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Proposal to amend the Electricity Industry Participation Code 2010

Send to info@ea.govt.nz or fax to 04 4608879

This form is to propose:

☒ An amendment to an existing clause in the Electricity Industry Participation Code 2010; or
☐ A new clause in the Electricity Industry Participation Code 2010.

Please complete as many sections of this form as possible and email or fax it to the above number/email address. The more information you include in your proposal, the faster your proposal will be able to be assessed/progressed.

Proposer's details

Name:	Keith Hutchinson
Position in company:	Regulatory Manager
Company:	Electricity Networks Association
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Signature:	
Date:	20 May 2021

The proposal / preferred option

Suggested proposal name (please keep it short)	Distributor Prudential Terms (additional security for repeated non-payment)
State the objective of your proposal.	Effective allocation of trader default risk, resulting in resulting lower costs for consumers.
Does the proposal relate to an existing Code clause? If yes, please state the full clause reference.	Yes, Sch 12A.4, cl 10. and clause 14.41(h)

Describe the specific amendment(s) that you propose be made to the Code *OR* attach a draft of the proposed Code amendment (optional). Note the Code drafting manual provides guidance on drafting.	Proposal 1. Amend Sch 12A.4, cl 10.7 create a special purpose additional security for repeated non-payment. Under which a Distributor may request from a trader an addition security where that trader fails to pay distribution charges by the due date three times in a rolling 12-month period. This special purpose security may only be held for 18 months from the date of the most failure to pay by the due date. Proposal 2. Amend Sch 12A.4, cl 10.8 to require that the special purpose security for repeated non-payment be provided as a third-party guarantee unless the trader provides specific reasons this is not possible. Proposal 3. Amend Sch 12A.4, cl 10.9 to remove the requirement for Distributors to pay interest on special purpose security for repeated non-payment. Proposal 4. Amend clause 14.41(h) to align the definition of an Event of Default with that set out in Sch 12A.4, cl 18.3. Allowing a Distributor to request the Electricity Authority start the trader event of default process where there has been a failure to remedy a breach of Agreement.
Identify how your proposal would support the Authority's objective, as set out in section 15 of the Electricity Industry Act 2010 (Act)[i], specifically addressing the competition, reliability and efficiency dimensions of the objective.	Details of how the proposal supports the Authority's objective, as set out in section 15 of the Electricity Industry Act 2010 is contained in section 3 of the attached proposal.
Which of the purposes listed in section 32(1) of the Act does your proposal most closely relate to?	32(1)(c) the efficient operation of the electricity industry.
Identify whether you consider your proposed change to be urgent, providing supporting rationale.	Amendment is not considered urgent.
Please set out the expected costs and benefits of your proposal. These should include your assessment of the direct cost to develop and implement the proposed Code amendment, and the consequential costs and benefits as a result of the amendments, to all affected parties.	The expected costs and benefits of the proposal are quantified in Appendix B of the attached proposal.
Who is likely to be substantially affected by this proposal?	Retailers and Distributors.

Identify whether you consider (providing supporting rationale): (i) your proposed change to be technical and non-controversial; or (ii) there is widespread support for your proposed change among the people likely to be affected; or (iii) there has been adequate prior consultation so that all relevant views have been considered.	The Electricity Networks Association has consulted widely with both distributors and retailers in the preparation of the proposed amendment. A summary of the engagement, the feedback received and how it has been taken into consideration can be found in Appendix C of the attached proposal.
Why this is your proposed option?	The option set out above and in the attached proposal is preferred as it: • resolves the imbalance in the allocation of trader default risk; • removes the incentive for traders to act in way that discourages the Distributors to hold additional security; and • lowers costs to consumers. It achieves this without placing additional regulatory burden or cost on either party.
Any other relevant information you would like the Authority to consider.	The attached proposal sets out, in detail, the context of the proposed amendments, its cost and benefits and provides evidence of the need for change.

Assessment of alternative options

Please list and describe any alternative means of achieving the objective you have described for your proposal. For each alternative, please provide the information in the table below (i.e. repeat this table below for each alternative). The list of alternatives should include both regulatory (i.e. Code amendments) and non-regulatory options (e.g. education, information, voluntary compliance). If you have a preferred option please identify it and explain why it is your preferred option.

Brief description of an alternative means of achieving the objective. Note if this is your preferred option.	An analysis of the alternative options considered is set out in the attached proposal (Table 2).
The extent to which the objective of your proposal would be promoted or achieved by this option.	See Table 2 of the attached proposal.
Who is likely to be substantially affected by this option?	See Table 2 of the attached proposal.
The expected costs and benefits of this option, including direct costs to develop it, and consequential costs and benefits to all affected parties.	See Table 2 of the attached proposal.

[i] ***Section 15: Objective of Authority***

The objective of the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.

Distributor prudential arrangements Code amendment proposal:

SUMMARY

1. The Electricity Networks Association (ENA) is applying for an amendment to the Electricity Industry Participation Code to improve the distributor prudential arrangements.

2. The proposed amendment is expected to benefit consumers primarily by promoting more efficient operation of the electricity industry through reducing the costs incurred by electricity distribution businesses (EDBs) of managing the risk and impacts of trader defaults. Specifically, the proposed amendment addresses a range of issues with the existing distributor prudential arrangements which inefficiently increase the cost of risk and inefficiently increase the cost of default. These issues are:

    a. an increased risk from trader default for EDBs due to uncertainty about whether prudential security reflects the credit risk of each trader (as EDBs do not have sufficient expertise or information to assess a trader's credit risk and probability of default)

    b. reduced ability for EDBs to fully mitigate the impact of a trader default because explicit and indirect constraints on the amount of prudential security requested from traders prevent alignment of security and credit risk

    c. inefficient costs incurred by EDBs for holding additional security because traders have the ability and incentive to select the highest cost method for providing additional prudential security, with no countervailing benefit

    d. extra credit management costs for EDBs because traders have the ability and incentive to not pay on time

    e. inefficient allocation of the costs of managing trader default because a proportion of the cost of risk is transferred from traders and the customers of each trader to consumers.

3. The proposed amendment is not expected to harm retail competition and may promote increased retail competition to the extent more efficient allocation of the cost of risk of trader default enables traders to direct capital from funding prudential security requirements to service delivery.

4. The ENA estimates the proposed amendment will result in operating cost savings of about $638,000 a year, representing a net benefit of $4.4 million (net present value) over 10 years. Consumers are expected to benefit through a combination of incremental improvements to the distribution service, reduced distribution charges and reduced retail prices.

5. The ENA's purpose in developing the proposed amendment is to balance the interests of EDBs and traders. The proposal has been developed with input from electricity retailers, following engagement with the Electricity Retailers Association of New Zealand, and Electric Kiwi, Flick Energy, and Pulse Energy.

PROPOSAL IS EXPECTED TO BENEFIT CONSUMERS THROUGH A REDUCTION TO THE COSTS OF RISK MITIGATION

6. The proposal is expected to benefit consumers through a reduction to the costs of mitigating the risk of trader default. The cost of prudential security is higher than necessary for EDBs and most traders. These extra costs are borne by consumers through distribution charges and retail prices. The costs can be reduced by amending the Code to:

    a. enable EDBs to request additional security from a trader which fails to pay distribution charges by the due date three times in a 12-month period, with the additional security applying for 18 months from the date of the most recent failure by the trader to pay distribution charges in full by the due date.

    b. remove the requirement for EDBs to pay interest on additional security if the additional security is imposed because there have been three late payments in a 12-month period

    c. require EDBs to pay an interest rate equal to the 90-day bank bill rate (BBR) plus 15% on cash-based additional security and the 90-day BBR plus 3% for a third-party guarantee when additional security is requested from a trader which has made fewer than three late payments in a 12-month period

    d. require traders to provide additional security requested after failing to pay distribution charges by the due date three times in a 12-month period as a third-party guarantee unless the trader provides specific reasons as to why this is not possible. Additional security provided at other times can be provided in as either cash or third-party guarantee at the traders' discretion.

PROPOSAL IS EXPECTED TO REDUCE THE SIZE OF THE OVERALL FINANCIAL EXPOSURE FROM A TRADER DEFAULT

7. The proposal is expected to reduce the size of the overall financial exposure from a trader default. EDBs potential financial exposure from a trader default arising from non-payment of distribution charges is higher than necessary due to outdated processes. Updating these processes would reduce potential financial exposure and reduce the associated costs of risk for EDBs and traders.

8. Costs can be reduced by amending the Code to reduce the time required for an EDB to complete the distributor agreement termination. The proposal is to reduce the time required for an EDB to complete the distributor agreement termination process following a serious financial breach by six working days by enabling an EDB to request the Electricity Authority start the trader default situation after notifying the trader of an event of default following a serious financial breach.

FURTHER WORK TO IMPROVE CREDIT RISK INFORMATION AND ASSESSMENT COULD BRING MORE SIGNIFICANT BENEFITS

9. Improved credit risk information and assessment could bring additional, potentially significant, benefits by enabling EDBs, and the wholesale market, to more accurately determine the amount of prudential security required from a trader given its expected probability of default.

10. EDBs do not have sufficient information on credit risk to estimate the appropriate prudential security required from a trader, except for the four traders with a credit rating. This lack of information creates significant uncertainty for EDBs and traders about whether the amount of security held is efficient. For EDBs, this uncertainty exacerbates the risk of trader default, and the associated cost of risk.

11. The same issue exists for the wholesale market. Wholesale market prudential security is set based on an assumption each trader has a 100% probability of default each month. A risk-adjusted approach to determining prudential security would reduce the amount of security required from all traders.

12. There are several options for the market to obtain an improved understanding of credit risk, thereby providing a more efficient basis for determining prudential security requirements and reducing the costs of prudential security.

13. A centralised credit risk assessment process could be established to obtain trader credit information and determine the efficient amount of prudential security. The same process could be used to set wholesale prudential security.

14. Establishing a centralised payment mechanism for distribution charges, and centralised holding of distributor prudential security, like the existing wholesale payment and prudential security arrangements, could be considered at the same time.

15. The ENA considers there is merit in developing a business case to identify the high-level costs and benefits of centralising credit risk assessment, centralising payment of distribution charges, and centralising holding of distributor prudential security.

16. The ENA recommends the Electricity Authority include developing an initial business case in its work programme.

17. The ENA would be pleased to participate in developing the business case, but does not consider it appropriate to lead the process due to the market-wide implications for existing market operation processes and systems, and the contractual relationship between the Electricity Authority and the relevant market operation service providers.

1. PURPOSE AND STRUCTURE OF THIS PAPER

18. This paper is prepared to support making a Code amendment proposal to the Electricity Authority and includes information required by the EA's Code amendment proposal process.[1]

    a. Section 2 provides the context for the proposals and describes the implications of the existing arrangements (the problem definition).

    b. Section 3 describes the proposals to improve the existing arrangements, plus the alternatives considered.

    c. Appendix A provides more details on the issues with the existing arrangements and the reasons for the proposals.

    d. Appendix B provides the assessment of the benefits and costs of the proposal relative to the status quo and the alternatives.

    e. Appendix C lists the parties the ENA discussed the proposal with, summarises the feedback received and the ENA response.

19. The Code amendment proposal form submitted to the Electricity Authority is based on this paper.

2. CONTEXT FOR PROPOSAL

20. Distributor prudential security arrangements are expected to assist EDBs to mitigate the risk and impact of a financial loss from a trader defaulting on payment of distribution charges and avoid prudential security costs creating a barrier to retailer entry and exit. Given these expected outcomes, the arrangements are designed to:

    a. assist EDBs to mitigate the impact of a trader default by requiring traders to provide prudential security equivalent to the risk and financial impact of a trader default

    b. prevent EDBs from requiring a trader provide 'too much' prudential security

    c. efficiently allocate the cost of managing the risk of trader default between EDBs (and all consumers) and traders (and customers of each trader).

21. The existing distributor prudential security arrangements were introduced via a series of Code changes between 2011 and 2014. The arrangements have these main elements:

    a. **Limits on the amount of prudential security an EDB can request from a trader** were introduced in October 2011. The limits are prescribed in Part 12A.

       An EDB can request a trader provide initial prudential security of two weeks (14 days) charges, with the option to request additional security up to a total of eight weeks (56 days) charges, subject to paying default interest on the additional six weeks (42 days) security. The intention was to balance the interests of EDBs and traders with an upper limit on the amount of prudential security a trader must provide.

[1] The EA's Code amendment proposal process is described here: https://www.ea.govt.nz/code-and-compliance/the-code/amendments/amending-the-code/.

b. **A regulated trader default scheme** prescribing a process and timeframe for a purchaser (a trader) which defaults on wholesale or distribution payments to transfer its customers (and associated financial obligations) to another trader. The scheme was introduced in early 2014. The Electricity Authority has discretion about whether to begin the trader default process.[2] Completing the process requires 17 elapsed days.

   Prior to 2014 an EDB had no effective way to exit a retailer failing to pay distribution charges other than disconnecting that retailers' customers. Disconnecting ICPs is not practicable for an EDB for reasons including cost, community expectations and contractual rights. Additionally, disconnection does not stop the financial loss. This occurs when a new trader takes on responsibility for the customer and associated distribution charges.

c. **A conditional ability for EDBs to request the Electricity Authority begin the trader default process** in response to the failure of a trader to pay distribution charges. Conditions include the non-payment being a serious financial breach[3] and the EDB terminating the distributor agreement with the trader. The process requires between 15 to 25 elapsed days, depending on the cause of the serious financial breach.[4]

EXPERIENCE WITH EXISTING ARRANGEMENTS HIGHLIGHTS ISSUES – PROBLEM DEFINITION

22. Prudential security is intended to assist EDBs manage the risk and impact of a trader default without imposing inefficient costs on traders.

23. The efficient amount of security provided by a trader will reflect the credit risk (and probability of default) of the trader and the EDBs financial exposure from default by that trader, and the security will be provided at lowest cost paid for by the appropriate party (the trader).

24. The existing distributor prudential security arrangements are not achieving these outcomes. The impacts are borne by consumers through inefficient increases to EDB and trader operating costs which result in a combination of a diminished distribution service, increased distribution charges and increased retail prices. Existing distributor prudential arrangements inefficiently increase the cost of risk and inefficiently increase the cost of default. These two problems are the result of:

    a. an increased risk from trader default for EDBs due to uncertainty about whether prudential security reflects the credit risk of each trader as EDBs do not have sufficient expertise or information to assess a trader's credit risk and probability of default.

[2] The trader default process starts after the Electricity Authority satisfies itself a trader has committed an event of default and provided notice to the defaulting trader. Refer clause 2, schedule 11.5 of the Code. This requirement applies for both distribution and wholesale-related defaults.

[3] A serious financial breach is defined in Part 1 of the Code as a failure by a retailer — (a) to pay to a distributor an amount due and owing that exceeds the greater of $100,000 or 20% of the actual charges payable by the retailer for the previous month, unless the amount is genuinely disputed by the retailer; or (b) to pay to a distributor 100% of the actual charges payable by the retailer for the previous two months, unless the amount is genuinely disputed by the retailer; or (c) to comply with the prudential requirements under a distributor agreement between the retailer and a distributor.

[4] A minor adjustment to the definition of serious financial breach was made in July 2020 as part of amendments to Part 12A introducing the default distributor agreement arrangements. The change implies a potential financial exposure equivalent to 113 days charges. The 113-day scenario is not discussed in this paper as the situation is not plausible.

b. reduced ability for EDBs to fully mitigate the impact of a trader default because explicit and indirect constraints on the amount of prudential security requested from traders prevent alignment of security and credit risk.

c. inefficient costs incurred by EDBs for holding additional security because traders have the ability and incentive to select the highest cost method for providing additional prudential security, with no countervailing benefit.

d. extra credit management costs for EDBs because traders have the ability and incentive to not pay on time.

e. inefficient allocation of the costs of managing trader default because a proportion of the cost of risk is transferred from traders and the customers of each trader to consumers.

25. These issues reduce the efficient operation of the electricity industry and potentially reduce retail competition. No impact is observed on the reliability of supply.

26. Appendix A provides more detail on the cause and impact of each of these issues.

INDICATIVE SIZE OF THE PROBLEM

27. The size of the problem is the difference between the total cost of mitigating the risk of trader default and the total amount of distributor prudential security held.

28. The frequency of late payment is a symptom of the problem and indicator of the probability of default by a trader. The frequency of late payment does not reflect the size of the problem.

29. The total cost of mitigating the risk of trader default can be estimated by calculating the expected (forward-looking) credit loss from an event of default. Historical credit losses are not a useful guide to the size of the problem because they do not reflect the current or future risk of trader default, particularly given ongoing changes to wholesale prices and market structure.

30. The expected credit loss calculation indicates the efficient amount of insurance or prudential security an EDB would want to hold for a trader of a given probability of default. This requires estimating the probability of default, probability of loss given default and financial exposure given default. The probability of default (ie, the credit risk) is the most difficult to accurately estimate as it depends on the current and near-term financial capability of each trader, and market conditions.

31. The total amount of distributor prudential security held can be calculated by summing the amounts of initial and additional prudential security held by each distributor.

32. Existing distributor prudential security arrangements result in prudential security being less than the risk-weight cost of trader default.

33. For example, for a small trader (3000 ICPs) with a credit risk equivalent to a CCC rating, EDBs would face an estimated expected credit loss of $200,000 (with no security), $160,000 (with 14 days initial security) and $44,000 (with 56 days additional security) were that trader to default on its wholesale market obligations.[5]

[5] The estimated financial exposure of EDBs in this scenario would be $740,000, nearly $600,000, and $165,000, respectively.

34. The scenario indicates the minimum size of the problem. Even with maximum additional security, the EDBs do not have the ability to fully mitigate the risk-weighted cost of a trader default and are expected to absorb a proportion of the costs, thereby diverting funds from delivering distribution services or returning the savings to consumers.[6]

35. The true size of the problem requires knowing the credit worthiness of each trader. This information is available only for the four listed traders with a credit rating. As such, the size of the problem is difficult to estimate.

36. The size of the risk is greater than when the current distributor prudential arrangements were introduced in 2013 and 2014 due to the significant increase in the number of entrant retailers with unclear capital backing, the increased volatility in the wholesale market, and the increasing intensity of retail competition affecting profitability. These factors, plus the risk of an economic downturn from major economic shocks like the pandemic, will have altered the risk bell curve, with a higher number of outlier high risk traders.

3. PROPOSALS TO IMPROVE DISTRIBUTOR PRUDENTIAL SECURITY ARRANGEMENTS

37. The objective of the proposed Code amendments is to promote more efficient operation of the electricity industry and to promote retail competition by improving distributor prudential arrangements.

38. Consumers would benefit from reductions to operating costs incurred by EDBs and retailers of managing the risk and impacts of a trader default situation by amendments to the Code to:

    a. enable EDBs to request additional security from a trader which fails to pay distribution charges by the due date three times in a 12-month period, with the additional security applying for 18 months from the date of the most failure to pay by the due date

    b. remove the requirement for EDBs to pay interest on additional security if the additional security is imposed because there have been three late payments in a 12-month period

    c. requiring EDBs to pay an interest rate equal to the 90-day BBR plus 15% on cash-based additional security and the 90-day BBR plus 3% for a third party guarantee when additional security is requested from a trader which has made fewer than three late payments in a 12-month period

    d. require a trader to provide additional security requested after failing to pay distribution charges by the due date three times in a 12-month period as a third-party guarantee unless the trader provides specific reasons as to why this is not possible. Additional security provided at other times can be provided in as either cash or third-party guarantee at the traders' discretion.

[6] EDBs remain 'under-insured' assuming a 10% probability of default (EA assumption for small traders) and a 3.75% probability of default (average annual default rate for firms with speculative grade ratings).

Note: refer discussion from paragraph 106 on the reasons the efficient allocation of cost of prudential security means the costs are borne by the trader.

e. reduce the time required for an EDB to complete the distributor agreement termination process following a serious financial breach by five working days by enabling an EDB to request the Electricity Authority start the trader default situation after notifying the trader of an Event of default following a serious financial breach.

EXPECTED OUTCOME AND IMPACT OF PROPOSED CHANGES

39. The expected outcome and impact of the proposals are described in Table 1. The proposals are expected to address the issues described in section 2 and Appendix A.

40. The practical impacts of the proposals include a reduction to the number of additional security deposits requested by EDBs. This outcome is expected because the 'three late payments' criteria for requesting additional security represents a higher threshold than the current discretionary approach.

41. Essentially the proposals introduce an additional process for an EDB to request additional security at no cost to it, subject to the request being made based on the best available objective measure of risk of trader default.

42. The proposal is expected to improve the balance between the interests of consumers (EDBs having sufficient security over risky retailers without incurring excessive costs) and the interests of traders (confidence they do not need to pay unnecessary additional security).

Table 1 Expected impact of proposed changes to distribution prudential security arrangements

Proposal	Expected outcome and impact
Proposal 1. Enable EDBs to request additional security from a trader which fails to pay distribution charges by the due date three times in a rolling 12-month period, with the additional security applying for 18 months from the date of the most recent failure to pay by the due date. Late payment refers to failure to pay in full the monthly EDB invoice for distribution services only, not washup or other payments.	The proposal is expected to realise net benefits to consumers by promoting more efficient operation of the electricity industry through improved allocation of the cost of risk of default. No adverse competition effects are expected. This outcome is expected from: • with proposal 2, reducing the disincentive for EDBs to request additional security from traders considered to have an elevated probability of default • with proposal 2, providing a consistent basis for EDB requests to traders to provide additional security which reflects EDB financial risk without imposing inefficient barriers to entry and expansion on traders • reducing EDB credit management costs by strengthening incentives for traders to pay EDBs on time with a clear financial consequence of regular late payment.

Proposal	Expected outcome and impact
Proposal 2. Remove the requirement for EDBs to pay interest on additional security if the additional security is imposed because there have been three late payments in a 12-month period Require EDBs to pay an interest rate equal to the 90-day BBR rate plus 15% for cash-based security or 3% for a third party guarantee for requests made at other times	The proposal is expected to realise net benefits to consumers by promoting more efficient operation of the electricity industry through more efficient allocation of the cost of prudential security and discouraging requests for prudential security not required given the credit risk. This outcome is expected from: • with proposal 1, removing the disincentive for EDBs to request additional security when required given the credit risk • with proposal 1, providing a consistent basis for EDB requests to traders to provide additional security which reflects EDB financial risk without imposing inefficient barriers to entry and expansion on traders.
Proposal 3. Require a trader to provide additional security as a third-party guarantee unless the trader provides specific reasons this is not possible or the EDB has requested the additional security for reasons other than three late payments in a 12-month period	The proposal is expected to realise net benefits to consumers by reducing the risk to EDBs caused by uncertainty about the alignment between security and credit risk by increasing the likelihood that banks and parties with credit risk expertise will be involved in the assessment of credit risk of individual retailers when asked to provide a third-party guarantee.
Proposal 4. Reduce the time required for an EDB to complete the distributor agreement termination process following a serious financial breach by six working days by enabling an EDB to request the Electricity Authority start the trader default situation after notifying the trader of an Event of default following a serious financial breach.	The proposal is expected to realise net benefits for consumers by promoting more efficient operation of the electricity industry by reducing EDBs potential financial exposure from a trader default. No adverse competition impacts are expected, particularly because the premise that the termination process encourages commercial negotiation does not reflect experience. This outcome is expected from: • aligning distributor prudential security arrangements with the related trader default process, plus current (and future) market circumstances, rather than continuing with a practice developed in the early-2000s • reducing an EDBs potential financial loss from a distributor-initiated trader default six working days. This would reduce default related costs borne by consumers • reducing EDB credit management costs by reducing the incentive for a trader to pay late (by reducing the time required to start the trader default process).

PROPOSAL TO CONSIDER FURTHER CHANGES TO IMPROVE AVAILABILITY OF CREDIT RISK INFORMATION

43. The proposals do not fully address the costs arising from the difficulty faced by EDBs to estimate with reasonable accuracy the amount of prudential security required from a trader given its credit risk and probability of default.

44. EDBs do not have sufficient information on credit risk to estimate the appropriate prudential security required from a trader, except for the four traders with a credit rating. This lack of information creates significant uncertainty for EDBs and traders about whether amount of security held is efficient. For EDBs, this uncertainty exacerbates the risk of trader default and increases the amount of prudential security required to manage that risk.

45. Improved credit risk information and assessment could bring more significant benefits by improving estimates of prudential security requirements.

46. The ability for EDBs to request additional security equivalent to the actual credit risk associated with a specific trader could realise efficiency benefits through reduced prudential security and improved allocation of the cost of risk of default. Traders would be requested to provide prudential security which reflects their credit risk, rather than a conservative estimate. Additionally, traders with a higher credit risk would bear a cost of risk of default which reflects their credit risk.

47. The cost for each EDB to individually obtain trader credit risk information and assess credit risk could be significant.

48. There are several options for the market to obtain an improved understanding of credit risk, thereby providing a more efficient basis for determining prudential security requirements and reducing the costs of prudential security.

49. A centralised credit risk assessment process could be established to obtain trader credit information and determine the efficient amount of prudential security. The function could be outsourced to a party with relevant expertise – credit risk assessment and monitoring is a core function for banking and insurance firms. The same party could set wholesale prudential security.

50. Establishing a centralised payment mechanism for distribution charges, and centralised holding of distributor prudential security, like the existing wholesale payment and prudential security arrangements, could be considered at the same time.

51. The ENA considers there is merit in developing a business case to identify the high-level costs and benefits of centralising credit risk assessment, centralising payment of distribution charges, and centralising holding of distributor prudential security.

ALTERNATIVES CONSIDERED

52. The alternatives to the proposals considered are described in Table 2.

Table 2 Alternatives to proposals

Alternative	Reasons for rejecting
Do nothing	Doing nothing incurs costs equivalent to the benefits of the proposals. Consumers would be worse off.
Increase initial security amount from two weeks (14 days) to four weeks (28 days)	Increasing the amount of initial security would increase the cost of prudential security for an uncertain benefit. Many traders would be required to provide excessive security amounts. An improved understanding of trader credit risk and probability of default is required to determine whether the amount of initial security adequately reflects associated credit risk.
Increase additional security amount from six weeks (42 days) to eight weeks (56 days) to allow EDBs to hold security of up to 70 days	Increasing the amount of additional security would increase the cost of prudential security for an uncertain benefit. The ability for EDBs to request extra additional security could result in traders providing excessive security amounts without an effective method for determining if the extra security is required. An improved understanding of trader credit risk and probability of default is required to determine whether the amount of initial security adequately reflects associated credit risk.
Increase credit rating threshold from BBB- to BBB	Increasing the credit rating threshold would increase the cost of prudential security for an uncertain benefit. An improved understanding of trader credit risk and probability of default is required to determine whether a higher credit rating would materially alter the risk and impact of a trader default. S&P Global corporate default rate data indicates firms with a BBB rating have a 0.17% annual probability of default compared to a 0.25% annual probability of default for firms with a BBB- rating.
Require trader default process to begin five days following event of default unless Electricity Authority decides otherwise	Reduces discretion of market regulator with potential adverse implications for resolving a trader default prior to starting the regulated trader default process. A key risk is disruption of commercial negotiations for sale of the defaulting traders' customer base, thereby reducing the value of the business.
EDBs agree alternative prudential arrangements with traders via alternative distribution agreements	Relies on mutual agreement between each EDB and the traders operating on their networks. Current arrangements favour traders with an elevated credit risk. Does not address Code-related issues.

APPENDIX A: ASSESSMENT OF ISSUES AND REASONS FOR PROPOSAL

53. Distributor prudential security arrangements are expected to assist EDBs to mitigate the risk and impact of a financial loss from a trader defaulting on payment of distribution charges and avoid prudential security costs creating a barrier to retailer entry and exit. The arrangements are designed to:

    a. assist EDBs to mitigate the impact of a trader default by requiring traders to provide prudential security equivalent to the risk and financial impact of a trader default

    b. prevent EDBs from requiring a trader provide 'too much' prudential security

    c. efficiently allocate the cost of managing the risk of trader default between EDBs (and all consumers) and traders (and customers of each trader).

54. The intention is to balance the interests of EDBs and traders to promote the efficient operation of the electricity industry and to promote retail competition for the long-term benefit of consumers.

55. The existing distributor prudential security arrangements are not achieving these outcomes for the following reasons:

    a. an increased risk from trader default for EDBs due to uncertainty about whether prudential security reflects the credit risk (because EDBs do not have sufficient expertise or information to assess trader's credit risk and probability of default)

    b. reduced ability for EDBs to fully mitigate the impact of a trader default because explicit and indirect constraints on the amount of prudential security requested from traders prevent alignment of security and credit risk

    c. inefficient costs incurred by EDBs for holding additional security because traders have the ability and incentive to select the highest cost method for providing additional prudential security, with no countervailing benefit

    d. extra credit management costs for EBDs because traders have the ability and incentive to not pay on time

    e. inefficient allocation of the costs of managing trader default because a proportion of the cost of risk is transferred from traders, and the customers of each trader, to consumers.

UNCERTAINTY ABOUT THE LEVEL OF CREDIT RISK DUE TO A LACK OF INFORMATION

56. EDBs face increased risk from trader default due to uncertainty about whether prudential security reflects the credit risk because EDBs do not have sufficient expertise or information to assess trader's credit risk and probability of default. This increased risk increases costs by increasing the amount of security needed to mitigate the risk.

57. Central to determining the efficient amount of security needed is the credit risk or probability of default of each trader.

58. EDBs do not have sufficient information on credit risk to estimate the appropriate prudential security required from a trader, except for the four traders with a credit rating. This lack of information creates significant uncertainty for EDBs and traders about whether the amount of

security held is correct (ie, efficient). This uncertainty exacerbates the risk and cost of a trader default because the impact is known while the likelihood is uncertain. The impact is to increase incentives on EDBs to adopt more conservative estimates of the level of risk and require an increased amount of prudential security.

59. The existing arrangements do not address this information asymmetry problem. EDBs have discretion to request additional security to reflect their assessment of credit risk. However, there is no effective mechanism for EDBs to obtain credit risk information.[7] EDBs use proxy data to assess credit risk, such as late payment rates. The result is EDBs remain uncertain that the amount of security reflects the level of risk.

60. Similarly, traders will not be confident the amount of security is appropriate. Because probability of default is not explicitly or consistently considered when determining security levels, it is plausible that due to the power of averaging most traders provide more security than efficient, while the riskier traders provide less security than is efficient.

61. **Table 3** provides a reference point for the relationship between the probability of default of a trader and the amount of security an EDB can hold to insure against a trader default.

62. Initial security provides sufficient risk-weighted insurance up to a 20% probability of default. With additional security, an EDB would have sufficient risk-weighted insurance up to a 75% probability of default.

63. Expert advice is required to determine the probability of default for each retailer. However, the estimates indicate that the 14-day initial security provides adequate security for traders with a probability of default below 20%, but more security is required for more risky traders.

Table 3 Indicative estimate of security required given a probability of default

Probability of default	14 days (initial) security as % expected credit loss	56 days (additional) security as % expected credit loss
0.17% (BBB rating default rate 1-year period)	11,440%	45,750%
0.25% (BBB- rating default rate 1-year period)	7780%	31,100%
3.75% (average of speculative grade ratings 1-year period)	519%	2075%
20%	97%	390%
27% (CCC/C rating default rate 1-year period)	72%	290%
75%	26%	100%
100%	19%	78%

[7] Clauses 10.12(c) and 10.15 of the Code oblige a trader to inform an EDB if it has 'reasonable cause to believe that its financial position is likely to be materially adversely impaired such that its ability to pay for Distribution Services will be affected'. The intent of these clauses is to provide EDBs information relevant to the credit risk of a trader. However, the clauses are not effective as there are strong incentives for a trader to withhold information to avoid higher prudential security costs and no effective sanction.

Note: Expected credit loss calculated based on financial exposure of 72 days (wholesale-related default), and probability of default based on credit rating data from S&P Global.

64. The expected credit loss is a method for estimating the amount of prudential security required from a trader, thereby placing a value on the EDBs financial risk. The expected credit loss is calculated as the function of the probability of default, the probability if loss given default and the financial exposure given default.

INABILITY TO MITIGATE THE IMPACT OF A TRADER DEFAULT DUE TO EXPLICIT AND INDIRECT CONSTRAINTS

65. The potential financial loss by an EDB from a trader default situation is determined by the amount of distribution charges owed by the defaulting trader at the time of default, plus the charges incurred during the period required for the customers of the defaulting trader to be transferred to another trader.

66. An EDBs potential financial loss from a trader default depends on the cause of the default and the amount of security held. The potential financial loss from a trader default due to the failure by a trader to pay distribution charges is 97 days charges assuming no prudential security.[8] The potential financial loss from a trader default due to the failure by a trader to pay wholesale charges is 72 days charges assuming no prudential security.[9]

67. An EDB can offset the potential financial loss by requiring a trader to provide initial security (14 days) and additional security (42 days, making a total of 56 days security).

68. EDBs incur inefficient costs from under-procurement of prudential security. Under-procurement occurs when the amount of prudential security held is less than the potential financial loss for an EDB of a trader default.

69. Under-procurement is a feature of the existing arrangements for two main reasons:

    a. restrictions on the amount of security which an EDB can request, with security additional to 14 days charges discouraged and capped at 56 days charges

    b. the extended process an EDB must use to start the trader default process.

70. **Table 4** provides an indicative estimate of the extent of under-procurement of security when the EDB starts the trader default process. With 14 days security the EDB is exposed to 83 days of non-payment (86%) and with the additional security the EDB is exposed to 41 days on non-payment (42% of the potential financial loss).

[8] A potential financial loss of 97 days from an EDB-initiated trader default is based on a default occurring on 20th of the month, with the trader owing the 30 days charges from the prior month, the 20 days charges owing for the month to date, charges incurred during the 15 to 25 day process for an EDB to terminate the distributor agreement with the trader for a serious financial breach (the 97 day estimate reflects the 25-day process), the charges incurred in the 5 or more day period for the Electricity Authority decision to approve starting the trader default process, and the charges incurred during the 17 day trader default process.

[9] A potential financial loss of 72 days charges from a wholesale-related trader default is based on a default on 20th of the month, with the trader owing 30 days charges for the prior month, plus the 20 days charges for the month to date, plus charges incurred during the 5 or more day period for the Electricity Authority to start the trader default process, plus charges incurring during the 17 day trader default process.

Table 4: Indicative financial loss and financial exposure given EDB started trader default

Per installation connection point	Days	$/ICP	% of potential financial loss
Potential financial loss given default	97	$323	-
Exposure with 14 days security	83	$276	86%
Exposure with additional security	41	$137	42%

Note: indicative cost per ICP based on on the Vector ARHLC, WRHLC TOU rate on 1 April 2020 for an ICP consuming 30kwh/day (60% peak, 40% off-peak). The potential financial exposure of 97 days assumes a trader default process started by an EDB after the trader fails to replace security. This is the most likely EDB-initiated default situation.

71. For an EDB started trader default process, the EDB has a financial exposure equivalent to between 42% to 86% of the distribution charges incurred by defaulting trader before and during the exit process depending on the amount of security held. This represents a probability of loss given default of 100%.[10]

72. An EDBs financial exposure is less if the trader default process starts due to a failure by the trader to make wholesale market-related payments. In this situation, the potential financial loss is 72 days charges ($240/ICP) with no security, 58 days charges ($193/ICP) with 14 days security and 16 days charges ($53/ICP) with full additional security.[11]

73. As noted in paragraphs 61 to 64 the financial exposure does not represent the efficient amount of security required unless there is a 100% probability of default. After adjusting for risk, the current arrangements mean EDBs will under-procure security for traders with a probability of default greater than 20% if only relying on the 14 days initial security.

Restrictions on the amount of security which can be requested

74. The arrangements are designed to compensate traders for the cost of providing additional security by requiring EDBs to pay a retailer a default interest rate[12] on additional security held over 14 days charges. The (intentional) effect is to discourage EDBs from requesting more than 14 days security. EDBs are also prevented from requesting security equivalent to more than 56 days charges.

75. The impact is EDBs face a 100% probability of loss given default. Even with additional security, an EDB is exposed to a minimum loss of 22% of the amount owed by the defaulting retailer assuming a wholesale market caused default (72 day process). Without additional security and assuming an EDB-initiated default, an EDB is exposed to a loss of 86% of the amount owed. The financial impact will differ between EDBs based on their pricing.

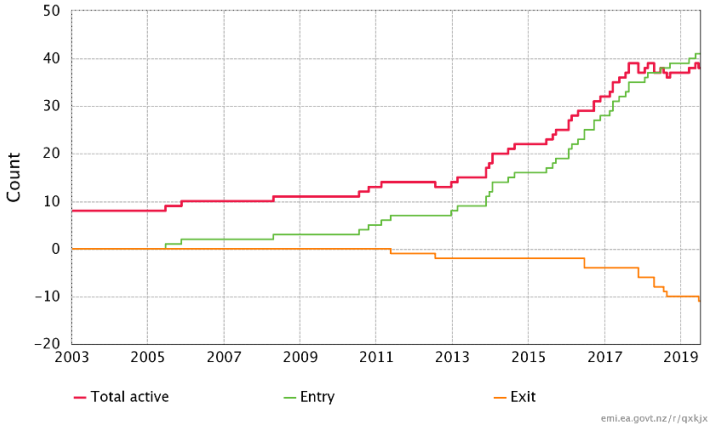
[10] A possible exception to the 100% probability of loss given default is for a trader with a credit rating and traders with generation assets which could be sold through a liquidation process.

[11] The minimum potential financial loss for a wholesale market related trader default is 72 days, with the default occurring on 20th of the month, the EDB being owed 30 days charges for the prior month (assumes distribution charges are unpaid if wholesale market payments are not paid), and 20 days charges for the month, plus 5 days for the Authority to decide to start the trader default process, plus the 17 days of the trader default process.

[12] The Code specifies the default interest rate for cash-based additional security as the 90-day bank bill rate (BBR) + 15%, meaning the current rate paid on cash-based additional security is about 15.25%. The default interest rate for third-party additional security is the BBR + 3%. The 15% and 3% rates reflect 2011 assumptions about the cost to traders of borrowing (unsecured) funds or purchasing a bank guarantee. Refer EA, Standardisation: Model use-of-system agreements and proposed cost amendments consultation paper, 11 August 2011, paragraphs 4.8.18-4.8.20.

76. The Electricity Authority decision in 2011 to restrict the amount of security requested was made assuming there would not be a material risk or cost for EDBs because the annualised level of retailer bad debt was expected to be relatively small. The Electricity Authority assumed a probability of default of 1 in 10 years for small retailers and 1 in 40 years for large retailers.[13]

77. Electricity Authority data indicates the number of active retailers increased from 11 to 38 between June 2011 and June 2020, with 11 exits in the same period.[14]



78. All exits followed the sale of customer base, though in at least two instances the sale occurred during the sale phase of the trader default process.[15] These retailer exits are understood to have resulted in financial losses for several EDBs.

79. **Table 5** provides an indicative estimate of the financial impact based on a defaulting retailer having 100, 1000 and 10,000 ICPs.

Table 5: Indicative financial loss from a retailer default for all EDBs

Financial loss from defaulting retailer with:	Total potential loss	With 14 days security	With 56 days security
100 ICPs	$32,000	$28,000	$14,000
1000 ICPs	$323,000	$277,000	$137,000
10,000 ICPs	$3,230,000	$2,764,000	$1,365,000

Note: Assumes EDB-initiated default and potential financial loss equivalent to 97 days charges; indicative cost per ICP based on the Vector ARHLC, WRHLC TOU rate on 1 April 2020 for an ICP consuming 30kwh/day (60% peak, 40% off-peak). All figures rounded to nearest '000.

80. At 30 June 2020, there were 24 traders with fewer than 1000 ICPs (total of 2764 ICPs); 5 traders with between 1000 and 10,000 ICPs (total of 15,541 ICPs); and 4 traders with 10,000 to 100,000 ICPs (total of 190,063 ICP).

Extended process for EDBs to start the trader default process increases EDB potential financial loss with no obvious benefit

81. The distributor prudential security arrangements rely on the trader default scheme introduced in early 2014. The key element of the scheme relevant to distributor prudential security arrangements is the conditional ability for EDBs to initiate the default process.

[13] Electricity Authority, May 2011, More standardisation of distribution arrangements consultation paper, page 79. A 1 in 10-year event has an annual probability of 10%. A 1 in 40-year event has an annual probability of 2.5%

[14] Electricity Authority, EMI, Entry and exit report, at www.emi.ea.govt.nz/r/qxkjx. Note, some retailers continued operating as a separate brand after exit. For example, Wise Prepay Energy exited as a parent company in April 2019 on being sold to Nova but continues operating as separate brand.

[15] The trader default process was started for Payless Energy and NextGen after they failed to pay the clearing manager.

82. The Code requires EDBs to follow a 15 to 25-day distribution agreement termination process[16] following a serious financial breach prior to the commencement of the trader default process. The termination process extends an EDBs potential financial loss from a trader default without providing an obvious benefit. The termination process specified in the Code is summarised in **Table 6**.

Table 6: Process to terminate a distributor agreement for a serious financial breach

Serious financial breach cause	Call security	Replace security	Breach of agreement	Remedy	Event of default	Pause	Terminate	Advise Authority	Total working days
Fail to pay amount >$100k or 20%	-	-	1	2	1	1	5	1	**11**
Fail to pay and replace security	2	5	1	2	1	1	5	1	**18**

Note: 11 working days is 15 elapsed days. 18 working days is 25 elapsed days. Working days are converted to elapsed days by dividing by 5 and multiplying by 7.

83. The underlying reason for the conditional ability for EDBs to initiate the default process was to give maximum opportunity for the EDB and retailer to reach a commercially negotiated outcome.

84. The termination process was developed by industry working groups in the early 2000s to allow for commercial negotiation. The assumption was the period would be used by the retailer to obtain finance to cover the outstanding distribution charges or transfer its customers.

85. Experience of EDBs since 2014 indicates the assumption is not relevant to current circumstances. The process was designed for circumstances without a regulated prudential regime, without a regulated trader default process and with significantly fewer retailers. Commercial negotiation, followed by legal action, were the main options available when an EDB went unpaid by a retailer.

86. Circumstances are now different with a regulated prudential regime and regulated trader default process.

87. The assumption the termination process was necessary to effect a managed exit may have been appropriate when developed by industry working groups in the early 2000s. Particularly as prior to 2014, EDBs had no practical way to exit a trader in default. The assumption – reflected in the model use-of system agreement (UoSA) termination process – was that an EDB and a defaulting retailer would resolve the situation by commercial negotiation.

88. The trader default process introduced in 2014 provided EDBs an effective way to exit a retailer failing to pay distribution charges by creating a hard stop to commercial negotiation.

89. Commercial negotiation remains a preferred tool for EDBs to manage late payment by retailers. This reflects the discretion given to EDBs to use the termination process. This discretion is routinely used, indicating the termination process is not required for commercial

[16] The termination process requires 15 days (11 working days) if the serious financial breach is a failure to pay an amount greater than $100,000 or 20% of the amount owed or 25 days (18 working days) if the serious financial breach is a failure to replace security.

negotiation to occur.[17] Experience indicates starting the default process is a last resort for EDBs unable to address issues by commercial negotiation.

90. In this context, the effect of prescribing the 15 to 25-day termination process is to increase an EDB's potential financial loss while it waits to start the trader default process after exhausting all commercially negotiated options. Effectively there is a duplicate process which results in costly delays. EDB experiences with retailer defaults since 2014 support the conclusion the termination process is not required for commercial outcomes or a managed transfer of customers. Instead, it is acting to delay exit and increase the potential financial loss.

91. The trader default process exists to ensure a managed transfer of a defaulting retailers' customers if a commercially negotiated transfer does not occur. Experience indicates the termination process 'extra' time delays the exit without making a managed exit more likely. In effect, the EDB is providing the retailer an unsecured loan while it attempts to sell its customers. Reducing or removing the termination process would reduce an EDB's potential financial loss and strengthen incentives for a retailer to begin the sale process before it failed, without altering the incentives for commercial negotiation or altering the likelihood of a managed exit of a defaulting retailer.

INEFFICIENT COSTS FROM DEFAULT INTEREST ON CASH-BASED ADDITIONAL SECURITY

92. The default interest rate for cash-based additional security of BBR + 15%, and the discretion for traders to offer cash-based security, creates a perverse incentive for retailers to select the highest cost method for providing additional security, despite a bank guarantee delivering equivalent security at a lower cost. The impact is to increase EDB operating costs with no countervailing benefit.

93. Under existing arrangements an EDB can request additional security, subject to paying default interest on the additional security. The retailer has the option to provide additional security using cash or a bank guarantee. The additional interest rate is the BBR plus 15% for cash and 3% for third party security.

94. Retailers requested to provide additional security have a strong incentive to offer cash. The default interest rate which must be paid by the EDB on cash significantly exceeds commercial rates.

95. Retailers show an overwhelming preference for providing cash-based additional security. Based on EDB information, 100% of additional security deposits held by 21 EDBs in October 2020 were cash-based.

96. EDB operating costs are higher than necessary due to the ability and incentive for retailers to prefer cash-based additional security. A bank guarantee delivers equivalent security at a lower cost. At current BBR, an EDB will pay $1.53 a year for every $10 of cash-based additional security, compared to $0.33 a year for every $10 of guaranteed additional security.[18] This represents an extra $1.20 a year in costs incurred by EDBs for every $10 of additional security without any corresponding change to the associated credit risk.

[17] EDB information indicates that over 3 years about 9% of late payment events were regarded as a serious financial breach and 2% of late payment events resulted in an EDB starting the termination process.

[18] The 90-day BBR rate as at 30 October 2020 was 0.27%. Refer https://www.rbnz.govt.nz/statistics/key-graphs/key-graph-90-day-rate. The default rate for cash-based additional security is 15% + 0.27% = 15.27%. The default rate for guaranteed based additional security is 3$ + 0.27% = 3.27%.

97. The cost discourages EDBs from requesting additional security, with additional security requested as a last resort rather than based on actual credit risk. This is a further reason for under-procurement of security, contributing to an inefficient allocation of the cost of risk of default by requiring EDBs and consumers to provide an implicit subsidy to retailers with a higher credit risk (not matched by equivalent prudential security).

98. Additionally, the preference for cash means banks (which are more expert at credit assessment than EDBs) are less likely to be involved in the credit assessment process, resulting in increased uncertainty about a retailer's level of credit risk. An expert assessment might show the credit risk to be lower than assessed by the EDB or higher (ie, the bank may choose to not sell a guarantee, or do so for a premium).

INEFFICIENT COSTS FROM PERVERSE INCENTIVE FOR LATE PAYMENT

99. The materiality threshold for an EDB to request a start to the trader default process, and the 15 to 25-day distribution agreement termination process, reduces an EDBs ability to apply standard credit management practices, creating the ability and incentive for traders to not pay on time, particularly if facing cashflow shortfall. The impact is higher EDB operating costs.

100. Together the requirement for a serious financial breach and the termination process provide a regulated late payment process which allows a retailer to obtain multiple days free or cheap credit on 30 or more days of charges.

101. EDB information indicates differing frequency of late payment events. On average, each EDB experiences two late payment events a month. Each EDB also experience an average of one late payment event a month when payment was made more than four days late.

102. The Electricity Authority was unsympathetic to EDB concerns about late payment in its 2011 distributor prudential security decision, noting a retailer that can settle the payment by the due date, but chooses not to, is a slow payer and holding high levels of security does not in itself change the behaviour of these slow payers. It considered EDBs were tacitly or explicitly allowing slow-paying retailers the ability to extend their credit terms and should apply remedies such as applying Default Interest on outstanding amounts.[19]

103. The Electricity Authority is correct regarding the incidence of late payment not being changed by the amount of prudential security. However, experience since 2011 indicates a mis-match between the ability and incentives for late payment and the effectiveness of the remedies and sanctions available to EDBs.

104. Late payment is more frequent than desirable because other elements of the distributor prudential security arrangements provide a retailer:

    a. the ability to make late payments. The termination process, and the presumption of commercial negotiation in effect requires the EDB to extend credit past the payment due date

    b. the incentive to make late payments because the sanctions and remedies are not effective. Applying default interest is not an effective sanction, particularly compared to the sanction

[19] Electricity Industry Participation Code 2010, Part 12A, Schedule 12A.4, Appendix A, clause 9.6. …If any part of a Tax Invoice that is properly due in accordance with this Agreement is not paid by the due date, Default Interest may be charged on the outstanding amount for the period that the Tax Invoice remains unpaid. Default Interest Rate" means the Interest Rate plus 5%. "Interest Rate" means… the bid rate for 3-month bank accepted bills of exchange.

for late payment to the Clearing Manager.[20] The last resort remedy of starting the trader default process involves considerable time and effort and can be averted at the last minute.

105. The impacts of the resulting increased frequency of late payment by retailers are the opportunity cost of management time, opportunity cost of funds not received on time, and potentially higher revenue at risk.

EFFICIENT ALLOCATION OF PRUDENTIAL SECURITY COSTS BY ALIGNING THE SOURCE OF THE RISK AND COST OF MITIGATING THE RISK

106. The distribution prudential security arrangements share the costs of prudential security between the EDB and the trader. Traders incur the cost of initial security. EDBs incur the cost for additional security (assuming the default interest is equivalent to the opportunity cost of the additional security).

107. This allocation is not efficient. Requiring EDBs and all consumers to bear some of the cost of prudential security represents a regulated subsidy to traders with an elevated credit risk.

108. Suppliers of a good or service are exposed to financial risk whenever payment is made after goods or services are supplied. The risk can be managed by the supplier in several ways, including making a credit loss provision, purchasing trade credit insurance, or requiring a bond or security deposit from the purchaser.

109. Additionally, in most cases, the supplier can withhold the good or service if payment for previous deliveries has not been made. For example, electricity retailers disconnect customers for non-payment.

110. The purchaser incurs the cost of a bond or security deposit, with the cost passed to its customers. In contrast, when the supplier incurs the cost of a credit loss provision or trade credit insurance, the cost is passed to its customers (ie, all purchasers of its goods or services).

111. The choice of risk management option should reflect the relative ability of the supplier or the purchaser to manage the risk and efficient allocation of the cost of risk management.

112. The financial risk of non-payment of wholesale costs and distribution charges is managed using a bond or prudential security.

113. Prudential security is the efficient method for managing the financial risk of default when:

    a. the supplier has less ability than the purchaser to manage the credit risk

    b. the costs of risk management are more appropriately borne by the customers of the purchaser rather than the customers of the supplier.

114. EDBs have limited ability to manage or alter the credit risk of individual retailers, particularly as an EDB cannot practicably withhold supply of the distribution service. The credit risk of a retailer is determined by its ability to meet its financial commitments from the payments made by its customers. An EDB has limited ability to alter the ability of a retailer to meet its

[20] For each 10 ICPs, the default interest of BBR + 5% represents an indicative cost to the trader of $4.31 a day. The financial impact does not represent a credible sanction for late payment. Further the EDBs administration costs of applying the sanction would plausibly outweigh the penalty, if received from the trader.

financial commitments (aside from setting distribution charges) or to ensure payment by its customers.

115. Following from this, allocating the costs of prudential security to traders achieves a more efficient allocation of the cost of credit risk.

116. The cost of a credit loss provision or trade credit insurance would be borne equally by all consumers on the EDBs network, despite the source and size of the credit risk being retailer specific. Smearing the cost of credit risk means consumers supplied by lower credit risk retailers will be paying slightly higher distribution charges than would be the case if the costs of credit risk were allocated according to specific credit risk.

117. Allocating a share of prudential security costs to EDBs and all consumers via distribution charges may improve competition by reducing each trader's operating costs. However, requiring each trader to bear the actual cost of risk is unlikely to reduce competition. In a workably competitive market, the cost would be borne by the trader or the customers of that trader would pay a price reflecting its operating costs.

118. Allocating the cost of risk (prudential security) to each trader is likely to promote dynamic efficiency by exposing each business to its true cost of supply. The current situation could be contributing to sustaining firms which are not commercially viable over the long term (ie, the subsidy could be in part responsible for zombie traders which should otherwise exit the market or not enter in the first instance).

EDB ability to recover bad debt costs does not address underlying problem

119. EDBs can recover some foregone revenue from a trader default. Non-exempt EDBs can recover up to 77% of foregone revenue under the incremental rolling incentive scheme, while exempt EDBs can recover additional costs to the extent they can increase charges.[21]

120. The Electricity Authority decision in 2011 to restrict the amount of security requested was made assuming the additional costs associated with retailer non-payment of distributor charges could be recovered, either through price increases, through the weighted average cost of capital, or through increased operating expense allowances for bad debt in the subsequent regulatory period.

121. The ability for EDBs to recover some foregone revenue does not address the underlying problem. The effect is to transfer the cost of a trader default from the failed trader to the EDB and consumers, thereby inefficiently increasing the cost of supply and distribution charges. When borne by the retailer, it is an efficient cost because it is an operating cost of a retailer of that risk profile.

[21] Commerce Commission, Revenue cap for electricity distribution businesses and Covid-19 related impacts, question 8, at: https://comcom.govt.nz/__data/assets/pdf_file/0022/223753/Revenue-cap-guidance-for-electricity-lines-businesses-August-2020.PDF. The default price path revenue cap provides for EDBs to recover their operating expenditure forecast. Higher or lower bad debt represents a change in operating expenditure, meaning higher bad debt (ie, from a trader default) is subject to the incremental rolling incentive scheme. Net under recovery of operating expenditure, including bad debt, is shared between the EDB and consumers over time. The current settings mean EDBs will bear (not recover) 23% of foregone revenue from a trader default on a present value basis.

APPENDIX B: ASSESSMENT OF COSTS AND BENEFITS OF PROPOSAL

122. **Table *7*** gives an overview of the expected effect of each proposal and the resulting economic benefit and cost.

123. The proposals are expected to realise cost savings of $638,000 a year, representing a net benefit of $4.3 million over 10 years, relative to the status quo.

124. The costs of the initial four proposals are expected to be small. The proposed changes are not expected to alter the status quo benefits of the current arrangements, such as those arising from promoting retail competition.

125. The main costs of the proposed interventions are associated with completing Code change process and implementation – these are estimated to be a one-off $100,000. Ongoing operating costs, specifically costs incurred by traders or EDBs relating to additional security, are nil for the purpose of calculating economic costs. There are two reasons:

    a. an EDB will incur additional security costs only when requesting additional security without applying the three late payment criteria. These costs result from a business decision and represent an efficient operating cost for that EDB. As such, these costs are not economic costs.

    b. a trader will incur additional security costs when an EDB requests additional security applying the three late payment criteria, or discretion. Additional security costs incurred from applying the three late payment criteria represent efficient operating costs for a business of that risk profile. Additional security costs incurred at other times will be compensated for by the EDB paying default interest. As such, these costs are not economic costs.

Table 7 Overview of expected effect of proposals and economic benefit and costs

Proposal	Expected effect	Benefit	Cost
1. Enable EDBs to request additional security after three late payment events	• Reduce constraint on requesting additional security (EDBs request additional security when required given implied credit risk) • Avoid requests for unnecessary additional security (ongoing) • Strengthen incentives for on-time payment (reduced frequency of late payment)	• Reduce costs of under-procurement of security • Reduced credit management costs	• Implementation costs: Code change costs • Ongoing costs: nil

Proposal	Expected effect	Benefit	Cost
2. Remove default interest on additional security requested after three late payment events	• Reduce constraint on requesting additional security • Avoid requests for unnecessary additional security	• Reduce costs of under-procurement of security • Reduce cost of obtaining additional security • Avoid cost of unnecessary additional security	• Implementation costs: Code change costs • Ongoing costs: nil
3. Preference for third party guarantee	Improve information available to EDBs regarding trader credit risk	Supports proposals 1 and 2. Potential reduction to over-procurement of security.	• Implementation costs: Code change costs • Ongoing costs: nil
4. Reduce distributor agreement termination process	• Reduce EDBs financial exposure from EDB-initiated trader default • Strengthen incentives for on-time payment	• Reduce cost of default for EDBs and consumers • Reduce credit management costs	• Implementation costs: Code change costs • Ongoing costs: nil
5. Assess merits of centralised credit risk assessment	Improve assessment of credit risk enabling more accurate estimates of prudential security requirements	• Reduce cost for traders of over-procurement of distributor and wholesale security • Reduce cost for EDBs of under-procurement of security	• Implementation costs: Code change costs; new function establishment costs • Ongoing costs: new function operating costs

126. The quantitative assessment of the benefits and costs of proposals 1 to 5 are summarised in **Table 8**.

Table 8 Summary of estimated benefits and costs of proposals

Proposal	Description of benefits and costs	Benefit ($ PV)	Cost
Proposal 1: Enable EDBs to request additional security after three late payments in 12 months	Reduce cost of default by reducing under-procurement of security	$829,000	-
	Reduce credit management costs	$350,000	
Proposal 2: remove interest requirement for additional security requested after three late payments	Reduce cost of default by reducing under-procurement of security	-	-

Proposal	Description of benefits and costs	Benefit ($ PV)	Cost
	Reduce cost of maintaining additional security	$325,000	
	Avoid cost of unnecessary additional security	NA	NA
Proposal 3: prefer third-party guarantees for additional security	Increased confidence in assessment of level of credit risk. Not quantified	NA	NA
Proposal 4: reduce termination period	Reduce cost of default by reducing financial exposure	$2,900,000	-
	Reduce credit management costs	-	-
Proposal 5: consider merits centralised credit risk assessment	Reduce cost of prudential security	NA	NA
Implementation of proposals: 1 to 4	Code change process		$100,000
	Total:	$4,404,000	$100,000
	Net benefit:	$4,304,000	

Note: Present value calculated over 10 years with 5% discount rate.

REDUCED COST OF A TRADER DEFAULT BY REDUCING UNDER-PROCUREMENT OF SECURITY

127. Proposals 1, 2 and 4 are expected to reduce the cost to EDBs and consumers of a trader default by reducing under-procurement of prudential security.

    a. Proposals 1 and 2 are expected to reduce the cost to EDBs and consumers of a trader default by reducing the constraint on EDBs requesting additional security.

    b. Proposal 4 is expected to reduce the cost to EDBs and consumers of the risk of a trader default by reducing the financial exposure from a trader default initiated by an EDB.

128. The proposals are not expected to result in traders incurring costs associated with unnecessary additional security due to the requirement that additional security be requested after three late payments in a 12-month period and the requirement EDBs pay default interest on additional security not requested according to the criteria.

Reduced cost of default

129. EDBs are discouraged from requesting additional security despite a trader having an elevated credit risk due to the cost of the requirement to pay interest on additional security. As such, EDBs chose not to request additional security despite concerns about a traders' credit risk. The impact is an implicit subsidy to traders with elevated credit risk, with the cost borne by EDBs and consumers (through distribution charges) rather than the trader and its customers (through reduced profit or retail charges).

130. Proposals 1 and 2 are expected to address this problem by reducing the constraint on EDBs requesting additional security based on an implied credit risk of a failure to pay on-time three times in a 12-month period, and by removing the requirement to pay interest on additional security requested according to this test.

131. The expected economic benefit of reducing the constraint on requesting additional security is to reduce the cost of default borne by EDBs and consumers by transferring the cost to traders with an elevated credit risk (implied by a failure to pay on-time). The transfer is expected to result in an economic benefit because retail competition will limit the cost being passed on to consumers. The cost will be internalised by the trader or passed to its customers (or both). For a trader with an elevated credit risk, the cost of additional security represents an efficient operating cost for a business of that risk profile.

132. The economic benefit to consumers of the proposals is equivalent to the change (reduction) in the expected credit loss for all EDBs because they can more easily request additional security to reflect a trader's credit risk, thereby reducing the potential financial exposure from trader default.

133. Based on EDB information, EDBs would request more additional security to reflect the credit risk of traders on their networks. Based on EDB information, proposals 1 and 2 are conservatively expected to result in EDBs holding additional security for one small trader and two micro-traders. Information on the extent to which EDBs are discouraged from holding additional security by the cost of default interest is not available.

134. **Table 9** shows the change in the expected credit loss for all EDBs from reducing constraints on EDBs to request additional security when efficient to do so given trader credit risk.

Table 9 Change in expected credit loss from reducing constraints on requesting additional security

Trader	ICPs	Expected credit loss, current state	Expected credit loss, with proposal	Difference
Small trader[22]	3090	$160,000	$44,000	$116,000
Micro trader 1[23]	209	$10,800	$3000	$7800
Micro trader 2	209	$10,800	$3000	$7800
Total change in expected credit loss				**$131,600**

Note: current state expected credit loss based on a wholesale-related default with initial security compared to the future state with EDBs holding additional security. Using a wholesale-related default scenario does not change the relative impact on the expected credit loss.

135. Assuming EDBs apply a consistent credit risk assessment method, reducing the disincentive to request additional security is expected to realise an annual economic benefit equivalent to the $131,600 reduction in the expected credit loss. This amount reflects the reduction to the insurance premium EDBs would be prepared to pay each year to secure against default of one small trader and two micro-traders.

[22] A small trader has between 1000 and 10,000 ICPs. There were five traders in this category on 30 June 2020 supplying 15,451 ICPs (an average of 3090 ICPs each).
[23] A micro trader has fewer than 1000 ICPs. There were 24 traders in this category on 30 June 2020 supplying 2764 ICPs (an average of 209 ICPs each, excluding traders with fewer than 10 ICPs).

136. The net benefit of the proposal is the difference between the expected economic benefit, the expected credit loss covered by additional security under the status quo, plus the proportion of costs of future additional security passed by traders to their customers.

137. Based on EDB information, additional security currently held reflects an expected credit loss of about $24,000. The proportion of costs of future additional security requested is expected to be nil given the cost of additional security – ie, the annual cost of a bank guarantee for a potential exposure of about $650,000 – would be less than $1000.[24]

138. The expected net benefit of the proposal is $107,000 a year, with a net present value of $829,000 over 10 years with a 5% discount rate.

139. The economic benefit of the ability to request additional security when warranted from a further micro-trader is $7800 a year, with a net present value of $60,500 over 10 years with a 5% discount rate.

Reduce cost of default by reducing potential financial exposure

140. The 15 to 25-day process for an EDB to terminate a distribution agreement following a serious financial breach before starting the trader default process increases the potential financial loss with no countervailing benefit. The impact is to increase the cost of default by increasing the under-procurement of security (above the 56-day threshold).

141. Proposal 4 is expected to reduce the financial loss and cost of default from an EDB-initiated default by reducing the duration of the termination process.

142. The termination process requires 15 days (11 working days) if the serious financial breach is a failure to pay an amount greater than $100,000 or 20% of the amount owed or 25 days (18 working days) if the serious financial breach is a failure to replace security.

143. Proposal 4 shortens the process by six working days by removing the one-day pause and five-day termination process steps and enabling an EDB to request the Authority to initiate the trader default process the day after notifying the trader of an Event of default.[25]

144. Reducing the 'termination' process by six working days would reduce the potential financial loss by eight elapsed days. This would reduce EDBs financial exposure, and the associated cost of risk, without altering incentives on EDBs and retailers to reach a commercially negotiated solution to non-payment by the retailer or adversely impacting the likelihood of a managed exit.

145. **Table 10** provides an indicative estimate of the reduction in financial exposure from shortening the termination process.

[24] Based on cost of a bank guarantee from ASB, refer, https://www.asb.co.nz/international-business/bank-guarantee.html
[25] Note: the EDB can notify the trader of a Breach of agreement immediately if the trader fails to pay an amount greater than $100,000 or 20% of the amount owed. For a serious financial breach for failing to replace security, the EDB must wait 7 days, with 2 days for the trader to provide security and 5 days to replace the security before notifying a Breach of agreement.

Table 10: Indicative financial exposure given EDB started trader default and proposed shortened termination process

Per installation connection point	Days	$	% of potential financial exposure (now)
Potential financial exposure (now)	97	$324	-
Potential financial exposure, shortened termination	89	$297	92%
Exposure with 14 days security, shortened termination	75	$251	77%
Exposure with additional security, shortened termination	33	$111	34%

Note: Termination for failure to replace security. Indicative cost per ICP based on the Vector ARHLC, WRHLC TOU rate on 1 April 2020 for an ICP consuming 30kwh/day (60% peak, 40% off-peak). Termination process reduced by six working days or eight elapsed days.

146. The six working day reduction to the termination process reduces the potential financial exposure by $27 per ICP relative to the current situation. For a trader with 10,000 ICPs, the six working day reduction to the termination process reduces financial exposure at default by $266,000 across each EDB-initiated default scenario.

147. The economic benefit of the proposal is the change (reduction) in the expected credit loss for all EDBs by reducing the potential financial exposure from an EDB-initiated trader default. The reduction to the expected credit loss represents an economic benefit because it relates to a risk mitigation tool – the ability to initiate the trader default process – controlled by EDBs. As such, the change to the expected credit loss from an EDB-initiated trader default relative to the status quo represents the value to EDBs of increased certainty regarding the effectiveness of credit management actions, the extent of credit risk and potential financial exposure, irrespective of the likelihood of an EDB-initiated default versus a wholesale-related default.

148. For a representative trader with 3000 ICPs (the average for traders with between 1000 and 10,000 ICPs) the proposed shortened termination process reduces the expected credit loss by $8000 a year, with a net present value of $62,000 over 10 years with a 5% discount rate.[26]

149. **Table 11** shows the change in the expected credit loss and economic benefit from the proposal.

[26] The expected credit loss for the representative retailer assumes a 10% probability of default (EA assumption for default rate of small retailers from 2011), a 100% probability of loss given default and financial exposure at default of 97 days charges (current state, no security) and 89 days charges (with shortened termination process, no security).

Table 11 Change in expected credit loss from proposal to reduce duration of the termination process

Trader type	ICPs	Expected credit loss, current state, no security	Expected credit loss, proposed, no security	Difference
Micro (<1000 ICPs)	2764	$240,000	$220,000	$20,000
Small (1000-10,000 ICPs)	15,451	$500,000	$459,000	$41,000
Medium (10,000-100,000 ICPs)	190,063	$2,309,000	$2,119,000	$190,000
Larger (>100,000 ICPs)	372,717	$1,509,000	$1,385,000	$124,000
Total change in expected credit loss				$375,000

Note: ICPs on 30 June 2020 from EMI. ICPs for large trader category are net of ICPs supplied by the four traders with a credit rating.

150. For all traders, except those with a credit rating, the proposed shortened termination process reduces the expected credit loss by $375,000 a year, with a net present value of $2.9 million over 10 years with a 5% discount rate. Reducing the potential financial exposure reduces financial risk, and the associated cost of mitigating the risk.

151. Expected costs of this proposal relate to implementation and the Code change process. There are no ongoing costs of this proposal.

REDUCED COST OF MAINTAINING ADDITIONAL SECURITY

152. Proposal 2 is expected to reduce the cost incurred by EDBs of maintaining additional security provided by traders with an elevated risk of default.

153. The default interest rate for cash-based additional security of BBR + 15%, and the discretion for traders to offer cash-based security, creates a perverse incentive for retailers to select the highest cost method for providing additional security, despite a bank guarantee delivering equivalent security at a lower cost. The impact is higher operating costs for distributors for no countervailing economic benefit.

154. Proposal 2 is intended to avoid the inefficient cost of maintaining additional security by removing the requirement for EDBs to pay a default interest rate for additional security requested after three late payment events in 12 months.

155. EDBs would continue to be required to pay default interest at the BBR + 15% on cash-based security and BBR + 3% on third-party additional security requested at other times. These costs would be incurred at the discretion of the EDB.

156. With the current arrangements, an EDB will pay $1.53 a year for every $10 of cash-based additional security and $0.33 a year for every $10 of guaranteed additional security.[27]

157. Based on current levels of additional security held, removing the default interest requirement is expected to reduce EDB costs for maintaining additional security by $50,000 a year, with a

[27] The 90-day BBR rate on 30 October 2020 was 0.27%. Refer https://www.rbnz.govt.nz/statistics/key-graphs/key-graph-90-day-rate. The default rate for cash-based additional security is 15% + 0.27% = 15.27%. The default rate for guaranteed based additional security is 3% + 0.27% = 3.27%.

present value of $210,000 over 10 years with a 5% discount rate. Consumers will receive an equivalent benefit as the cost saving is passed on or is diverted to more productive purposes.

158. Based on EDB information, proposals 1 and 2 are conservatively expected to result in EDBs potentially holding additional security for one small trader and two micro-traders. Under this scenario, removing the default interest requirement would reduce EDB costs for maintaining additional security by $75,000 a year, with a present value of $325,000 over 10 years with a 5% discount rate.

159. Traders requested to provide additional security would incur costs equivalent to the cost of providing the additional security, with a bank guarantee is estimated to cost 1% of the amount guaranteed a year. The costs incurred by traders under the scenarios outlined in paragraphs 157 and 158 are estimated at $3000 and $5000 a year, respectively. However, these costs efficient operating costs for a business of that risk profile. As such, they are not considered in calculating the costs and benefits of this proposal.

160. As such, the net economic benefit of the proposal to remove the requirement for EDBs to pay default interest for maintaining additional security is estimated to have a net present value of $325,000 over 10 years.

REDUCE CREDIT MANAGEMENT COSTS

161. Proposals 1 and 4 are expected to reduce EDB credit management costs by strengthening the incentive for traders to pay on time.

162. EDBs do not have effective sanctions to apply to traders which do not pay on time. The current distributor prudential arrangements in effect provide traders the ability to not pay on time, particularly if facing a cashflow shortfall. The materiality threshold for an EDB to request a start to the trade default process, and the 15 to 25-day distribution agreement termination process reduces an EDBs ability to apply standard credit management practices. The impact is an increased likelihood of late payment and higher credit management costs.

163. Explicitly linking the requirement to provide additional security to the frequency of late payment enhances EDBs ability to sanction late payment, thereby reducing its frequency and associated credit management costs.

164. The proposal is expected to reduce the opportunity cost of late payment and additional credit management effort. However, the extent to which late payment is more frequent is difficult to measure due to differing EDB credit management practices and record keeping.

Opportunity cost of late payments

165. The opportunity cost of late payment is not material. Using forgone interest as a measure of opportunity cost of late payment the cost of a retailer failing to pay a $1000 invoice (10 ICPs) on time[28] is $2.05 a day at commercial rates (0.25% a year) or $4.31 a day at the default interest rate the Code enables an EDB to charge on late payments.[29] For 1000 ICPs, the foregone interest is between $205 a day and $430 a day.

[28] Based on distribution charges for 10 ICPs for 30 days at $3.33/day.

[29] Electricity Industry Participation Code, Schedule 12A.4, Appendix A, cl9.6 allows an EDB to charge default interest on late payment. The rate is the 90-day BBR rate plus 5%. The 90-day BBR is currently 0.27% and not included for these indicative calculations.

166. Based on EDB information, EDBs on average each experience two late payment events a month (a significantly higher frequency than seen in the wholesale market). Assuming this reflects late payment by one small trader and one micro-trader, and payment is made within four days, the opportunity cost of late payment is $2700 a month and $32,000 a year across all EDBs.[30]

167. Assuming a 50% reduction in the frequency of late payment, the benefit is $16,000 a year across all EDBs, with a present value of $70,000 over 10 years with a 5% discount rate.

Additional credit management effort

168. Credit management effort involves initial creditor management effort and termination process effort.

169. Based on EDB information, the average cost of credit management effort relating to late payment by retailers is an estimated $130,000 a year for all EDBs.

170. The impact of the proposals on the frequency of late payment is unknown. Assuming a 50% reduction in late payment, EDBs would potentially reduce credit management effort by the equivalent of $65,000 a year with a net present value of $280,000 over 10 years with a 5% discount rate.

THE BENEFITS AND COSTS OF FOR EXPLORING OPTIONS TO IMPROVE CREDIT INFORMATION HAVE NOT BEEN QUANTIFIED

171. A centralised credit risk assessment mechanism could promote more competition and more efficient operation of the electricity sector by right-sizing prudential requirements to reflect the risk of default more closely by traders on distribution and wholesale payments. By not considering probability of default, the current distributor and wholesale prudential settings are likely to result in overly conservative prudential requirements, with low credit risk traders paying more than is efficient and high credit risk traders paying less than is efficient.

172. Improved credit risk information and assessment could bring additional, potentially significant, benefits by enabling EDBs, and the wholesale market, to more accurately determine the amount of prudential security required from a trader given its probability of default.

173. An improved understanding of credit risk could reduce the amount of prudential security required, thereby reducing the costs of prudential security. These benefits need to be considered against the costs of centralised credit risk assessment.

174. Establishing a centralised payment mechanism for distribution charges, like the arrangements for wholesale payments, could be considered at the same time, particularly to understand the potential to reduce EDB costs by centralising payment (perhaps like the wholesale market).

[30] Assuming cost of funds of 2.5% a year.

APPENDIX C: SUMMARY OF ENGAGEMENT AND FEEDBACK

175. **Table *12*** lists the traders the ENA sought feedback from on the proposals during February and March 2021.

Table 12 ENA engagement with traders

Trader
Contact
Electricity Retailers Association of New Zealand
Electric Kiwi
Flick Energy
Mercury
Meridian
Pulse Energy
Nova Energy
Trustpower

176. Traders were asked for feedback on the proposal and assessment of costs and benefits, including:

    a. the practical and operational effects of proposals

    b. the likelihood of proposals to realise the expected outcomes

    c. the assessment of expected impacts, costs and benefits.

KEY THEMES OF FEEDBACK AND RESPONSE

177. The key themes of the feedback received and the response to the feedback are summarised in **Table 13**.

178. The main issue with the proposal identified by traders was the credibility of the check on EDBs exercising discretion to request a trader provide additional security without reference to the underlying credit risk. That is, requesting additional security when it is not necessary or efficient to do so. This feedback was addressed by revising the proposal to maintain the existing check on EDB discretion by requiring EDBs to pay the BBR + 15% and BBR + 3% default interest rate on additional security requested without applying the three late payment test.

Table 13 Summary of feedback and response

Feedback	Response
Amount of prudential security needs to be set to balance creditor interests (EDBs and generators) and trader interests. Putting in place a mechanism that potentially increases the prudential requirement for independent retailers is at odds with goals to increase competition and therefore is unlikely to be in the best interest for consumers	Noted. The proposal is intended to achieve a more efficient balance between EDB and trader interests.
The problem to be addressed is frequency of late payment rather than risk of trader default and (mis) allocation of cost of that risk (to consumers). Requiring retailers to bear prudential security costs equivalent to their specific credit risk would create inefficient barriers to entry and expansion and reduce retail competition.	The assessment indicates the problem is the existing arrangements do not provide EDBs sufficient ability to manage the risk and cost of default, and also inefficiently transfer the risk and cost of default from traders to EDBs and consumers. The frequency of late payment is a symptom of the issue, not the problem.
Concerns the proposal will result in traders (ie, small traders) facing higher distributor prudential security costs, particularly due to the discretion for an EDB to request additional security without 3 late payment events, subject to paying 5% default interest. The proposed 5% default interest rate is not sufficient to discourage EDBs requesting additional security at any time. Proposal appears designed to provide EDBs with more security and pay less for it.	Noted. Proposal has been adjusted to require EDBs to pay default interest for additional security not requested without three late payment events. The proposal is designed to enable EDBs to obtain the efficient amount of security, and to reduce the associated costs.
Current mechanisms for EDBs to manage risk of trader default are effective. EDBs experiencing late payment can manage the impact by starting the termination process. Also, EDBs are largely immune to retailer default through the wash up process and, for unregulated networks, through the ability to increase future lines charges	The assessment indicates the current mechanisms for EDBs to manage risk of trader default are not effective. In particular, the termination process reflects outdated and inaccurate assumptions. The assumption EDBs are largely immune to retailer default does not reflect real world exigencies.
Clarify the proposal has a specific mechanism to account for current “wash up” payments between retailers and distributers, and how that relates to the trigger based on late payments.	Noted. Proposal clarified.

Feedback	Response
Costs and benefits of the proposal require further explanation, particularly the assumption regarding nil ongoing costs.	Noted. Discussion of costs and benefits updated.
Could be value in reviewing prudential requirements for both generation and distribution given the length of time since the current settings were introduced.	Noted.