

Submission - NECF2 package

Summary

If cure is less expensive than prevention then there would well be an argument for the emphasis on cure. For the energy market we see both curative and preventative measure.

The principle of 'Retailer of Last Resort' bears the characteristic of curative. The preventative measures are evidenced in the prudential guidelines that are in place to ensure that energy retailers are financially positioned to pay the energy generators.

Thus the regulation of the energy market is constructed to ensure the end-customer and energy generators are protected from the vagaries of the market.

This prompts the question – what are we trying to cure or to prevent? One clear answer to that is the type of collapse that Jackgreen Ltd, an energy retailer, has demonstrated.

What contributed to the collapse was the way the Corporation Act and the energy sector's regulations were exercised which created opportunities for some and demise for others.

The price the Australian community pays for this kind of institutionalised regulatory inequality is concretely evidenced when the wider spread of the Jackgreen collapse is calculated. Energy Generators are protected whilst the Energy Retailers (who like the generator companies fall under the Corporations Act) are accorded no protection.

The submission appended provides the details and submits there is a clear need for the NECF2 package to address that deficiency.

Submission for 26th February 2010

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Sent via email to <MCEMarketReform@ret.gov.au>

Dear Sir/Madam

Re: Submission - NECF2 package

Prevention is better than cure, especially where the wider-side effect of cure is onerous. It is from this perspective that I comment on the Second Exposure Draft of the NECF Package.

The experience of what has happened to Jackgreen Ltd, an energy retailer, is used as a concrete example to substantiate my comments which could have only been conceptually mounted pre-December 2009.

By quoting this concrete example of the dying stages of Jackgreen Ltd, I seek to demonstrate that the regulation of what can be described as the 'middle segment' of the market is 'wobbly'. It needs to be addressed from a regulatory perspective, in specific a preventative stance so that the need to invoke Retailer of Last Resort (RoLR) is minimised and so too suspension of licenses that pertain to a) the wholesale purchase and b) retail sale of energy, which are operated at the federal and state level, respectively. Suspension of either license cripples the business viability of an energy retailer.

Weak Point in Regulation

To understand the price paid for weak points in the regulatory framework, it is worthy to estimate the full cost of the Jackgreen collapse.

This cost goes beyond what creditors and shareholders' lost. It includes Administrator, Receiver, legal and court costs, and loss of employment which undoubtedly would have cost the Australian government Centrelink payments and the associated costs that goes with it.

There is also the potential for lawsuits which challenge the inherent bias of the regulatory framework which entertains conflict of interest and favours the dominant retailer of an area. The consequence that stemmed from Integral's court winding-up application on Jackgreen International is a demonstration of such conflict of interest that took place in NSW.

A business case viewed from this wider perspective would clearly suggest the need to improve the energy sector's regulatory framework.

Certainly, warranted are consumer protection measures so they are assured uninterrupted power supply. This guarantee is also required if small players are to do business in the de-regulated energy market and meaningfully compete with the big players. There is also a valid argument for the energy generators to ensure their payments are secure.

However, why make the energy generators the only market players protected? To exclude other energy market players from protection is questionable, as the Jackgreen case clearly demonstrates.

Let me explain.

The Way the Market Operates in Catastrophic Conditions

The focus of the current regulation is two-fold. At the top end is *protection* given to the energy generators via prudential financial guidelines that accompany AEMO's settlement rules so that energy payments to generators are secure. At the bottom end, is a *cure* offered to household customers via RoLR that gets triggered in the event of an energy retailer becoming insolvent

What Jackgreen has clearly shown is that its financial catastrophe, triggered by Integral's winding-up court application and Jackgreen opting for voluntary administration, results in the entire loss of its customer base occasioned by RoLR. In addition, its wholesale license to buy energy earns default status; and soon passes to suspension status. The same would happen even in the New Draft Default procedure – refer 3.15.21 (10, 11, 12, etc).

This poses the question - why opt for 'voluntary administration' which under Australian Corporation Law is the choice invoked to protect assets and continue trading. Yet the Australian Energy Regulatory Framework requires that two of the primary assets of an energy retailer is forsaken no sooner voluntary administration is chosen. It can neither continue trading, since it mandatorily loses its customers, nor can it protect its primary assets – its licence is suspended and its customers are torn away under RoLR.

Clearly, this contradiction between regulatory requirements and the Corporations Act must be eradicated from the energy sector's regulatory framework if it to overcome the future risk of a legal challenge. There is already a challenge brewing with Jackgreen.

At the very minimum, preventative measure must be put in place to monitor and guide those companies whose performance is moving towards being ‘wobbly’ and who at the time pose a high risk of triggering RoLR action.

Furthermore, Integral’s actions evidence conflict of interest, for they are a dominant supplier in the NSW market and consequently stand to benefit heavily from the customer base they acquired as a consequence of the way RoLR is applied. The fallback position of the regulatory system favours the dominant player and thus it is inevitable that the dominant market players will benefit from the exercise of RoLR.

In the meanwhile, all Integral did was exercise the Corporation Law for an amount owing for which the payment terms offered by Jackgreen was found to be unacceptable. What is even more important is that this outstanding payment was outside the jurisdiction of the AEMO to influence and find an amicable solution. The +\$800,000 money owing was reportedly for distribution network charges, not purchase of wholesale energy which falls within AEMO’s purview.

What triggered the suspension of license was ‘voluntary administration’. This means no customer can be supplied with energy because the energy retailer having had their license suspended cannot purchase electricity in the solitary market which is regulated by the government to be run as a monopoly. Therefore, RoLR gets invoked and the customer base is irrevocably lost and is no longer an asset which ‘voluntary administration’ under Corporation Law would have normally protected.

As a shareholder my compelling question is - why did Jackgreen’s Board of Directors invoke voluntary administration when the regulatory framework enforces the loss of two of Jackgreen’s critical assets – its license and customer-base?

- Was it because it enabled Jackgreen to pursue its debtors for payments due and amounts owing given the billing cycle? I would expect not. Court appointed administrators/receivers have that power.
- Why not opt for the court to decide upon the winding order? Jackgreen’s initial stance, notified to ASX, was that it was going to contest the winding-up order.
- Why did Integral opt for *Creditor’s Statutory Demand for Payment of Debt*? Was it because it potentially opened the way to trigger RoLR which would significantly bestow customers to Integral, a dominant retailer?
- Did either Jackgreen or Integral propose the recourse of alternative dispute resolution? If so, who was proposed as the neutral arbitrator/expert/mediator?

Answers to these await the Administrators report¹. What can be seen from ASX and court notifications are:

¹ Telephone discussion with PKF on 25th and 26th Feb 2010 indicate this report will be presented at the 2nd creditors meeting. Supreme Court has extended the convening period for the 2nd meeting of

- 30th November 2010 – Executive Chairman’s Address at the AGM

“in order to address this short-term situation (volatility in the wholesale electricity market during the hottest November on record) we have decided undertake a small placement over the next 2 days as well as finalise some additional lines of credit to see us through this period. In these circumstances, we felt if appropriate to call a trading halt whilst these fund raising activities are undertaken. It also states “the company has signed a term sheet with a major financier”².

The Executive Chairman’s address warrants shareholders asking if this was a fair report of the state of the company given that three weeks later the company opted for voluntary administration consequent to the court winding-up application placed by Integral. Two days later (23rd December 2010) Jackgreen International, the trading arm, was forced into receivership.

At the AGM, which I attended, no mention was specifically made of the debt exposure to Integral or the gravity of what Jackgreen may face if negotiations with Integral failed.

Certainly it is a question for ASIC’s attention given that a Creditor’s Statutory Demand for Payment of Debt requires payment in 21 days or application made to the court to have the statutory demand set aside³. If neither was done, then Jackgreen International the trading arm of Jackgreen Ltd would slide into Integral taking the next step which is a court-winding-up application which could then mature into different permutations - the worst being placed in administration/receivership which under AEMO rules means suspension of license and RoLR.

From a regulators perspective it is worthwhile to gain a sense of signals and the rapidity of action of the final weeks of Jackgreen.

- 2nd Dec - Two days after the AGM, the ASX notification states

“Share Placement and Convertible Note Issue Raises 2.8 million plus ... that it (Jackgreen) has negotiated a \$500,000 increase in its existing debtor facility while it concludes a new facility in coming weeks with an increased capacity to meet the needs of Jackgreen’s growing business.”⁴

- 3rd Dec - Court winding-up application is placed by Integral on Jackgreen International (100% owned by Jackgreen Ltd)

creditors until the 16th April 2010 - source:

<http://www.asx.com.au/asxpdf/20100128/pdf/31ncf67kv0fghx.pdf> (accessed 26th February 2010)

² <http://www.asx.com.au/asxpdf/20091130/pdf/31mf7jwvjjwgkf.pdf> (accessed 26th Feb 2010)

³ http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s459f.html (accessed 26th February 2010)

⁴ <http://www.asx.com.au/asxpdf/20091202/pdf/31mhgt7bsscs91.pdf> (accessed 26th February 2010) This ASX/Media Release is dated 2 **October** 2009 (should be **December**?)

”on the basis of an alleged failure by the subsidiary to pay an amount of \$808983.10 identified in a Creditor’s Statutory Demand dated 3rd November 2009⁵”.

- 7th December, Jackgreen notifies ASX it will defend the court winding-up action
- 8th December, NSW Supreme Court adjourned the case to 18th December.
- 9th December, ASX is notified of the issue of 40million new ordinary shares at 4 cents per share
- 11th December, ASX notification – Change of substantial holding from HHL – concerns 53,334,000 shares.
- 14th December, ASX notification states that UBS AG (Australia and London Branch) has become a substantial holder on 9th December with 17,567,928 shares and refers to them as Prime Brokers with the power to control the exercise of the power to dispose of shares pursuant to a Prime Broking agreement.
- 14th December, ASX notification states Trading Halt is called.
- 21st December, ASX notification states Jackgreen announces Voluntary Administration - being unable to reach agreement with Integral despite the Company’s attempt to recapitalise Jackgreen.

AEMO default procedures specify that voluntary administration triggers suspension of license and invokes RoLR action.

Pending the report from the administrators, questions abound to understand the choice of voluntary administration by the Executive Chairman of Jackgreen, Mr Greg Martin. This comes from employees, creditors and shareholders who have and will be severely burnt by the collapse.

Who Tripped the Weakness

It is hoped some regulators will be asking the deeper question is Jackgreen evidence of a weakness in the energy market that is better prevented than let to collapse.

Voluntary Administration totally deflected any chance of political intervention being brought to bear given that Integral is 100% owner by the NSW State government. Given the recapitalisation millions it had raised, was there potential for Jackgreen to be given a lifeline so that it would save itself and consequently save the Australian taxpayer the wider-expense associated with company collapses?

Furthermore, Mr Greg Martin (appointed Executive Chairman of Jackgreen in July 2009) as director on the board of AEMO and former CEO of AGL would have understood well the death knell being struck for employees, shareholder and creditors as the Board volunteered to have two of its prime assets cease to operate by virtue of suspension and RoLR. His is a rich

⁵ <http://www.asx.com.au/asxpdf/20091207/pdf/31ml7pv629p6lh.pdf> (accessed 26th February 2010)

experience - highly conversant with the way the energy market operates and the price it pays in these catastrophic conditions. Interestingly, on 30th November, Jackgreen announced its new CEO was from AGL another big energy retailer.

As rich as the new players sound, on 3rd November 2009 these remained unattractive to Integral. Their commercial decision grew to a court application for the winding-up of the trading arm – Jackgreen International. No chance was to be given to Mr Greg Martin, his new board and executives, for a chance to run the company and see it make good on the +\$800,000 that Integral was owed for network distribution charges.

Many small companies set-up, survive, thrive and then position themselves for a buy-out by a big player. It is tempting to suggest that what Integral initiated by its court winding-up application and rejecting Jackgreen's payment proposal was a cheap way to enlarge its customer-base without having to buy-out a small competitor.

Yet it appears it was Jackgreen that opted not to allow others to help it survive – the courts, the NSW state government – to save its employees, creditors and shareholders (RoLR safeguards the customers). It increased its capital base and borrowing capacity but when rejected by Integral it voluntarily rang its own death knell.

Was this 'rich experience' serving itself as proof of the sheer inequality and conflict that simmers within the way the retail energy sector is regulated – where the energy generators are protected but not the energy retailers, especially small players who are not also energy distributors?

Even if that was not an underlying motive, I hope it results in an investigation into Jackgreen for it is a rich in experience of failure from which the energy sector can learn and reform its regulatory framework.

Preventative Measures

The questions posed lay the groundwork for what is discovered. Thus in evaluating the new draft Retail Policy the query is whether a 'Jackgreen repeat' can be avoided? It appears not and predictably so, as it falls outside the objectives set for the energy sector's regulators to pursue.

The proposition of this submission is that it is prudent to build in preventative measures so that collapse of energy retailers is avoided. Since company collapse is another state of affairs that can occur, there is need for the regulation to deal with that, which commendably the current draft continues to address.

This brings us to the question - what are the avenues that may productively reform the energy sector's regulatory framework, laws, regulations, guidelines given that the market players also operate under the Corporations Act, ASIC, ACCC, etc?

My response is the need for preventative measure so that when a company, like an energy retailer, becomes ‘wobbly’ they fall under the notice of a regulatory operational body. This is because if a ‘wobble’ goes unnoticed or unchecked by the regulators it has the potential to collapse and the overall price paid is very costly.

Currently, there is little evidence to suggest that the regulators are in anyway required to find out what those ‘wobbly’ indicators are let alone monitor them. If the regulator was to converse with the financial and legal community (e.g. administrators, receivers, bankers, insolvency lawyers), many of those indicators would come to light.

With hindsight there are a whole lot of indicators evidenced by the documents Jackgreen filed at ASX, in its annual report, market commentary by analysis. This is especially so when viewed over a longer period of time. Revealed are their things like a) reliance on capital raising to meet operational needs, b) weak billing system, c) impacting on debt recovery d) the interrelationship between these components which over time make for a very wobbly company. Few, including myself, looked at these indicators.

Another suggestion is that one missed financial payment, especially below a certain threshold, should not trigger collapse. This is consistent with default notice provision as a precursor to suspension notice when AEMO settlement payments have not resulted on time. However, this is scarcely possible when voluntary administration is invoked under the Corporations Act.

There are many non-payment permutations that require deeper consideration especially when viewed from the perspective of lifting suspension and what it means to on-selling/transferring a license. Also distinction is warranted for financial thresholds and types of unpaid debt that can trigger a suspension of license and RoLR.

The energy sector needs to understand and institute regulatory measures in the broader context of Corporation Law, the way financial markets and financial recovery markets work.

As far as regulatory markets go, it is worthwhile to also consider how the Telecommunication sector and Banking Sector work. Certainly the Reserve Bank has long been the Lender of Last Resort to Bankers and is known to have a market of different sized players who have different gearing ratio restrictions for its banks, building societies and credit unions. What light can the Reserve Bank shed on the way it maintains its monitoring vigilance to reduce Australia’s exposure to financial crashes and mismanagement.

Following the 1996 Financial Enquiry (aka as Wallis Enquiry), APRA (Australian Prudential Regulatory Authority) has taken over the role of prudential regulation since 1998. Amongst its rich experience is Zurich Australian Insurance Limited (ZAIL) in 2007⁶, and irregular foreign currency options trading at the National Australia Bank (NAB) in 2004⁷.

⁶ Refer: http://www.apra.gov.au/media-releases/07_10.cfm (accessed 1st March 2010)

⁷ Refer: http://www.apra.gov.au/Media-Releases/04_09.cfm (accessed 1st March 2010)

As stated at the outset the need for prevention is clear. The Jackgreen debacle proves the way market rules in conjunction with the regulatory framework triggers actions which is very difficult for the energy retailer to recover from, particularly small players who do not carry the political attractiveness to warrant government initiated bailout.

Addressing the Deficiency

There are matters of content which require addressing. It requires a team of people to come into conversation to understand the different angles from which the reality of the seamless market operates.

How this can be done is something I am happy to be consulted on.

Thank you

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