

16 April 2013

Hon Simon Bridges
Minister of Energy and Resources
Parliament Buildings
Wellington

Dear Minister

Advice on whether generic regulation is necessary for gas retailer insolvency

This letter provides you with Gas Industry Co's advice on whether generic regulation is necessary for gas retailer insolvency.

In late 2010, the E-Gas group of companies (E-Gas) went into liquidation. At the time, E-Gas was a retailer to 3% of all gas customers and around 9% of the market by allocated volumes. Due to concerns at the time, Gas Industry Co worked with the then Ministry of Economic Development and the Parliamentary Council Office to develop the Gas Governance (Insolvent Retailer) Regulations 2010 (the Regulations). Gas Industry Co has the power to recommend regulations for gas retailer insolvency under section 43G of the Gas Act 1992 (the Gas Act). The Regulations would have transferred "orphaned" customers of E-Gas' according to an allocation methodology developed at the time. A commercial sale of E-Gas' customers occurred which meant that the Regulations were not used.

Because the Regulations were passed under urgency, retrospective consultation was required. The result of that consultation was our formal advice to the then Minister of Energy and Resources in May 2011 that the Regulations should be allowed to lapse and that Gas Industry Co should review whether generic regulation is necessary for any future retailer insolvency. The Minister endorsed this advice.

This letter provides our formal advice that permanent backstop regulation, which would supplement existing insolvency legislation, is not necessary for gas retailer default but that Gas Industry Co should develop with the industry drafting instructions for regulations that could be tailored in the very rare and unique circumstances that future intervention was required. In such an unlikely event, the urgent regulation making powers in section 43P of the Gas Act will be required.

Discussion and Advice

It is first important to highlight features of the gas market in terms of whether and how any gas retailer insolvency might occur. Gas retailer insolvencies are rare events: the E-Gas liquidation was the

only gas retailer insolvency in the nearly 10 years since Gas Industry Co's inception. Further, a retailer insolvency will not necessarily lead to "orphaned" customers; in fact, experience with insolvencies and takeovers in the electricity and gas markets suggests that a retailer's customer base is a valuable asset that other retailers would be willing to purchase. Orphaned customers will therefore only result if the business is wound up without the sale of the customer base, or if customer contracts are disclaimed by the insolvency practitioner. In other words, large-scale orphaned customers arising from an insolvency event would be a rare outcome of a rare event.

Further, the fact that customers are orphaned does not mean that they are negatively impacted. Gas will continue to flow to their premises, and the primary impact is on other retailers. This is because the consumption of gas by orphaned customers at shared gas gates would be met by other gas retailers in the form of increased allocations of unaccounted-for-gas (UFG) to those retailers. Further, the gas market, and management of risks, is largely governed by long-term bilateral contracts between producers, transmission/distribution companies and shippers/retailers. Accordingly, the focus of potential concerns is on whether there is a "market failure" in gas market governance arrangements if existing insolvency legislation is not supplemented by further gas-specific regulation, rather than on addressing specific risks for consumers.

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

Gas Industry Co consulted on the Castalia Report. Submitters generally agreed with Castalia's findings and conclusions. No issues were raised by submitters that required additional attention.

Gas Industry Co prepared an Options Paper in December 2012, which identified and assessed the relevant options available for managing the identified orphaned customer risk. Our assessment did not show the need for a more interventionist approach than relying on the urgent regulation-making provisions as per the response to the E-Gas event. Generally, normal insolvency arrangements in New Zealand work well and should be allowed to run their course for as long as possible. There is also a

risk that additional gas-specific backstop regulation will reduce the incentive for industry participants to reach a commercial agreement. Other problems with such regulations include a lack of flexibility to deal with the range of potential retailer defaults and the reduced scope for a new competitor to enter the gas market by way of acquiring an insolvent retailer's assets.

Submissions on the Options Paper generally supported not intervening with a normal insolvency process if a gas retailer became insolvent. However, if necessary, most submitters either supported or were favourable towards the preparation of drafting instructions for backstop regulations, which could be tailored and implemented under urgency using section 43P of the Gas Act in the rare circumstances they were needed.¹ This would be an efficient response and would not deter the efforts to reach a commercial solution.

We note the Electricity Authority is considering the advice of its Retail Advisory Group (RAG) for backstop arrangements that will apply in the event of electricity retailer default. There are several 'dual-fuel' retailers operating in New Zealand. However, our assessment is that the gas market is different in key respects from the electricity market: the gas industry is built on a system of bilateral contracts which allows financial oversight of contracted counterparties. The key risk for the electricity industry is that retailer default results in orphaned customers and their consumption of electricity compromises transactions through the multilateral wholesale market. This key difference makes a uniform regulatory response inappropriate. In addition, we could not align our response with the EA even if there was a strong rationale for doing so: the Gas Act limits a regulatory response to when a gas retailer has become insolvent – the RAG's recommended approach does not require that a retailer is insolvent.

Notwithstanding the above, we are confident that having two different regulatory responses would pose no risk to reaching acceptable outcomes in the event of a dual-fuel retailer insolvency. The RAG's model, if implemented, may result in some dual-fuel customers being switched to a viable dual-fuel retailer but will otherwise only capture electricity customers. Any remaining gas customers will be subject to a commercial sale process or, if a sale is unsuccessful and significant numbers of customers orphaned, captured by backstop regulations based on drafting instructions that Gas Industry Co can develop.

Our formal advice to you is accordingly that permanent backstop regulation is not necessary for retailer default, but that Gas Industry Co should develop with the industry drafting instructions for backstop regulations which could be tailored and implemented under urgency in the rare

¹ One submitter preferred that permanent regulations were made.

circumstances they were needed. If this advice is accepted, we intend to convene a technical working group to develop the parameters that will apply in such an event.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'S. Bielby', with a long horizontal flourish extending to the right.

Steve Bielby
Chief Executive

Copy: Simon Lawrence, MBIE