Network Tasman Submission on the Electricity Authority's: Code amendment proposal: Default Distributor Agreement – Consultation

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Dear Craig,

This letter constitutes Network Tasman's submission on the Authority's *Code amendment proposal: Default Distributor Agreement – Consultation*.

Network Tasman has read and contributed to the development of the ENA's submission and supports its conclusions and recommendations.

In summary, Network Tasman considers that:

- The Authority's analysis is insufficiently robust to justify the significant change being proposed. There may be benefits from moving to a DDA, but the CBA provided is insufficiently detailed or robust to justify the proposed changes.
- The Authority is proposing to significantly change the way that services worth $2.6b/year are contracted. This change is justified on the basis of annual benefits to consumers of just $1m-$1.3m, or 0.05% of the revenues collected for the services in question.
- Despite the inherent difficulty of drafting accurate contracts, no apparent consideration has been given to the likelihood of drafting error or the consequences of such an outcome. The DDA will be the sole contract that will govern the terms and conditions under which $2.6b worth of services are provided. The Authority's proposal consolidates and significantly amplifies the cost of any unintended consequence and means that even a minor error could result in costs that would swamp the proposed benefits of the DDA.
- The Authority's "broad approach to cost-benefit analysis" is simply not an appropriate tool for assessing the costs and benefits of such a fundamental change to the way in which distribution service are contracted.
- The Authority assumes that the presence of unequal bargaining power between distributors and retailers inhibits retail competition. The presence of unequal bargaining power is not in itself bad for consumers. It is only when unequal bargaining power is used to the detriment of consumer interests that it becomes a problem. The Authority has not presented evidence that distributors' have used unequal bargaining power to the detriment of consumers.

The Authority's cost benefit analysis is insufficiently robust

By its own admission, the Authority has taken a "broad approach" to the cost/benefit analysis (CBA) used to justify the introduction of a DDA.

Network Tasman agrees with this characterisation and submits that a proposal to materially alter the way that $2.6b worth of services each year are contracted should be justified by something more robust than a simplified high-level CBA.

The Authority's CBA fails to take account of any relevant nuance or detail and lacks sufficient rigour to justify the magnitude of the changes the Authority is proposing.

Effectively, the Authority's quantitative CBA consists of estimating the number of new UoSAs that will be agreed in coming years – based on retailers response to a survey question - and multiplying this number by the difference in the costs that retailers and distributors stated they would incur if negotiating a UoSA under the status quo and their costs if a hypothetical DDA was in place.

We comment later in this submission on the merits of basing a quantitative CBA solely on data derived from a survey in which respondents to the survey have strong opinions on the survey topic and are unlikely to be fully objective.

In this regard, it is worth contrasting the comprehensive CBA the Authority has completed for the TPM which is seeking to alter the way that Transpower allocates its annual charges of around $850m/year with the cursory CBA the Authority has relied upon for this project.

Network Tasman submits that the Authority must conduct a robust and comprehensive CBA before further progressing the DDA project.

Issues identified with the status quo

The Authority has identified three problems that the proposed Code amendment seeks to address. These are:

- Higher-than-necessary transaction costs and duplication of effort; and
- Unequal bargaining positions that inhibit competition in the retail market; and
- Unequal bargaining positions that inhibit competition in related-services markets.

Network Tasman has reservations about the Authority's analysis and conclusions on the first two issues. These are discussed below.

Higher than necessary transaction costs

The Authority has identified $1.1m-$1.3m of annual benefits from lower transaction costs as a result of introducing a DDA.

These benefits have been calculated using the results of a survey the Authority undertook in 2018 of 22 retailers and 23 distributors. Given the respondents to the Authority's survey are almost certainly subject to bias,[1] Network Tasman is concerned that the Authority has taken these responses on face value and has taken no obvious steps to independently verify or scrutinise the results of the survey.

Network Tasman observes that the survey contains a number of questions about how the presence of a "default agreement" would affect the respondent. Respondents don't appear to have been given further information about what this hypothetical "default agreement" consists of. This leaves considerable

[1] Retailers are generally strong advocates of a DDA and distributors are generally reticent to lose the ability to specify the terms and conditions under which their services are provided.

scope for interpretation and means that the Authority has no way of determining how each respondent has interpreted the term or whether each respondent has interpreted the term consistently. This undermines the Authority's ability to draw robust conclusions from the survey results.

Further, the Authority has assumed that the "default agreement" respondents had in mind when completing the survey is consistent with the DDA that has been proposed by the Authority. Given the significant change in the structure of the DDA proposal from what have previously been proposed by the Authority, Network Tasman submits that it is highly unlikely that the default agreement the respondents had in mind when completing the survey could be considered comparable to the DDA currently being proposed. Survey respondents presumably assumed that a 'default agreement' would result in a single consistent UoSA being applied across all distributors. However, a DDA would only be consistent across core terms. Operational, recorded and collateral terms will be distributor specific.

Operational, recorded and collateral terms will be distributor specific and will in all likelihood account for at least half of the terms included in a DDA.[2] All of these components will require retailer review and the cost of reviewing these components are unlikely to have been factored into retailers' or distributors' survey responses.

Finally, the results of the DDA survey certainly don't align with Network Tasman's experience with UoSA negotiations. Since the beginning of 2016, we have had 14 retailers enter our network. Of these 14 retailers, not one has sought to negotiate different terms to those provided in our template agreement. Nor has Network Tasman (explicitly or implicitly) discouraged the possibility of entering into negotiations. Our experience with new retailers primarily involves a retailer asking for a copy of our UoSA, the exchange of key contact details and the exchange of signed hard copies of the completed UoSA. It is a low cost process from Network Tasman's perspective and although prospective retailers will invariably review our UoSA prior to joining our network, the absence of any requests to negotiate any new terms suggests it is a low cost process for retailers too.

Unequal bargaining positions that inhibit competition in the retail market

The Authority states that it has received comments that the bargaining positions between distributors and retailers are unequal. The Authority then remarks that distributors are able to use their bargaining power to develop UoSAs which mainly incorporated their preferred terms and conditions.

Firstly, the presence of an unequal bargaining position is not a problem in itself. An unequal bargaining position (or substantial market power) is only a problem if the party with the bargaining power exploits it to the detriment of consumers.

It is unquestionable that distributors are in a position of having unequal bargaining power – this is the reason we are regulated under Part 4 of the Commerce Act. However, the Authority has presented no evidence in its evaluation of the costs and benefits of its proposal in Chapter 5 that distributors are using that bargaining power in a way that is not in the long-term interests of consumers.

Rather, the Authority appears to assume that retailers inability to have their preferred terms and conditions incorporated into the UoSA as evidence that distributors are abusing their bargaining power. However, this requires a number of assumptions that the Authority has not tested. This includes

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[2] The core terms of the DDA are 49 pages long. The operational and collateral terms contained in Network Tasman's current UoSA are also 49 pages long.

assumptions that the terms and conditions proposed by the retailer were reasonable, would have resulted in better outcomes for consumers and would have been accepted by the distributor in the event both parties had equal bargaining power. The Authority has not investigated whether this is the case in any of the examples it uses to justify its premise that the presence of unequal bargaining positions are inhibiting competition in the retail market.

For example, the Authority notes that distributors have introduced prudential requirements beyond those specified in the Code.

The Authority doesn't provide any evidence of how widespread the issue is or the harm caused by imposing these alternative conditions. It is not clear whether it is limited to one or two distributors or whether it is standard practice across the industry. The Authority must understand how widespread the practice is before it can establish the size of the problem and assess the net benefits of any proposed solution.

While on the face of it, requiring prudential security that exceeds those set out in the Code appears to be a breach of the Code, the DDA project isn't a compliance project. The Authority's sole focus should be on identifying the level of prudential requirements that efficiently allocate the relevant risks of retailer default. Nowhere in the consultation paper does the Authority consider the efficient level of prudential requirements or how the risks of retailer default should be allocated.

Network Tasman submits that in the event of retailer default that results in the Authority's entire trader (retailer) default process being completed, distributors will be left with more than two months of unpaid lines charges, after prudential security has been called upon. The trader default process and the commercial implications of that process for distributors are set out in Appendix A.

The Authority is silent on why it is efficient (and therefore in the long-term benefit of consumers) for distributors to carry this level of commercial risk as a result of a failed retail business. Especially given that the Authority also sets the prudential security that is available to the Clearing Manager and the prudential security available to the Clearing Manager is such that it is not subject to any commercial risk in the event of trader default.

Network Tasman considers it unlikely that maintaining the current prudential requirements, as set out in the DDA, are in the long-term interests of consumers because it artificially lowers the bar to entry and encourages inefficient entry to the retail market.

Ironically, should this be the case, distributors imposing prudential requirements that are more onerous than those specified in the Code would be in the best interests of consumers.

The Authority cannot simply assume that distributors including their preferred terms and conditions in their UoSAs is evidence of distributors abusing their unequal bargaining power. The Authority must assess each of the issues raised on their merits and has not done so.

Comments on specific drafting

Not withstanding the comments above, Network Tasman has comments on the following aspects of the proposed DDA:

- Trust account rules
- Serious financial breach

- Income distribution services – Schedule 12A.1 Appendix A
- Provision of consumption data – Schedule 12A.1 Appendix C

Trust account rules

Clause 10.26 of the proposed DDA requires that the prudential cash deposit received from each retailer to be held in an individual trust account in the name of the retailer providing the cash deposit.

This is an overly burdensome administrative task that offers little obvious benefit. Network Tasman submits that this obligation should be amended to require distributors to maintain a single trust account for the purposes of holding prudential cash deposits.

Serious financial breach

Serious financial breach is defined as a failure by the trader to pay an amount due and owing that exceeds the greater of $100,000 or 20% of the actual charges payable by the trader for the previous month.

Twenty one of the traders operating on our network could default on their monthly invoice and fail to meet this threshold. Given it is smaller retailers that are more likely to default, this exposes Network Tasman (and other small to medium distributors) to significant commercial risk that larger distributors don't face. Especially if challenging wholesale conditions result in multiple small traders defaulting in quick succession.

Network Tasman is a medium sized distributor, the effects for networks smaller than us would be even bigger.

Network Tasman submits that a serious financial breach should be specified either as a failure by the trader to pay an amount due that equals or exceeds the actual charges payable by the trader for the previous month.

Income distribution services

Schedule 12A.1, Appendix A refers to 'Income distribution services'. The money distributed is not income and is not subject to income tax. We suggest replacing 'income' with the term 'financial' or 'monetary'.

Clause 4(2) states that the trader must provide a file requested by the distributor no later than 10 working days after the distributor's request.

Although it is not clear from the drafting, it is assumed that the reference to the distributor's request refers to the strike date for payment eligibility. We are in regular contact with retailers about the process prior to the strike date.

In our experience 10 working days is too long as a material volume of switching can occur in the 10 working days from the strike date/date of distributor's request. For each ICP that switches after the strike date, the lists from retailers is subject to great volumes of omissions and duplicates.

We can address this by making our request 8 working days prior to the strike date, but this is simply a workaround solution to ensure files are supplied within a reasonable time after the strike date. We suggest updating the timeframe to 2 working days to avoid the need for distributors to resort to workarounds.

Our experience is that retailers largely have no problem providing the required information within 2 working days and it significantly reduces the number of wash-ups required as a result of initial data being inaccurate.

Clause 4(3) requires the distributor to return the file to the trader within 2 working days of receipt of the traders file.

Distributors' require all traders' files before confirming payments to each consumer as this allows us to identify omissions and duplicates. We are unable to identify omissions and duplicates until we have all trader files. This process as drafted does not allow us to provide an accurate file back to each trader if one trader provides their file late.

We suggest the timeline for distributor to trader file transfer to be "no later than 2 business days of receiving all trader files".

Provision of consumption data

Clause 4(d) of Schedule 12A.1, Appendix C states that data must not be combined with any other data or database. The value of consumption data to distributors is in the ability to combine data from traders for pricing and network management purposes. Preventing distributors from combining the data significantly decreases the value of the data provided.

We suggest removing the requirement to gain prior written agreement from the trader.

Clause 10(2)(a) states that the information security plan must ensure that data is physically and electronically quarantined and unable to be accessed by any person other than data team members. This clause as it is drafted would preclude storing the data on the same server, server room or possibly even the same building. This is impractical and in all likelihood would serve as a barrier to distributors requesting consumption data from traders.

Appendix A – Commercial implications of trader default

Network Tasman has recently had two retailers trading on our network abruptly exit the retail market and the prudential requirements as specified in the Code have left Network Tasman exposed to significant commercial risk. Network Tasman has adopted the Authority's MUoSA, which contains the same prudential requirements and termination processes as specified in the DDA. The following scenario runs through our experience of the process of terminating the UoSA as a result of trader default.

There are two ways a retailer can satisfy the prudential requirements – maintain an acceptable credit rating or provide sufficient security. Security can be provided via cash, third party guarantee (generally from a bank) or a combination of cash and third party guarantee.

Retailers can choose how they satisfy our prudential requirements.

We can require a total security equal to a reasonable estimate of the lines charges each distributor would be expected to pay over a two month period but must pay 15% interest on any 'additional security' we require over the 2 weeks referred to in the previous bullet point.

If the retailer chooses to provide security we can require the equivalent of 2 weeks of lines charges.

There are considerable information asymmetries between retailers and distributors about the retailer's financial sustainability and the retailer has a strong incentive to ensure distributors have no knowledge of any financial difficulties the retailer may be facing.

Network Tasman submits that given this information asymmetry, distributors are ill equipped to efficiently use the option to require 'additional security' from retailers. Given the considerable cost of holding the additional security distributors will avoid calling on it unless absolutely necessary and by the time it becomes apparent that additional security is necessary, there is very little likelihood that the retailer is unable to provide the security being called upon.

Even in the unlikely event that distributors could use the option of additional security with perfection, distributors are still exposed to commercial risk from failing retailers because a failing retailer will accrue more debts that exceed two months of lines charges.

Network Tasman bills retailers in arrears, with payment (generally) being due on the 20th of the following month – for example, an invoice for May lines charges is due for payment on 20 June. Should a retailer fail to pay an invoice, we only become aware of this on the 21st of the month, by which time the retailer has incurred 7 weeks of lines charges (assuming a 4 week month). On the 21st we can issue a breach notice – which requires the retailer to remedy the breach within 5 working days. Should the retailer fail to remedy the breach, we must wait one working day before we can issue a termination notice. If the default is a Serious Financial Breach (which is unlikely for the small retailers most likely to default) we only have to give 2 working days' notice of termination. If it is not a Serious Financial Breach we have to give 5 working days' notice of termination.

An added complication is that if the breach is not a Serious Financial Breach, the Authority's trader default process isn't triggered and the DDA provides no mechanism for a distributor to remove the retailer off its network. In fact, the DDA doesn't provide distributors with any mechanism to force a retailer that has had its UoSA terminated to stop operating on the distributor's network or to even stop them adding new customers. That process is managed by the Authority and MOSPs, which have no visibility or recognition of the fact a retailer is operating without a UoSA.

networktasman
Your consumer-owned electricity distributor

In the event that a trader continues to trade on our network following the termination of their agreement, a scenario we have experienced recently, we would have to allege a breach to the Authority. If not remedied, this breach would make its way to the rulings panel, which has the ability to stop a trader from operating on a network for which it doesn't have a UoSA. It is not clear how long this process would take, but we have been given informal guidance that this could take more than a month. This would result in outstanding debts of more than 4 months of lines charges.

In a best case scenario the table below outlines the events and debt accumulated as a result of a defaulting trader.

Event	**Debt**
Establish trader has an unpaid invoice - Issue breach notice	1 month and 21 days of lines charges
Window for trader to remedy the breach - 7 days (5 working days)	
Trader fails to remedy the breach	1 month and 28 days of lines charges
Stand-down period before issuing termination notice - one working day	1 month and 29 days of lines charges
Notice period for termination – Serious Financial breach - 2 working days	2 months and 1 day of lines charges
Convene EA board to begin trader default process - 7 days (5 working days)	2 months and 8 days of lines charges
Trader default process - 18 days	2 months and 26 days of lines charges

Assuming that the distributor has unsuccessfully requested additional security from the retailer, the distributor is left with debt of around two months and 12 days' worth of lines charges.

I am happy to discuss any further details, should the Authority have any questions.

Kind regards,

Daniel Vincent

Regulatory and Commercial Manager