report is whether any externalities have or may occur in the event of a retailer insolvency such that third-parties are burdened with any spill-over costs.

As a result of this workstream, if the GIC decides that regulatory intervention is necessary based on identifiable market failures then they will be unable to intervene in any way that is inconsistent with the Companies Act. We also understand, based on the GIC's empowering provision in the Gas Act, that they will only be able to make a regulatory intervention for a transitional arrangement aimed at protecting *consumers* or managing the liabilities of other *gas retailers* (s43G(2)(d) of the Gas Act).

The remainder of this report is structured as follows:

- Section 2 summarises the features of standard insolvency arrangements that apply in most markets, and identifies situations and markets in which these features are not provided by standard insolvency law
- Section 3 summarises the important features of New Zealand's gas industry, and highlights some unique characteristics that make the New Zealand gas different from other non-energy markets
- Section 4 considers how gas retailer insolvencies are likely to play out, and any challenges created by insolvency events in the gas industry
- Section 5 summarises the incentives of different parties in the gas industry when a retailer becomes insolvent
- Section 6 describes how any identified market failures may be resolved through contracts
- Section 7 concludes by considering whether the market failures identified in this report support the introduction of a generic regulatory solution, or indicate that other regulatory changes would likely have benefits that outweigh their costs.

Discussion questions are posed at the end of each section. We also welcome any other comments on the issues raised in this discussion paper.

## 2 Summary of Standard Insolvency Arrangements

All commercial entities face the prospect of insolvency. While there are various reasons why companies become insolvent, a standard set of arrangements has emerged to ensure that the economic costs of insolvency are managed appropriately. These standard arrangements are widely recognised as striking a balance between providing financiers and contractual counterparties with the confidence to deal efficiently with commercial entities, while also ensuring that these parties bear the risks of their decisions.

This section briefly summarises the objectives of standard approaches to insolvency. We then consider reasons why the objectives of standard insolvency arrangements are not achieved in all markets, drawing on regulatory experience in financial and insurance markets.

### **Establishing a benchmark for “standard” insolvencies**

Standard insolvency arrangements have evolved over centuries and work well in most markets. Under current New Zealand law, insolvency arrangements are given legal effect through three Acts: Parts 15, 15A and 16 of the Companies Act 1993, 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 the firm’s assets.

Standard insolvency arrangements provide at least three important functions:

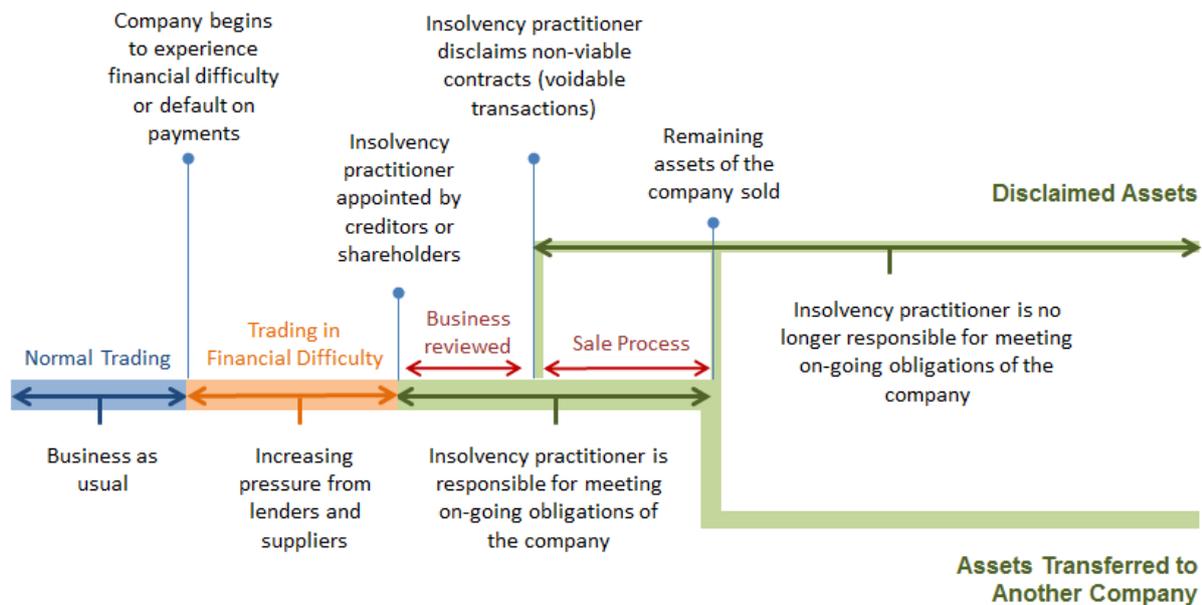
- Replacing existing management with professionals that have financial expertise and experience with insolvent companies (the administrator, statutory manager, receiver, or liquidator—in this report referred to as the “insolvency practitioner”)
- A critical review of the company’s responsibilities and 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 1993)
- A process to realise the value of any remaining assets, and pay liabilities according to a pre-determined order of priority.

A high-level overview of how standard insolvency arrangements often play out is provided in Figure 2.1. In fact, no two insolvencies are the same—the relevant facts in each insolvency will include the nature and size of the business, the extent of the financial problems experienced by the company, and the risks of attempting to salvage value by continuing to operate prior to a sale. Figure 2.1 highlights that once a company starts to experience financial difficulty, the lenders and suppliers of the company will typically start to place pressure on the company to meet its obligations. This pressure can take various forms, including threatening to cancel existing contracts, calling on any security that the company has provided, and following the legal processes required to ultimately place the company into liquidation (for example, by issuing statutory demands for payment).

Once an insolvency practitioner is appointed, an assessment will be completed of the ongoing financial viability of the company. As noted above, the insolvency practitioner may be entitled to disclaim some of the obligations entered into by the company (for example when these obligations arose after the company was already unable to pay its debts). In some cases, the insolvency practitioner may be able to trade the company out of insolvency. More commonly, the insolvency practitioner will decide to wind the company

up immediately and sell any remaining assets. If the assets of the insolvent company will have a much higher value if they are sold as a going concern, the insolvency practitioner may choose to continue to operate the company. This option involves some risk for the insolvency practitioner, who will be responsible for meeting the on-going obligations of the company and is accountable to creditors if the value of the company reduces following the decision to continue operating.

**Figure 2.1: Timeline of a Standard Insolvency**



### Standard insolvency arrangements clearly define the rights of different parties

The reason that standard insolvency arrangements generally work well is that all parties affected by the insolvency have clear legal rights and obligations. Standard insolvency arrangements also explicitly address any misalignment in the interests of the parties that are most affected by the insolvency situation—shareholders and creditors (secured and unsecured). When insolvency occurs, all of these parties want to maximise the value of the insolvent entity in order to recover at least part of the stake they have placed in the company.

OECD reviews of standard insolvency arrangements have found that the following three characteristics of insolvency arrangements are especially important for achieving an efficient resolution of the insolvency:<sup>2</sup>

- **Legal and financial certainty.** Market participants and consumers need to know the risks of transacting, so they can make choices based on their willingness to bear risk. This ensures that the process for any insolvency can be resolved as quickly as possible, with limited spill-over effects.

<sup>2</sup> See for example OECD (2001). “Insolvency Systems in Asia: An Efficiency Perspective”. Available online at: <http://www.oecd.org/dataoecd/60/7/45747128.pdf>

- **Efficiency.** The incentives of managers, creditors, shareholders, and other interested parties should all work towards lowering the administrative costs of the insolvency and minimising the inconvenience caused by the insolvency.
- **Fairness.** Outcomes should reflect a consensus on who should bear the burden of the insolvency (for example through the usual hierarchy of claims between secured and unsecured creditors).

### **Standard insolvency arrangements do not eliminate risk or inconvenience**

The benchmark of a “standard” insolvency needs to be realistic. Insolvencies will inevitably create problems for parties that have contracted with the insolvent company—either as suppliers or as customers. The benchmark of standard insolvency arrangements:

- **Does not eliminate counterparty risk.** Standard insolvency arrangements do not insulate creditors, shareholders, or other parties from the consequences of their contracting decisions. These parties generally should bear the risk that their counterparty becomes insolvent because they are in the best position to identify and manage counterparty risks.
- **Does not provide a seamless process for counterparties and customers.** Insolvencies create inconvenience in any market. Customers may be frustrated, for example because they have to travel further to transact with another supplier or cannot find a supplier that provides the same quality of product or service that they received before the insolvency. As discussed later, in the New Zealand gas market these customer inconveniences should be low given both the existence of well-functioning switching arrangements and the fact that the physical flows are controlled by parties other than the failed retailer.

The features of standard insolvency arrangements help to minimise “moral hazard” problems, which arise when decision makers do not face the full consequences of their decisions. Standard insolvency arrangements are designed to minimise the ability of parties to spread the costs of their decisions among other groups—which ensures that the risks accepted through contracts accurately reflect the risk appetite of the decision-maker. In contrast, moral hazard problems cause parties to take undue risks because they do not bear the full consequences of their decisions. This reduces overall efficiency, for example by creating opportunities for “hit and run” entry where eventual insolvency becomes a viable commercial strategy.

### **The benchmark of a “normal” insolvency breaks down in some markets**

There are markets where standard insolvency arrangements do not adequately address the challenges that arise when a market participant becomes insolvent. The clearest example is financial markets, where policy makers and regulators throughout the world have designed specific interventions (over and above standard insolvency law) to address the consequences of bank failures.

In New Zealand, recent government interventions to protect against bank failures have included the retail deposit guarantee scheme (introduced in 2008 and extended in 2010), and the Reserve Bank’s Open Resolution (OBR) policy. The main objective of the retail deposit guarantee scheme was to reduce the risk of a “run on the bank”, by protecting consumer savings in the event that a financial institution fails. The OBR policy shifts the costs of bank failures from the taxpayer (under the retail deposit guarantee scheme) to

wholesale lenders and shareholders of the insolvent bank.<sup>3</sup> OBR requires insolvent banks to apply a “haircut” to the bank’s obligations to wholesale lenders to allow the bank to reopen within days of an insolvency being discovered.

The insurance market in New Zealand provides another example of where standard insolvency arrangements have been found to be insufficient. The Insurance (Prudential Supervision) Act 2010 provides measures to identify solvency problems early and manage financial distress through an insurer licensing regime. The Act also gives the Reserve Bank the power to apply to the High Court to appoint a liquidator (section 151), and requires the Reserve Bank to approve any sale of an insolvent insurer by a statutory manager (section 183).

These examples highlight that standard insolvency arrangements may not guarantee good outcomes in all markets, and New Zealand policy makers and regulators in other markets have decided to intervene. These interventions take place when parties other than shareholders and creditors are substantially affected by the insolvency, or there is insufficient information available for contracting parties to properly assess risk. Other participants in a supply chain should not bear substantial unexpected or unknown costs. This means that the information that is available to contracting parties needs to enable a reasonable assessment of the likely solvency of counterparties at the time agreements are reached.

### **Features of markets where the benchmark of “normal” insolvency may break down**

Standard insolvency arrangements may not be sufficient to safeguard efficiency, fairness and reliability when the following market features are present:

- **Monopoly network characteristics.** Monopoly networks can be required to provide open and non-discriminatory access to their network infrastructure. This helps to improve efficiency by ensuring that monopolies do not favour any particular downstream market participant and are motivated to maximise use of the monopoly network. Open access on gas transmission and distribution networks is not required in New Zealand—existing open access arrangements are implemented through bilateral and multilateral contracts. However, a desire for non-discriminatory contracts may prevent network service providers from imposing more stringent terms on less creditworthy retailers, although standard contractual terms on prudential requirements differ depending on the creditworthiness of the retailer.
- **Products or services are considered to be “essential”.** Society may decide that for certain products or services a “normal” amount of customer inconvenience will not be tolerated. Retailer of Last Resort (ROLR) schemes for electricity and gas services in Australia and the United Kingdom are based on government priorities to ensure uninterrupted electricity and gas supply. For example, the United Kingdom Government describes the objective of its ROLR scheme as ensuring *“uninterrupted and safe provision of essential services in the event of a company becoming insolvent.”*<sup>4</sup>

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<sup>3</sup> See Reserve Bank of New Zealand, <http://www.rbnz.govt.nz/finstab/banking/4368385.html>

<sup>4</sup> UK Department of Energy and Climate Change, <http://www.decc.gov.uk/assets/decc/11/policy-legislation/Energy%20Act%202011/3222-energy-act-2011-special-administration-regime.pdf>. A similar justification is used in Australia, see Ministerial Council on Energy, Standing Council of Officials, National Energy Customer Framework, Explanatory Material, November 2009.

- **Insolvency creates systemic consequences.** In some markets, the interrelated nature of market participants means that it is not possible to manage consequences solely through contracts. This problem may be compounded if the retailer is large, and is considered to be “too big to fail”. This was recently recognised as a policy issue in the energy sector in the United Kingdom, and led to the adoption of a new Special Administration Regime in 2011 (discussed further in section 5).

As discussed above, the availability of information on insolvency risks is also important. If market arrangements do not allow the risks of contracting with a particular supplier or downstream market participant to be discovered, then there may be reasons for the Government to intervene to improve the information that is available.

The remainder of this paper considers whether standard insolvency arrangements are sufficient for the New Zealand gas market.

#### **Discussion Question**

1. Do you have any comments or concerns on the summary of standard insolvency arrangements provided in this section?

### 3 Unique Features of the Gas Industry

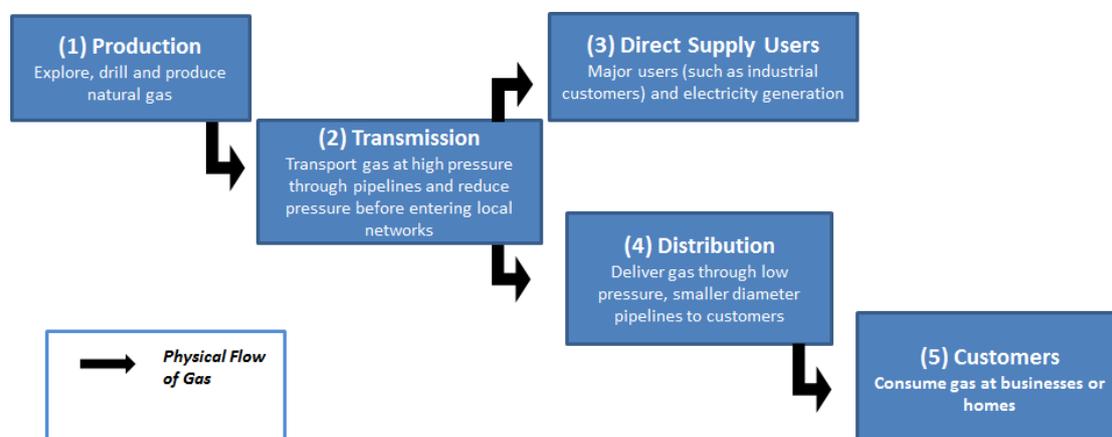
The New Zealand gas industry has a number of unique features, the most important of which is that the supply of gas to customers has a physical path that differs from the contractual relationships used to provide services, allocate risks, and ensure payment. This means that parties that are physically connected to each other (customers and gas distributors) do not have the direct contractual relationships needed to enforce payment for the services provided if the retailer link is broken. Processes for reconciling gas consumption and ensuring that gas pipelines remain in balance also create unique industry dynamics. These industry features need to be carefully analysed to determine whether standard insolvency arrangements will achieve the outcomes intended.

This section describes the physical flow of gas from producers to the customer, and the contracts that define the legal rights and obligations in this supply chain.

#### Gas production, transmission and distribution facilities manage the physical flow of gas

Figure 3.1 provides a simple illustration of the physical flow of gas from producers to consumers in the New Zealand gas industry. Gas is transported from processing facilities through high-pressure transmission pipelines to large gas users that are directly connected to transmission pipelines (such as industrial facilities and electricity generators), and to low-pressure distribution networks located in more populated areas. Homes and businesses are connected to low-pressure distribution networks. All of New Zealand’s gas pipelines are located in the North Island, and transport gas from production fields in the Taranaki basin.

**Figure 3.1: Physical Flow of Gas in the New Zealand Gas Industry**



Industry participants each play different roles in getting gas from the field to consumers:

1. **Production**—The production of natural gas in New Zealand is concentrated in the Taranaki basin, with most supply provided by the Pohokura field. Major gas producers in New Zealand include Shell, Todd Energy, Origin Energy, Greymouth Petroleum, and New Zealand Oil & Gas.
2. **Transmission**—High-pressure transmission pipelines transport gas from gas production facilities located in Taranaki to the entry points (“gates”) at distribution networks, and to users directly connected to transmission pipelines. Maui Development Limited (MDL) and Vector operate the two gas transmission systems in New Zealand. The Maui pipeline is a large pipeline

that operates with spare capacity, and is used to balance the system. In contrast, the Vector system is a series of smaller pipelines that are connected to the Maui pipeline. Capacity on parts of the Vector system is tight. As a result, some users (such as electricity generators) enter into longer-term contracts, while others (such as gas retailers) typically have one-year contracts. The quantity of gas entering and leaving transmission systems is metered (to enable wholesale billing, reconciliation and gas balancing), and gas pressure is reduced prior to entering distribution networks. Transmission pipelines in New Zealand are regulated by the Commerce Commission.

3. **Direct Supply Users**—Major end-users of gas (such as Methanex, Fonterra, NZ Steel, Genesis Energy, Contact Energy and Mighty River Power) receive physical supply of the gas directly from transmission pipelines. These parties use more than 90 percent of the gas consumed in New Zealand, with electricity generators accounting for around 50 percent of total consumption.
4. **Distribution**—At the entry point to gas distribution networks, gas leaving the transmission pipeline is metered and odorised (for safety reasons). Gas is then supplied to residential and business customers connected to the distribution network. Gas distributors are responsible for ensuring the safe and reliable transportation of the gas to the customer. Major gas distributors in New Zealand are Vector, Powerco, Gas Net, and Nova Gas. The prices charged by distribution networks are regulated by the Commerce Commission (with the exception of Nova Gas).
5. **Customers**—Commercial and residential gas consumers account for around 8 percent of the gas used in New Zealand.<sup>5</sup>

### **Gas retailers provide an important link in the contractual chain between producers and consumers**

The contractual relationships in the gas industry differ from the physical flow of gas. Gas retailers are incorporated into the supply chain at the interface between physical suppliers (gas distributors) and commercial and residential customers.

Gas retailers were created as part of a package of market reforms introduced in the 1990s, and given legal effect through the Gas Act 1992. These reforms limited the Government's role in the gas industry and introduced market-based pricing. Gas retailers are free to compete for customers on any distribution network, and are subject to the Gas (Switching Arrangements) Rules introduced in 2008 to improve the platform for customer switching.

Each customer enters into a contract with their gas retailer. Under these contracts, the gas retailer is responsible for:

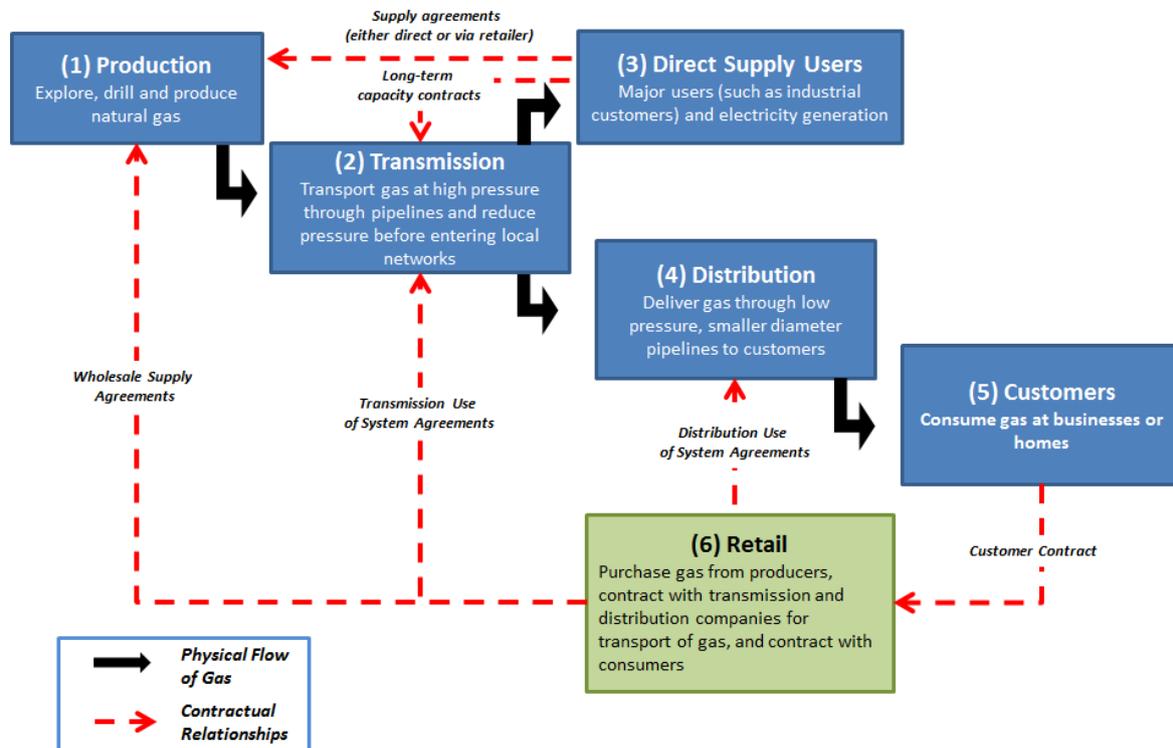
- **Customer service**—Handling complaints, providing service information, billing, and processing connection, disconnection and switching requests
- **Supply of gas to consumers**—Providing an interface with the physical supply of gas (producers, transmission and distribution pipeline owners) to ensure that the supply and transportation arrangements provide the level of service quality that customers expect (in areas such as gas quality and supply reliability).

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<sup>5</sup> <http://www.med.govt.nz/sectors-industries/energy/gas-market/overview-of-new-zealands-gas-sector>

Figure 3.2 illustrates the role that gas retailers play at the interface between consumers and physical suppliers and transporters of natural gas. The contracts that gas retailers enter into are also shown in Figure 3.2.<sup>6</sup> The divergence of the physical and contractual supply chain is different from what is observed in most markets, where end users are physically supplied by the same party that they are obliged to pay under contract.

**Figure 3.2: Contractual Relationships for Gas Supply in New Zealand**



To manage the interface between physical supply facilities and consumers, gas retailers enter into three types of contracts with suppliers and transporters of gas:

- **Wholesale supply agreements (contracts with gas producers to supply quantities of gas).** Retailers negotiate bilateral contracts with wholesale gas suppliers. These contracts are generally long-term, confidential, and establish the prices, quantities and terms of supply. These contracts may contain “take or pay” provisions for maximum demand quantities, which means that retailers take volume risk because they are required to pay producers even when the gas is not used.
- **Transmission service agreements (contracts with gas transmission pipelines to transport gas).** The multilateral terms and conditions of using the Vector pipeline are set out in the Vector Transmission Code (VTC). Under the VTC, retailers reserve and pay for capacity (known as contract carriage). Capacity can be transferred between retailers. On the Maui transmission pipeline, the multilateral terms are set out in the Maui Pipeline Operating Code (MPOC).

<sup>6</sup> Other stakeholders (such as creditors and the regulator) are not directly part of the physical flow or the contractual supply chain, but have an interest in gas supply and retailer insolvency issues.

- **Distribution use of system agreements (contracts with gas distributors to transport gas from distribution gates to customer connections).** These contracts charge retailers for the volumes of gas delivered, as well as for the connection point services at customer premises.

### **A reconciliation process is needed to balance gas injections with gas usage**

Several retailers compete to supply customers at each gas distribution gate. This creates the need for a process to ensure that injections to the system meet expected demand, and that the costs of gas and network charges are allocated to users. Allocating costs to users promotes efficiency because consumption decisions are made based on the costs of supplying the gas. In practice, however, injections will differ from reported consumption due to technical factors such as measurement errors and leakage. The objective of reconciliation is therefore to fairly allocate the costs that are not directly attributable to any individual party.

In New Zealand, the system of gas allocation and reconciliation is provided through the Gas (Downstream Reconciliation) Rules 2008. These rules require retailers to submit how much gas their customers have used in the previous month, based on available meter readings. Any difference between these consumption figures and the volume of gas that is injected to the gas system is known as unaccounted for gas (UFG). The volumes of UFG at each gas gate are allocated to all of the retailers operating at that gate, according to their market share by volume (i.e. the costs are allocated pro rata to the size of each retailer).

Arrangements have also been put in place to ensure that the balance of gas injections and gas usage maintains an acceptable level of pressure in the system. The Maui pipeline is the main party responsible for balancing the gas system in New Zealand, and maintains an exchange ([www.bgx.co.nz](http://www.bgx.co.nz)) to buy and sell gas options that can be exercised to bring the pipeline back into balance. For example, if the pressure in the Maui pipeline falls below an acceptable level, then the pipeline operator can exercise options that require producers to inject more gas into the pipeline. The costs of balancing gas are then either charged to the party that created the need for a balancing action (a “causer pays” approach) or socialised among all pipeline users. The results of the allocation process are also used, in conjunction with pipeline balancing processes, to ensure that retailers procure sufficient gas to meet their customers’ aggregate demands over time.

Having identified that the contractual flows and physical flows differ, it is worth considering whether standard insolvency arrangements are suitable for this unique feature of the gas market. This is the focus of sections 4 and 5.

#### **Discussion Question:**

2. Do you have any comments on the summary of the physical and contractual characteristics of the New Zealand gas market set out above?

## 4 The Impacts of Gas Retailer Insolvencies

Having defined the role that retailers play in the gas supply chain, we now consider the impacts of gas retailer insolvency. This section discusses why gas retailers become insolvent, and considers how the unique features of the gas industry might lead to outcomes that differ from those expected in standard insolvency arrangements. This section also evaluates how gas retailer insolvencies are likely to play out (drawing on the E-Gas insolvency).

### Why might a gas retailer become insolvent?

Retailers in the energy sector face a variety of challenges that need to be managed to maintain financial viability. The experience in New Zealand and overseas suggests that retailers can become insolvent for a range of different reasons. A common cause of several insolvencies in the past ten years (such as Energy One in Australia and On Energy in New Zealand) is the combination of high wholesale energy prices and fixed retail prices. Other energy retailers (such as Enron) have become insolvent due to poor performance or the pursuit of high risk strategies.

We see three general reasons why gas retailers might become insolvent:

- **Contract choice and volume risk.** Retailers serve customers in a market where it is easy to switch. This means that retailers would like to purchase gas on short-term contracts because demand is volatile. However, the prices paid under short-term contracts are generally higher than under longer-term contracts. Alternatively, retailers can enter into long-term contracts, which generally provide predictable and lower gas prices, but force the retailer to accept volume risk. Gas retailers typically manage volume risk by entering into contracts that allow them to purchase higher than average daily quantities over higher demand periods, developing or contracting for gas storage, and trading gas imbalances with other retailers.
- **Recovering fixed costs.** Retailers bear fixed costs through IT and billing systems. Marketing and branding costs are also largely fixed. These costs are recovered from relatively low margins, which typically account for less than 10 percent of retail gas prices. As a result, retailers benefit from scale in their customer bases. To consistently earn positive margins, retailers need to accurately forecast demand, have systems to ensure compliance with industry rules and regulations, and have sound risk management policies.
- **Cashflow risks.** Customers typically pay their bills on a monthly or quarterly basis, although the retailer's contractual obligations with producers and transporters may have shorter timeframes. Customer accounts are also charged in arrears, this exposes the retailer to cashflow risks, particularly if their customers pay late or debts cannot be recovered.

Some of these challenges and risks are specific to particular retailers—for example, when a management team does not have the skills or experience to manage gas industry rules. However, some risks may affect several retailers at the same time—for example, if gas supply becomes tight at a time when gas demand is high. Any difficulties in managing the insolvency of a single retailer will be compounded when other retailers are also experiencing financial difficulties that stem from a common cause.

## How are gas retailer insolvencies likely to play out?

When a gas retailer experiences financial difficulty, two important factors will influence how the event plays out:

- The actions of contracting counterparties—in the gas sector this includes gas producers, transmission pipelines, and gas distributors
- The legal obligations and responsibilities of the insolvency practitioner that is appointed to protect the interests of creditors and shareholders.

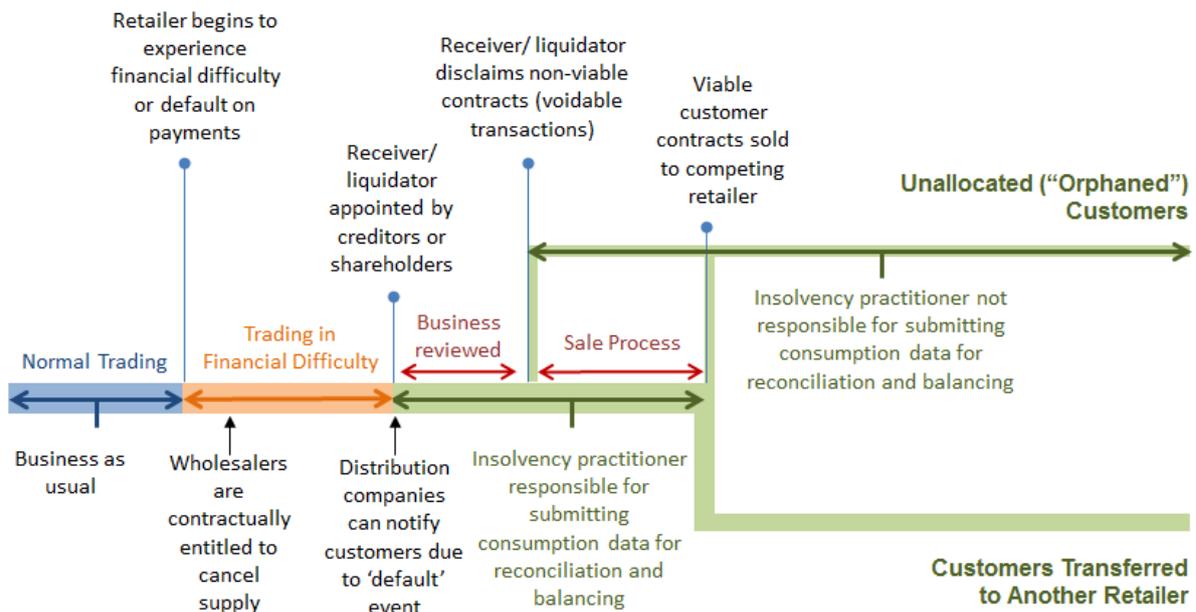
Figure 4.1 presents a timeline for a hypothetical gas insolvency (based on the E-Gas insolvency). As soon as a retailer begins to experience financial difficulty and defaults on payment, contracting counterparties may be entitled to cancel their contracts. However, counterparties may opt to continue operating under the terms of their contracts in an effort to preserve the retailer's ability to make future payments. Even if a gas retailer has complied with all of the terms of its contracts, the appointment of a receiver or liquidator will generally constitute an event of default.<sup>7</sup> Contracting counterparties will need to decide whether in fact to cancel their contracts, which will depend on the likelihood of being paid for any further services provided.

When an insolvency practitioner is appointed, a rapid assessment of the business will be completed (usually within 1-3 days of appointment). This review will allow the insolvency practitioner to make a decision about whether to continue to operate the business, or to close the business immediately and sell any remaining assets. Because the main asset of a gas retailer is likely to be its customer base, the insolvency practitioner may elect to continue to operate the business so as to allow time to market and sell the customers to another retailer or a new entrant. As discussed above, this places some risk on the liquidator, who may be liable for any further deterioration of the company's solvency over this period. If the insolvency practitioner continues to operate, it becomes responsible for making payments to suppliers (such as gas distributors) and submitting data for reconciliation.

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<sup>7</sup> For example, Clause 12.2.4 of the GIC's Wholesale Market Standard Terms (Version 2007-1) provides either party with the right to terminate the agreement if the other party experiences "financial failure"—defined as liquidation, the initiation of liquidation proceedings, and entering into any composition, assignment or other arrangement for the benefit of creditors.

**Figure 4.1: Timeline of a Hypothetical Gas Insolvency**



If the liquidator decides to continue trading, it may be entitled to disclaim some customer contracts, for example if those customers were gained when the company was already unable to pay its debts (section 292 of the Companies Act). These customers then become unallocated or “orphaned” because they are still physically connected to the distribution network, but have no retailer. As shown in Figure 4.1 customers may also become orphaned once the sale process is complete if the purchasing retailer does not want to buy all of the customers served by the insolvent company. The liquidator is not responsible for unallocated customers, which means that these customers’ meters will not be read and their consumption data will not be submitted for reconciliation.

**Box 4.1: Summary of Key Aspects of the E-Gas Insolvency**

The insolvency of E-Gas in late-2010 provides the most direct and relevant experience of how a gas retailer insolvency is likely to play out in New Zealand.

E-Gas was voluntarily placed into liquidation by the shareholders of the company. Soon after their appointment, the liquidator (BDO Spicers) called a meeting of industry participants to discuss its initial views on the company and to investigate whether continuing to trade in expectation of a sale process might be possible. The liquidator was prepared to continue to trade once creditors (including gas distributors) had signed an agreement on how future expenses incurred by the liquidator on behalf of E-Gas would be treated. This agreement provided protection for the liquidator, and provided the confidence needed to attempt a sale process.

While the sale process was being carried out, the Gas Governance (Insolvent Retailer) Regulations were introduced. The sale process was successful and the majority of E-Gas customers were transferred to Nova Gas. However, a small number of customer connections were not included in the sale and therefore became unallocated customers. The GIC and gas distributors worked together to

communicate with unallocated customers about the need to find a new retailer or face disconnection.

### **How do the physical and contractual relationships affect outcomes when a gas retailer becomes insolvent?**

The features of New Zealand's gas industry potentially create three outcomes in the event of gas retailer insolvency that differ from the standard insolvency arrangements described in Section 2:

- **Automatic disconnection of customers is unlikely.** Since customers do not contract with the firm providing the physical flow of gas (the distributor), and retailers do not participate in the physical flow supply chain, customers will not be immediately disconnected in the event of retailer insolvency. The time involved in disconnecting all customers of the insolvent retailer has the potential to impose large costs on the distributor. Disconnecting customers may also generate negative perceptions of gas as a viable energy source. Prudential requirements of around three-months provide some protection for gas distributors to recover on-going costs.
- **Distributors continue to interact with customers despite the absence of any contractual relationship.** Distributors have no direct contractual relationship or ability to charge for providing services to the customers of an insolvent retailer. This leads to some uncertainty about the rights of distributors to enter customer premises to read meters and process switches. In Australia, there is either a subcontracting arrangement where the distributor is a subcontractor to the retailer, or an agency relationship between the retailer and distributor. In either case, the distributor can disconnect customers of an insolvent retailer although this is unlikely given the high cost of *en masse* disconnections. These arrangements are not as clearly defined in the New Zealand gas industry. In New Zealand, the retailer's role in the contractual chain also enables payment to be made for the physical flow of gas to the consumer to cover production and transportation costs. When a retailer becomes insolvent, distributors and transmission providers are unlikely to be paid for continuing to provide capacity.
- **Gas and pipeline balancing costs may be socialised among retailers (or gas distributors).** Under the reconciliation process described above, when a retailer is no longer in place, the gas that is consumed by its former customers becomes UFG and is allocated between the remaining retailers. This creates tension among remaining retailers who are saddled with the costs especially as UFG was not intended to be used for this purpose. The consumption of gas by unallocated customers may also create the need for additional gas to be injected to balance the transmission pipelines (known as a "balancing event"). The costs of balancing events are typically allocated to the retailer(s) that creates the need for additional gas to be injected (parties that have not nominated sufficient quantities of gas to meet their customers' demand). However, in the case of insolvency, this party is either unable to pay or has been dissolved. If the party is still trading, albeit in a state of financial distress or on behalf of a liquidator, any balancing costs it owes are likely to exacerbate the retailer's financial distress. In a situation where the company has been

dissolved, it is likely that the cost of the balancing gas would be socialised as UFG.

Similar concerns about the impacts of retailer insolvency arise in the electricity sector. The Electricity Authority is currently considering whether to introduce specific regulations for when an electricity retailer becomes insolvent, either to enable the Clearing Manager to appoint a receiver or by enabling the Authority to transfer customers of an insolvent retailer.<sup>8</sup> We discuss some of the similarities and differences between retailer insolvencies in the electricity and gas sectors in Box 4.2.

#### **Box 4.2: Retailer Insolvency in Electricity and Gas Industries**

The electricity and gas sectors in New Zealand both have physical flows that differ from contractual relationships. This gives rise to the prospect that retailer default may result in disruptions to supply, uncertainty for consumers, and damage to the credibility of the industry.

However, there are important differences between electricity and gas that affect how insolvency events may be addressed from a policy perspective in New Zealand:

- Electricity is by its nature difficult to store and has to be available to meet instantaneous demand. This means that wholesale balancing mechanisms in electricity have much shorter timeframes (half-hourly in New Zealand), and balancing prices can have extreme fluctuations over very short time periods. In contrast, wholesale gas prices do not tend to fluctuate on a daily basis.
- Exchanges between electricity generators and retailers are facilitated through a spot market where a Clearing Manager aggregates generation and centrally-coordinates dispatch. This means that parties have less ability to reduce their risks through contracting strategies. In contrast, wholesale gas contracts are typically long-term bilateral agreements with take or pay clauses that require the purchaser to pay for a minimum quantity of gas each year regardless of the actual quantity used.
- The centrally-coordinated dispatch for electricity generators exposes all generators to residual risk if a retailer defaults on payment. This is because generators are unable to assess the creditworthiness of the retailers that they are effectively funding, so are therefore unable to effectively manage residual risk. In the gas industry, bilateral contracts ensure that gas producers understand the credit risk of the counterparty to the contract, enabling producers greater opportunity to manage this risk.
- Permanent backstop arrangements have been implemented in other countries for reasons of customer safety. For example, in the European Union, twenty countries have retailer of last resort (ROLR) schemes for electricity and sixteen countries have ROLR schemes for gas. However, these countries have different climates than New Zealand and many

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<sup>8</sup> See <http://www.ea.govt.nz/our-work/consultations/advisory-group/retail-customers-default-situations/>

customers may depend on electricity and gas for heating and other health reasons.

As evidenced by these differences, it is not necessary or even likely that electricity market policies ought to mirror gas market policies, and vice-versa.

### **Do customers know about the risks of gas retailer insolvency?**

As described in Section 2, insolvencies generally impose costs and inconvenience on the customers of the failing company. These costs should reflect the understanding that customers have of the risks and consequences of their supplier becoming insolvent. For example, in markets for financial services, customers are keenly aware of the risks of insolvency and actively seek out companies that they believe to be financially sound. Suppliers of financial services respond to this consumer behaviour by signalling their financial strength and trustworthiness—bank buildings commonly incorporate visual elements that suggest an established trading history (such as pillars), and finance companies use endorsements from trustworthy personalities.

In the gas industry, there is little evidence to suggest that residential or commercial consumers understand insolvency risks when choosing a retailer. These customers may not appreciate the risk of having their gas supply disconnected if their retailer becomes insolvent and they do not switch to another retailer. The apparent lack of customer understanding is likely to reflect the relatively minor cost and inconvenience imposed on customers in the event of retailer insolvency. However, there are relatively small changes that could be made to better inform customers of their rights and responsibilities before insolvency events occur. For example, retail customer contracts do not currently appear to provide any information for consumers on how they will be treated in an insolvency situation. Instead, insolvencies are covered under more general provisions, such as stating that customer contracts may be cancelled if the retailer “ceases to have an agreement with the network”.<sup>9</sup>

Although standard insolvency arrangements do not provide a risk-free process for contractual counterparties and customers, there is little reason for the customers of an insolvent gas retailer to be inconvenienced beyond making a single toll-free phone call to another retailer to arrange a switch. Customers may switch retailers whenever they wish, including if they are a “dual-fuel” customer. They are unlikely to receive the same terms and conditions as they had with their previous provider (whether that results in a better or a worse outcome for the customer) but given gas retailers operate in a competitive market and that insolvency events do not eliminate all inconveniences, customers should arguably not expect to receive the same terms and conditions, particularly if their insolvent retailer had been offering unsustainably discounted gas and given that retailers will have differing wholesale purchasing arrangements.

Customers that do not actively switch may simply not have heard that their retailer has become insolvent. They may therefore find themselves being transferred involuntarily to the retailer acquiring the insolvent party. However, assuming that there are no term

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<sup>9</sup> See for example Genesis Energy Terms and Conditions for electricity and gas. Available online at: <http://www.genesisenergy.co.nz/genesis/index.cfm?C2BC2742-BAD7-73BF-AD17-FF179DF6A6D2>

obligations in the transferred contract, these customers may still switch upon discovering this if they do not wish to be a customer of the acquiring retailer.<sup>10</sup>

If a customer does not voluntarily switch or is not transferred to an acquiring retailer they may become “orphaned” even though this is an unlikely eventuality. In that case, the customer is likely to receive correspondence from at least the liquidator/receiver (and possibly other retailers and the GIC) encouraging them to switch to a viable retailer by making a single phone call.

Customers of an insolvent retailer are likely to receive several indications that their retailer has become insolvent whether directly or indirectly through news media. If a disconnection process must still be undertaken then it is likely the orphaned customer to be disconnected has not actively sought a switch. In that case, disconnection is a viable last resort so that these customers do not continue to consume gas without being billed for it and impose system costs on other parties.

Given the relatively small number of gas retailer insolvencies in New Zealand, customers are unlikely to turn their minds to the prospect of their retailer becoming insolvent when they sign up with a new gas company. This makes the customer experience when insolvencies do occur more important. It seems likely (drawing on the experience with the E-Gas insolvency) that customers would be informed of the news of an insolvency through various channels, including notices from the insolvency practitioner, direct letters and phone calls from their gas distributor or the GIC, and news media reports. Customers would likely be provided with several opportunities to switch to a new retailer before getting disconnected, and measures already are in place to make it easier for these customers to switch (for example through retailers having toll-free numbers, and being sent contact details for other gas retailers as happened in the E-Gas case).

**Discussion Questions:**

3. Are you aware of any reason(s) why a gas retailer may become insolvent in addition to those mentioned in this section?
4. Are there other likely scenarios of how a gas retailer insolvency might play out that have not been discussed above?
5. Do you agree with the description of customers’ perceptions of the risk of insolvency, and the likely customer experience when their retailer becomes insolvent?

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<sup>10</sup> Of course a customer may elect to switch whether or not their existing contract has an agreed period yet to run. However, they will need to address any associated costs with the retailer that acquired their contract.

## 5 Incentives of Industry Participants in Gas Retailer Insolvencies

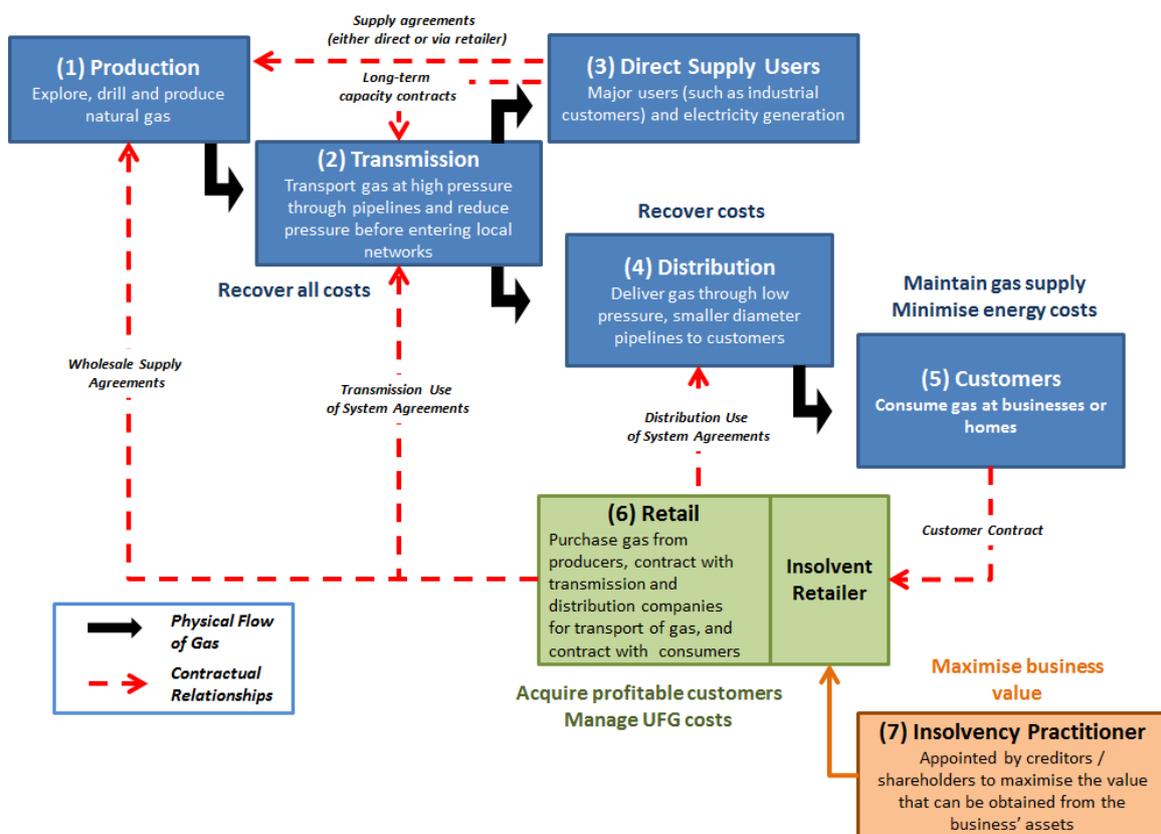
Having described the important features of the New Zealand gas industry, we now evaluate the incentives that different stakeholders in the supply chain face when a gas retailer becomes insolvent.

In our view, standard insolvency arrangements may not achieve all of the features of efficient markets when a gas retailer becomes insolvent. Of particular concern is the fact that some of the costs incurred when a gas retailer is placed into liquidation may be borne by parties that have no direct relationship with the insolvent retailer, and therefore have no opportunities to manage this risk. The fact that any unallocated customers of an insolvent retailer are unlikely to be immediately disconnected also means that other industry participants may bear costs that cannot be recovered. Some of these market failures can be addressed through contracts (discussed in Section 0), while any residual market failures could be resolved through regulatory interventions or industry rules (discussed in Section 7).

### The incentives of the insolvency practitioner of the insolvent retailer

Figure 5.1 highlights the incentives on industry participants when a gas retailer becomes insolvent. A new player enters the industry—the receiver or liquidator stands in the position of the insolvent retailer on behalf of creditors and shareholders.

**Figure 5.1: Overview of Incentives in a Gas Retailer Insolvency**



The role of the liquidator is defined by legislation that requires the value of the business' assets to be maximised. Where the liquidator opts to run a sale process for the customers

of the insolvent retailer, the liquidator's incentives are likely to result in generally positive outcomes. The liquidator will want to keep the customer base intact, and will be reluctant to "cut customers free" before the sale has been completed (which would tend to undermine the credibility of the sale). However, where a sale process is not pursued, the liquidator may make decisions that are not in the interests of other gas industry participants by:

- **Disclaiming customer contracts.** If the retailer's customers have value, then the liquidator will try to keep the customer base intact and minimise switching to other retailers until a sale can be arranged. If the liquidator does not expect the sale of customers to offset the costs incurred by continuing to operate, then the liquidator will close the business. In making this decision, the liquidator will assess the value of customers relative to the value of other assets that could be sold separately from the customers, such as pipeline capacity or rights to wholesale gas. Where other assets are worth more without the customer base, then a liquidator will be incentivised to cancel customer contracts. This has the potential to increase UFG and balancing charges that would be borne by other retailers if customers became orphaned and they do not actively seek a switch to a viable retailer.
- **Avoiding network service provider costs.** The liquidator will be required to meet the costs of providing services for the insolvent company as long as the company continues to trade (for example if a sale process is being run). If the liquidator does not pursue a sale process (and therefore stops the business trading) then all of the retailer's contracts will be cancelled, including its customer contracts. In this situation, any transmission and distribution agreements, producer agreements, and any related contracts such as metering services are also cancelled. It is likely that following this action, some or all of the retailer's former customers would continue to use gas and impose additional costs on gas distributors by remaining physically connected to the network.

The incentives of an insolvent retailer's customers will depend on their individual circumstances. Some customers will place a high value on continuity of supply, and will quickly respond to any threat of disconnection by finding a new retailer. Commercial users of gas are most likely to take this approach to avoid costly disruptions to their businesses. However, other customers who are focused on minimising their energy purchasing costs may have little incentive to find a new retailer. These customers could realise that they might not be forced to pay for any gas used before signing up with a new retailer, and may require repeated notifications before switching. In some cases, a plausible threat of disconnection will be required to prompt the customer to take action.

### **The incentives of other industry participants**

**Competing retailers** will generally have an incentive to expand their customer base when another retailer becomes insolvent, either by acquiring the insolvent retailer or by directly approaching its customers. This incentive will be influenced by the characteristics of the insolvent firm's customers, including the expected margin per customer, the financial risks posed by the customers, and the size of the insolvent retailer's customer base. The ability of other retailers to gain customers will also depend on the availability of sufficient wholesale gas, pipeline capacity and the suitability of the to-be-acquired customers into the new retailer's portfolio. Competing retailers' incentives to bid for the customers of the insolvent retailer will be influenced by what will happen if the sale process is unsuccessful. For example, a retailer will prefer not to pay for customers if it

knows that customers would be acquired without payment if a sale process cannot be concluded.

These incentives should not change subsequently when the insolvent retailer also has electricity customers (i.e. the company is a dual fuel retailer). If a dual fuel retailer becomes insolvent because of financial stress caused in its electricity business (for example, through exposure to wholesale electricity price risks), then competing gas retailers would remain interested in gas customers of the insolvent retailer. For the same reasons, if the financial difficulties of a dual fuel retailer are being caused by gas customers, then competing electricity retailers would only be interested in acquiring the electricity customers of the insolvent retailer. Customers that wish to continue to receive their electricity and gas supply from a single retailer would need to find another supplier that was able to manage the supply of both fuels in a financially viable way. Most gas retailers in New Zealand are dual-fuel retailers so this should not be too much of a problem. Having two separate retailers – one for electricity and one for gas – is not a significant problem either.

Competing retailers will also want to minimise the cost of UFG or the risk of being penalised through the balancing system. This means that it may be in the interests of competing retailers to approach customers before they become “orphaned”.

In the event that the insolvent retailer ceases trading, **gas distributors** face difficult decisions on how to treat “orphaned” customers. Apart from entering the retail market, distributors can either:

- Disconnect customers to minimise on-going costs and avoid concerns from the other retailers that the distributor is allowing customers to take gas without a contract for supply. This option imposes the cost of visiting customer premises, which may prove unnecessary if customers sign up shortly after being disconnected with another retailer. The gas distributor should be able to recover the costs of subsequent reconnection, although possibly not the initial disconnection.
- Continue supply on the expectation that competing retailers will take over the customers. This imposes the cost of continuing to provide network services to customers of the insolvent retailer without receiving payment. Because most network service costs are fixed, these costs are unlikely to be substantial. The scaling of variable costs against reconciliation data also helps gas distributors to recover their total expected revenue.

The E-Gas insolvency indicates that distributors are unlikely to immediately disconnect all customers of the insolvent retailer. Instead, distributors are likely to be willing to work with an insolvency practitioner to enable the company to continue to operate until a sale process can be completed. The incentives that gas distributors have to continue to supply the customers of an insolvent retailer are likely to work towards a lower cost outcome than if distributors simply move to disconnect customers as soon as an insolvency practitioner is appointed (as they are entitled to do). Maintaining supply to the customers of an insolvent retailer preserves the opportunity to obtain whatever positive value remains in the customer base, and also avoids the expensive process of disconnecting and reconnecting customers. Continuous supply also protects the reputation of gas as a secure and reliable energy source.

**Transmission companies** will have broadly similar incentives to gas distributors—to recover the costs of providing pipeline services to the customers of an insolvent retailer. However, this is likely to be a weaker incentive for transmission companies as

throughput charges, and possibly balancing charges, will be washed up and socialised amongst remaining retailers via the treatment of UFG. One important difference is that transmission companies have no ability to disconnect these customers, and therefore have no ability to control these costs.

**Wholesale gas producers** will want to ensure payment for any gas they supply. Where there is a risk of non-payment following insolvency, producers can elect to terminate their agreement and supply to another retailer (or to a direct supply user). This creates a risk that prices at the time the retailer becomes insolvent will be lower than the contract price, but the producer's revenues could also increase if gas is in short supply.

#### **Actual incentives depend on the circumstances of particular insolvencies**

The incentives facing different parties across the supply chain when a gas retailer becomes insolvent will vary with features such as:

- **The level of demand.** Gas is used (among other things) for heating in New Zealand homes and businesses, which means that gas-demand varies with weather conditions. During periods of high demand in winter, competing retailers may not have strong incentives to pick up new customers if they do not have access to additional wholesale gas or pipeline capacity.
- **The reasons for the insolvency.** If unexpectedly high wholesale gas prices caused the retailer insolvency event, then the same high wholesale prices will financially affect other retailers. This could increase the costs that unallocated customers impose on other parties, and increases the risks that other industry participants may also be facing financial stress from their existing customer base.
- **The size of the insolvent retailer.** The number of customers served by a gas retailer has an impact on the rest of the supply chain because the gas supplied to “orphaned” customers becomes UFG. The insolvency of a small mass-market retailer therefore has a lower impact on UFG and a reduced likelihood of causing a balancing event. The likelihood of one of the two largest mass-market retailers in New Zealand failing is a low-probability/high-impact event. The insolvency of a large volume-based retailer could present a somewhat different challenge.

#### **Summary of the impact of incentives in the event of gas retailer insolvency**

The incentives facing different parties may put some participants in a position to take advantage of the insolvency event and push costs onto other parties in the supply chain:

- The insolvency practitioner will seek to maximise any value for creditors, including where this requires disclaiming unprofitable customers or shutting the business down quickly. If any customers of the insolvent firm are “orphaned” these customers may have little incentive to find a new home, and may impose costs on other retailers (through UFG).
- Gas distributors are unlikely to minimise these costs by quickly moving to disconnect customers. This is good from the perspective of customer convenience and supports the perception of gas as a reliable energy source for household and commercial use. However, failing to disconnect unallocated customers will increase the level of UFG that needs to be paid for by remaining retailers, and may also impose balancing costs.

These issues are market failures because the pursuit of individual incentives is likely to lead to outcomes that are not efficient.

The problems caused by these incentives increase with the size of the insolvent retailer. The customers of large gas retailers in New Zealand could not be contacted by distributors and disconnected (if necessary) without substantial costs being incurred. These customers would represent a sizeable cost to remaining retailers if their consumption became UFG. A competing retailer may also require Commerce Commission clearance to purchase the customer base of a large insolvent retailer to ensure that the purchase does not result in a “substantial lessening of competition” (section 66 of the Commerce Act 1986).

The failure of a large gas retailer in New Zealand is a low probability, high impact event. Currently, the largest gas retailers are vertically integrated, dual-fuel (electricity and gas) retailers. Such large New Zealand retailers typically have investment grade credit ratings, and have a diversified portfolio of wholesale and retail assets that minimises (but does not eliminate) the risks of insolvency. However, the failure of any company cannot be entirely discounted.

The table below summarises the likely incentives that would apply in the event of gas retailer insolvency based on whether the insolvency practitioner continues operating the business or if the insolvency practitioner disclaims some or all customers.

**Table 5.1: Summary of Incentives in Gas Retailer Insolvencies**

Relevant party	Contractual relationship	Insolvency practitioner continues trading	Insolvency practitioner disclaims all/some customers
Insolvency practitioner	May be appointed by a third party or a creditor of the insolvent business	Seeks to maximise the value of the business – possibly by trading out of difficulty – but most likely with a view to selling the company’s assets (including the customer base) in order to repay creditors	Decides that the business is unviable. Incentive is to minimise losses
Customer	Contracts with the retailer to purchase gas	<ul style="list-style-type: none"> <li>▪ Loyalty – may wish to stay with insolvent retailer</li> <li>▪ Security of supply – may want to jump quickly to a new, stable supplier</li> <li>▪ Realist – will shop around and find the best retailer to switch to, particularly if they do not want to be “transferred” to a purchasing retailer via a sale process</li> </ul>	<ul style="list-style-type: none"> <li>▪ Free rider – may continue using gas given existence of physical connection but has no retailer to pay; or</li> <li>▪ Realist – will shop around and find the best retailer to switch to</li> </ul>

Relevant party	Contractual relationship	Insolvency practitioner continues trading	Insolvency practitioner disclaims all/some customers
Distributor	Has contracts with all retailers trading on its networks	Continues to be paid by the insolvency practitioner	<ul style="list-style-type: none"> <li>▪ Minimise costs associated with disconnection</li> <li>▪ Will want orderly, bulk transfer of failed retailer's customers</li> <li>▪ Minimise costs associated with orphaned customers</li> </ul>
Transmission system owner	Contracts with Shippers, may/will include failed retailer	Existing arrangements continue as usual	Minimise exposure to balancing costs attributable to failed retailer
Gas producer	Has contracts with one or more retailers	Existing arrangements continue as usual Likely to look favourably on interim arrangements with insolvency practitioner in hope that retail business can be sold as a "going concern"	Gas producers isolated from effects of insolvency except for any outstanding debts and/or lost sales to failed retailer
Meter owner	Has contracts with most/all retailers	Existing arrangements continue as usual	Will not receive any unpaid invoices from the failed retailer.
Retailer (failed)	Contracts with meter owners, distributors, transmission system owner(s) and gas producer	Insolvency practitioner manages the business	
Retailers (other)	Contracts with meter owners, distributors, transmission system owner(s) and gas producer	Existing arrangements continue as usual	Will want to minimise costs associated with UFG associated with failed retailer's customers (only occurs after business wound-up and where there are orphan customers) Possible incentive to "cherry pick" customers from the failed retailer as an alternative to purchasing the customer base

### Summary of market failures for gas retailer insolvencies

The misaligned incentives identified above have the potential to create market failures when there is a gas retailer insolvency. Orphaned customers may continue to consume gas without having to pay for it. Their consumption is likely to be paid for by remaining viable retailers in the form of UFG – this is an externality (market failure) because despite the gas market relying on bilateral contracts, orphaned customers may impose costs on third parties. There is a smaller risk that orphaned customers create the need for a pipeline balancing action that would also likely be paid for by third parties. Given the high cost of *en masse* disconnections, distributors would be unwilling to disconnect all orphaned customers.

Despite finding that market failures may occur if there is a gas retailer insolvency, the earlier contrast of standard insolvency arrangements with gas market insolvencies suggests that the likelihood of customers becoming orphaned depends largely on the decisions made by an insolvency practitioner to disclaim some assets or exclude customers from a sale process. As the summary of incentives above suggests, most parties in the supply chain are keen to ensure that the insolvency practitioner does not disclaim contracts.

**Table 5.2: Comparison of Outcomes between Standard Insolvencies and Gas Retailer Insolvencies**

Insolvency phase	Standard insolvency	Gas retailer insolvency
Normal trading	Business as usual	Business as usual
Financial difficulty	Company under increasing pressure from contractual counterparties	Gas retailer under increasing pressure from contractual counterparties
Insolvency practitioner (IP) appointed	IP reviews company	IP reviews company
(a) IP decides to trade on	<ul style="list-style-type: none"> <li>▪ IP responsible for ongoing costs and may be able to trade out of difficulty</li> <li>▪ Suppliers have incentives to trade with IP</li> <li>▪ Customers unaffected</li> </ul>	<ul style="list-style-type: none"> <li>▪ IP responsible for ongoing costs and may be able to trade out of difficulty</li> <li>▪ Suppliers of gas retailer (gas wholesalers, transmission companies, distribution companies) have incentives to trade with IP</li> <li>▪ Customers unaffected (but can always switch to another retailer unless contractually bound)</li> </ul>

Insolvency phase	Standard insolvency	Gas retailer insolvency
(b) IP decides to sell assets	<ul style="list-style-type: none"> <li>▪ IP will try to maximise value of assets</li> <li>▪ Customers may be affected, depending on whether company is sold as going concern</li> </ul>	<ul style="list-style-type: none"> <li>▪ IP will try to maximise value of assets. Customer base is likely to have positive net value and is likely to be sold</li> <li>▪ Competing retailers have incentives to buy the customer base</li> <li>▪ If customer base is sold, customers will be minimally affected, as they will be transferred to another retailer. Customers retain the option of switching to any retailer they select.</li> <li>▪ Any customers that are not included in the sale become “orphaned”</li> </ul>
(c) IP disclaims contracts	<ul style="list-style-type: none"> <li>▪ Company is closed.</li> <li>▪ Customers no longer able to access goods or services from that provider</li> </ul>	<ul style="list-style-type: none"> <li>▪ Customers still physically connected and can draw gas, even though they do not have a retailer. Some of these customers may switch retailers; others may not and become “orphaned”</li> <li>▪ Other retailers incur costs through UFG</li> <li>▪ Distributors can stop gas flowing to customers without a retailer, but may not recover the costs of disconnections</li> </ul>

**Discussion Question:**

6. Do you agree with this discussion of the incentives that apply in an insolvency event?
7. Do you agree with the market failures identified?
8. Do you agree that the market failures identified will only eventuate if an insolvency practitioner disclaims customer contracts or if an acquiring retailer does not acquire the whole customer base in a sale process?

## 6 How Contracts Address Insolvency Risks

Having found that market failures may exist when a gas retailer becomes insolvent, it is important to consider whether parties are able to anticipate these failures and manage these risks through their contracts. This section considers how contracts can be used to manage the expected costs of counterparty insolvency, and describes the measures that are typically included in gas industry contracts to mitigate insolvency risk.

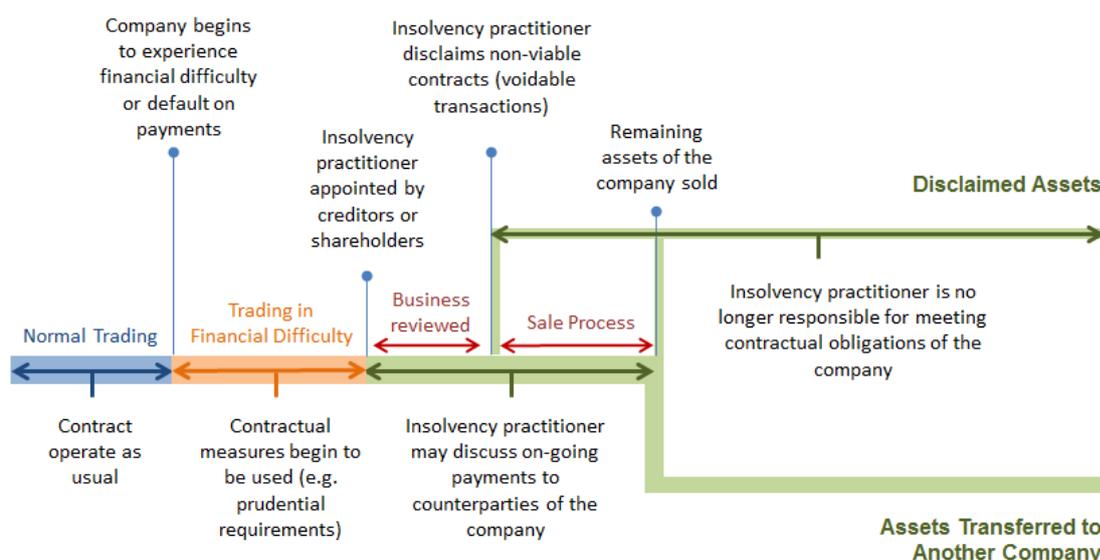
### Managing insolvency risks through contracts

Contracts are commonly used to manage the risks of insolvency. The strength of the measures included in contracts will generally reflect the expected costs when the counterparty becomes insolvent—if the costs of insolvency events are significant, then contracts will typically provide a clear ability to mitigate those costs. For example, construction contracts typically include “step-in” rights that allow the party paying for the construction to take over the project if the contractor becomes insolvent. This provides some assurance that the construction project can be completed on schedule, even if the contractor is not financially capable of delivering the project.

Other contractual measures can also help to manage the risks of insolvency. Performance bonds and prudential requirements require one of the contracting parties to provide cash or cash-equivalents up-front, and empower the other party to draw upon this cash if the other party defaults on its obligations. Less demanding contractual provisions can require parties to provide regular financial updates or notify their counterparties when certain financial issues arise (such as a breach of bank covenants). The position of contractual counterparties as an unsecured creditor also provides an ability to appoint an insolvency practitioner, once the required legal process has been followed.

Figure 6.1 provides an overview of how contracts are used before and during an insolvency situation. Contractual measures such as prudential requirements provide protection to counterparties when the company starts to experience financial difficulty. Once an insolvency practitioner is appointed, counterparties may be approached to agree new terms if the insolvency practitioner decides to continue to operate the company.

**Figure 6.1: The Role of Contracts in an Insolvency Event**



## Contractual protections in the gas industry

The New Zealand gas industry is based on bilateral contracts. Although the terms of these contracts are confidential, we have reviewed template wholesale and network contracts to gauge what protections might be built into gas industry contracts. We have also explored whether any contractual changes have been introduced since the E-Gas insolvency that would enable parties to better manage any risks.

In our view, contracts in the gas industry provide a reasonable level of protection for gas distributors when a counterparty retailer becomes insolvent. The prudential requirements that are posted by retailers without investment grade credit ratings provide an important form of protection for gas distributors. Having three months of prudential requirements allows distributors to identify any risk of payment default, provide notice of appropriate action (such as disconnecting customers), and then take action as necessary.

In practical terms, these agreements may not enable gas distributors to recover all costs resulting from an insolvency. Gas distributors are unsecured creditors, so the funds simply may not be available on liquidation. However, that very fact provides incentives for gas distributors (as well as transmission system owners and gas producers) to use the available legal means so as to limit the period of default and, thereby, cap their respective exposures.

After the E-Gas insolvency, gas distributors and transmission system owners appear to have placed a renewed focus on ensuring that sufficient prudential requirements are maintained, and that appropriate measures are available to deal with retailer payment default or late payment. For example, Vector has proposed to amend the Vector Transmission Code.

Use of system agreements also enables gas distributors to disconnect unallocated customers. This provides the basis for gas distributors to credibly threaten to disconnect customers if they are unwilling to change supplier after their retailer has ceased trading.

Wholesale gas contracts also provide some protection for producers—although the level of comfort is weaker, reflecting the fact that producers are unlikely to bear substantial costs when a gas retailer becomes insolvent<sup>11</sup>. As long as a contract can be agreed with another retailer on similar terms, then the gas producer will not be materially worse off.

### Discussion Question:

9. Do you agree that contracts provide some ability for gas industry participants to manage the costs that they might bear if their counterparty becomes insolvent?

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<sup>11</sup> Presumably a gas producer will only accept nominations whilst a retailer is in good standing, once the retailer defaults on payments the gas producer has the option of ceasing to supply.

## 7 Conclusions on Market Failures and the Case for Regulatory Intervention

This report has identified some unique features of the New Zealand gas industry that may create problems when a gas retailer becomes insolvent and the insolvency practitioner makes a decision which results in customers becoming orphaned—the physical flow of gas differs from the contractual chain, and the need to reconcile customers’ gas creates the possibility that orphaned customers’ gas is socialised as UFG amongst remaining viable retailers. In practice, gas distributors are unlikely to move quickly to disconnect customers due to reasons of cost and perception, yet the parties imposing these costs (the insolvent retailer and its customers) are not motivated to avoid these costs. This creates the potential for unallocated customers to impose costs on the industry.

### **Some market failures may remain when contractual options have been exhausted**

After the last retailer insolvency event (E-Gas) there have been some changes to some distribution Use of System agreements, and a renewed focus on the importance of prudential requirements. These changes reflect the fact that parties in the supply chain have some ability to manage the costs of retailer insolvency through their bilateral contracts.

However, some uncertainty remains about how existing contracts and industry rules will allocate the costs imposed by orphaned customers. This uncertainty is likely to lead to disputes if the sums involved are substantial. In general terms, it appears likely that:

- The costs of the gas used by unallocated customers becomes UFG that is allocated across all remaining retailers
- That same UFG may manifest as costs of balancing charges that will be borne by transmission companies in the first instance and passed on to solvent retailers wherever possible.

An important feature of this allocation of costs is that the parties that bear the costs also have some ability to prevent these costs from escalating: competing retailers can sign-up the unallocated customers of an insolvent retailer, and gas distributors can minimise the need for balancing events by disconnecting unallocated customers.

### **Solving these market failures may not improve overall outcomes**

In some overseas markets, regulators have established permanent backstop regulations, such as retailer of last resort (ROLR) schemes, to ensure that no customers are left without a retailer in the event of an insolvency. While the design of permanent backstop regulations may vary, interventions such as a ROLR scheme may solve the market failures described in this report.

While these regulations may improve certainty of outcomes for market participants, they also impose costs. Depending on how a scheme is designed, these schemes can impose high administrative costs. We have identified that the possibility for market failures to occur when a gas retailer becomes insolvent depends on the decision made by the insolvency practitioner. Other supply chain parties are keen to avoid the insolvency practitioner making that decision. Given that retailer insolvencies themselves are rare events, any regulatory interventions should be commensurate with the low probability of these market failures occurring—care must be taken to ensure that the infrequent benefits of backstop regulations outweigh the permanent ongoing costs of backstop regulations.

There are additional risks in designing permanent backstop regulations that may compromise normal insolvency processes. For example, in the New Zealand gas industry even a relatively low-cost ROLR scheme would pose risks to two important objectives when an insolvency occurs:

- **Minimising the overall costs of the insolvency.** Section 5 found that current market arrangements place incentives on gas distributors and competing retailers to minimise the costs of insolvency. Gas distributors, transmission system owners and gas producers all have incentives to continue to deal with a retailer even when an insolvency practitioner is appointed. Retailers have incentives to participate in any customer sale process. Interventions such as ROLR schemes can weaken these incentives.
- **Maintaining flexibility to deal with the specific facts of the insolvency.** Providing more certainty on how unallocated customers will be transferred to a new retailer means that solutions cannot be developed that are tailored to the circumstances of a particular insolvency whether by an industry-led insolvency process or by the GIC recommending tailored backstop regulations as and when required. The urgent regulations passed in the E-Gas insolvency were specifically designed to address the facts of that case. Providing more detail on how a ROLR scheme would work in advance would limit the freedom to implement similar tailored interventions in the future.

Before recommending a regulatory solution for the market failures identified in this paper, we recommend the GIC:

- Is able to establish a clear purpose for regulating these market failures
- Dissatisfied the gas industry's existing bilateral contracts are insufficient to manage these risks
- Tailor regulatory responses so that they are commensurate with the rare event/low probability outcome of these market failures occurring
- Ensure regulations will not interfere with normal insolvency processes—the market failures identified in this paper will only eventuate as one possible outcome of a standard insolvency process
- Are satisfied that the benefits of regulating outweigh the costs of regulating.

**Discussion Question:**

10. Based on the issues discussed above and for the market failures identified, do you consider that there is a need for regulatory intervention beyond using the urgent regulation-making powers in the Gas Act?



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Insolvent Retailers workstream: Castalia Strategic Advisors report

Submission prepared by: (company name and contact)

QUESTION	COMMENT
Q1: Do you have any comments or concerns on the summary of standard insolvency arrangements provided in this section?	
Q2: Do you have any comments on the summary of physical and contractual characteristics of the New Zealand gas market set out above?	
Q3: Are you aware of any reason(s) why a gas retailer may become insolvent in addition to those mentioned in this section?	
Q4: Are there other likely scenarios of how a gas retailer insolvency might play out that have not been discussed above?	
Q5: Do you agree with the description of customers' perceptions of the risk of insolvency, and the likely customer experience when their retailer becomes insolvent?	
Q6: Do you agree with this discussion of the incentives that apply in an insolvency event?	

QUESTION	COMMENT
Q7: Do you agree with the market failures identified?	
Q8: Do you agree that the market failures identified will only eventuate if an insolvency practitioner disclaims customer contracts or if an acquiring retailer does not acquire the whole customer base in a sale process?	
Q9: Do you agree that contracts provide some ability for gas industry participants to manage the costs that they might bear if their counterparty becomes insolvent?	
Q10: Based on the issues discussed above and for the market failures identified, do you consider that there is a need for regulatory intervention beyond using the urgent regulation-making powers in the Gas Act?	