10 June 2020

Dr. Brent Layton
Chair
Electricity Authority

By e-mail: HME.feedback@ea.govt.nz

Dear Brent,

Mandatory market-making would lead to increased competition in the electricity supply chain

Electric Kiwi and Haast Energy Trading (Haast) reiterate the importance of ensuring a strong and thriving competitive landscape develops where independent retailers, independent generators, and large users operate on a level playing field with the dominant vertically-integrated businesses. The Authority can create a step change in competition by ensuring reliable access to wholesale hedges which are priced on the same basis as internal transfer prices at gentailers. New Zealand continues to have one of the smallest non-integrated sectors globally as a percentage of retail and generation market share. Effective regulation of the dominant gentailers is long overdue and essential if the Authority wants competition to be the main driver of better price and innovation outcomes for consumers.[1]

Electric Kiwi and Haast have been clear the prohibition of saves and winbacks (short-term winbacks are now banned) and mandatory market-making are the two most important initiatives, barring further structural reforms, available to the Authority for removing barriers to competition and delivering (short and long-term) benefits to consumers.

We support the joint independent retailer submissions

We support the joint independent retailer submission in response to the April 2020 HME consultation paper. Given the Authority's repeated emphasis on "evidence-based" decision-making, we refer the Authority to the evidence already provided, and the details in our, and other independent retailer submissions (e.g. Vocus and the joint independent retailer submissions) of the types of analysis the Authority should undertake to make evidence-based decisions. We provide additional evidence of market concentration and limits on the level of competition in this submission. Absent response to previous submissions, it is unclear what additional evidence the Authority would consider to be of assistance.

Summary of Electric Kiwi and Haast's views on market-making reform options

- We welcome the Minister of Energy's reiteration that she is "very focused on outcomes for households as electricity consumers. **Now, more than ever, is the time to make progress on the Electricity Price Review's recommendations** …"[2] Hedge market reform is a critical element of the Government's Electricity Price Review (EPR) decisions for delivering more competition and better outcomes for consumers. It is now 8 months since the Minister announced the EPR decisions and there has been very little progress.[3]

[1] Reflected in Trustpower's recent dismissal of the impact of independent retailers on competition: "New entrant retailers have only had a modest impact on retail competition … Fewer than 300,000 of the over 4 million premise switches that occurred over the last ten years were as a result of new entrant (less than eight years old) activity. Reference: Trustpower, Investor presentation for the year ended 31 March 2020, 27 May 2020.
[2] Hon Dr Megan Woods, Minister of Energy and Resources, untitled letter, 18 May 2020.
[3] Ecotricity, Electric Kiwi, energyclubnz, Flick Electric, Pulse and Vocus, Letter of Minister's expectations 2020/21: Specific expectations regarding the Electricity Price Review, 20 March 2020.

- At this stage of the hedge market development process, the Authority should be in position to engage on design details, not just high level consultation on whether voluntary or mandatory etc arrangements should be put in place. **The Authority already knows stakeholder views on what type of hedge market reform it should adopt** from the December and EPR submissions.

- **Mandatory market-making should be introduced with urgency:** Electric Kiwi and Haast's recommendation that the Authority to develop and introduce mandatory market-making is unchanged: (i) Mandate market-making for largest 5 vertically-integrated utilities (Contact, Genesis, Mercury, Meridian and Trustpower); (ii) No portfolio stress or opt out mechanisms; (iii) Spreads of 1%; (iv) Covers baseload quarterly out 3 years, baseload monthly out 6 months, and peakload quarterly contracts out 3 years; and (v) 3 MW on the bid and offer for all contracts with 3 reloads of 3 MW each.

- **Market-making should** continue to **be funded on an "exacerbators-pay" basis**.

- **A voluntary approach** is excluded by the Government's EPR reforms and **has already failed**. The voluntary plus backstop approach has been undermined by back door changes watering down the scheme without consultation. Confidence has already been lost in this approach. The voluntary arrangments have been bent in a way which resulted in withdrawl of liquidity and increased costs on buyers of hedge products.[4]

- **Any industry-led initiative requires both supply and demand side involvement to be fit-for-purpose:** While the Minister of Energy provided direction that the EPR reforms included "mandatory market-making unless the sector develops an effective incentive-based scheme", we do not consider that the Authority's exclusive invitation to market-makers and the supply-side of the market to develop an incentive-based scheme would satisfy any reasonable interpretation of a sector-led initiative.[5]

- **Incentivised or hybrid schemes are unlikely to attract the diversity of participants the Authority desires** because the Authority is yet to address systemic issues with information disclosure, insider trading, and spot market trading conduct. Until the Authority implements a suite of reforms which give the market confidence that market abuse is not widespread, it is unrealistic to expect financial participants to provide these services at an acceptable cost.

- **The HME paper misdiagnoses the problem:** The "apparent lack of confidence among some stakeholders in market making and price formation on the ASX market" is a symptom of the problem and is not the problem itself. The problem is market concentration in the wholesale electricity market (additional evidence is provided in this submission) coupled with a high degree of vertical-integration between wholesale supply and retail services.

- **The assessment criteria in the HME paper is divorced from the Authority's statutory objective:** The assessment criteria needs to help determine the extent to which different market-making options would help promote competition and more efficient operation of the electricity market. The assessment criteria in the HME paper is unhelpful for this purpose.

- **The assessment criteria should have a specific focus on promotion of competition** and include the extent to which the different market-making options would: (i) enable non-integrated participants to manage wholesale electricity market risks, and (ii) address the problem that vertical-integration between retail and wholesale is limiting access to risk management products for other participants.

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[4] Refer to the Electric Kiwi and Haast e-mail responses to the Authority announcement, and the joint independent retailer letter, Weakening voluntary market making arrangements is an entirely inappropriate response to COVID-19, 30 March 2020.

[5] Contact, Genesis, Mercury, Meridian, Trustpower, Todd/Nova, Pioneer and Pulse were the only industry participants that were invited. The Authority invited Pioneer and Pulse – the only non-incumbent participants to be invited – on the basis that it considers that they qualify as a vertically-integrated supplier.

- **The assessment criteria should also include the time it would take to implement** (which, for example, should rule out options that would require legislative changes) **and the potential for the market-making scheme to evolve and adapt over time to meet access seekers' needs**.
- **Care is needed to ensure design options and assessment criteria aren't mixed up:** The Authority should not specify which funding option should be adopted in its assessment criteria.

Mandatory market-making is our preferred (longer-term) solution

Electric Kiwi and Haast reiterate our recommendation that the Electricity Authority develop and introduce mandatory market-making arrangments which have the following features:[6]

- Mandate market-making for largest 5 vertically-integrated utilities (Contact, Genesis, Mercury, Meridian and Trustpower).
- No portfolio stress or opt out mechanisms.
- Spreads of 1%.
- Covers baseload quarterly out 3 years, baseload monthly out 6 months, and peakload quarterly contracts out 3 years.
- 3 MW on the bid and offer for all contracts with 3 reloads of 3 MW each.
- Consistent with the direction the Authority has received from the Government the new market-making arrangements should continue to be funded on an "exacerbators-pay" basis.

The submissions in reponse to the EPR make clear mandatory market-making is supported by most market participants and consumers. The main objection is from a subgroup of current market-makers and Trustpower (who is concerned they will be required to be a market-maker).

There is a risk of unintended consequences from policy inertia

Hedge market reform is not being progressed with enough urgency.

We welcome the Minister of Energy's reiteration that she is "very focused on outcomes for households as electricity consumers. Now, more than ever, is the time to make progress on the Electricity Price Review's recommendations …"[7] The Minister has been clear hedge market reform is "one of the most important recommendations to improve the electricity market and … the Government expects the Authority to give this matter high priority". The Minister "do[es] not want to wait for a "better solution" that might never be found".

The risk of unintended consequences from continued delay in resolving problems with the hedge market are substantially detrimental to consumers. This amounts to a continuance of the handbrake on independent retailers' ability to aggressively compete for new customers on price. Electric Kiwi is low cost, nimble, and offers more innovating product offerings than any of the incumbents. Our customers have directly saved $21m by switching to us, but we are hampered by limits on wholesale price risk management, and higher effective wholesale costs than the incumbent operators.

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[6] Electric Kiwi and Haast, Urgent implementation of the Government hedge market reforms needed to promote competition and deliver better outcomes for consumers, 28 November 2020.
[7] Hon Dr Megan Woods, Minister of Energy and Resources, untitled letter, 18 May 2020.

There are problems with the latest HME consultation paper

We had been heartened this year by the Authority's decision paper on saves and winbacks, which transparently and explicitly acknowledged the areas where the Authority disagreed with our and other submissions and provided clear reasons why, and the High Standard of Trading Conduct consultation paper which was rigorous and thorough in the way it defined the problems and researched relevant precedent.

The April 2020 HME consultation paper falls well short of the standards set by these papers.

There are a number of problems with the latest HME paper which need to be resolved in order for the Authority to make robust decisions which resolve the ongoing and protracted problems in the hedge and contracting market and satisfy the objectives of the Government's EPR reforms. It is notable, for example, that there is no mention of the Government decisions on reform of the hedge market. We expressed concern that the November 2019 consultation paper "Attempt[ed] to downplay the recommendations from the EPR Panel", but the latest Discussion Paper goes a step further and doesn't even mention the EPR or the Government's electricity reform decisions.

The Authority should now be in a position to consult on detailed design issues

It is over 8 months since the Minister announced the EPR decisions. Hedge market reform was already on the Authority's work programme so it should have been able to 'hit the ground running'. Despite this, there has been very little progress on hedge market reform.[8]

At this stage of the hedge market development process, the Authority should be in position to engage on design details, not high level consultation on whether voluntary or mandatory etc arrangements should be put in place. The Authority already knows stakeholder views on what type of hedge market reform it should adopt from the December and EPR submissions.

We have already noted in numerous submissions that we support a mandatory solution. We have the following specific comments on the options presented in the HME paper:

- **Some of the options in the paper are not available to the Authority:** The intended purpose of the HME paper is to seek feedback on the approaches the Authority should consider, but the Authority has included voluntary market-making options which would not meet the requirements of the Government's EPR reforms.

  The Minister was clear hedge market reform should be "mandatory market-making unless the sector develops an effective incentive-based scheme", and an incentive-based scheme should be "funded largely by the vertically-integrated companies".

  The voluntary options should either have been excluded, or the paper should have detailed the potential implications of the powers the Government has announced it will introduce to allow it to override the Authority if it doesn't adequately implement the Government's electricity reforms.

- **The voluntary approach has already failed:** The voluntary plus backstop approach has been undermined by back door changes watering down the scheme without consultation. Confidence has already been lost in this approach with the rules bent in a way which withdraws liquidity and increases costs on buyers of hedge products.[9]

- **Incentivised or hybrid schemes are unlikely to attract the diversity of participants the Authority desires** because the Authority is yet to address systemic issues with information disclosure, insider trading, and spot market trading conduct. Until the Authority implements a suite

[8] Ecotricity, Electric Kiwi, energyclubnz, Flick Electric, Pulse and Vocus, Letter of Minister's expectations 2020/21: Specific expectations regarding the Electricity Price Review, 20 March 2020.
[9] Refer to the Electric Kiwi and Haast e-mail responses to the Authority announcement, and the joint independent retailer letter, Weakening voluntary market making arrangements is an entirely inappropriate response to COVID-19, 30 March 2020.

of reforms which give the market confidence market abuse is not widespread, it is unrealistic to expect financial participants to provide these services at an acceptable cost. The Authority should reconsider these approaches after market abuse reforms are enacted.

- **Any industry-led initiative requires both supply and demand side involvement to be fit-for-purpose:** While the Minister of Energy provided direction that the EPR reforms included “mandatory market-making unless the sector develops an effective incentive-based scheme”, we do not consider that the Authority’s exclusive invitation to market-makers and the supply-side of the market to develop an incentive-based scheme would satisfy any reasonable interpretation of a sector-led initiative.[10] A solution that is to work for the non-integrated retailers needs to include them, otherwise the solution is unlikely to be fit-for-purpose.

- We are also concerned about the apparent lack of transparency around the market-maker group’s work on an incentive-based scheme, and are yet to receive a response to our inquiries about what briefings the group has provided to the Authority.

The HME paper misdiagnoses the problem

The Authority has stated the “review will take an objective and evidence-based approach” but the HME Paper lacks evidence to support the Authority’s views, and appears to ignore the evidence of problems in the wholesale and hedge markets that Electric Kiwi and Haast, as well as other stakeholders, have already provided the Authority.

While the Authority has previously acknowledged “the hedge market’s importance for retail competition” this isn’t evident from the HME paper.[11]

The HME paper’s claim that “A lack of confidence in the market is ultimately detrimental to consumers because it may result in participants underutilising ASX contracts and the forward price curve” misdiagnoses the problem. It isn’t sufficient to purport that there is sufficient volume of hedge products available – if the price of the products isn’t economic for a reasonably efficient independent retailer, deploying a prudent hedging strategy, take up will be low. We reiterate “liquidity should be measured as volumes and prices”.

We reject entirely the HME Paper’s claim there is a demand-side problem with “participants underutilising ASX contracts and the forward price curve” and “New entrants can have relatively low levels of ... experience”. This is victim blaming. If the HME Paper’s description of the hedge market problem was accurate there would be no need for regulatory intervention. It is not the Authority’s role to ‘nursemaid’ new entrants to ensure they have an “understanding of exchange traded futures as a way of promoting risk management ...”.

The “apparent lack of confidence among some stakeholders in market making and price formation on the ASX market” is a symptom of the problem and is not the problem itself. The problem is market concentration in the wholesale electricity market coupled with a high degree of vertical-integration between wholesale supply and retail services.

Vertical-integration between retail and wholesale is limiting access to risk management products for non vertically-integrated retailers. This has been raised repeatedly as one of the most important barriers to competition over the last two decades, yet competition issues are barely afforded a mention in the HME consultation paper.

[10] Contact, Genesis, Mercury, Meridian, Trustpower, Todd/Nova, Pioneer and Pulse were the only industry participants that were invited. The Authority invited Pioneer and Pulse – the only non-incumbent participants to be invited – on the basis that it considers that they qualify as a vertically-integrated supplier.
[11] Letter from Carl Hansen (Electricity Authority), Initiatives to improve and solidify market activity and retail competition, 19 March 2018.

The EPR Panel was clear one of the "key factor[s] affecting the ability of independent retailers to compete is their ability to access risk management contracts on competitive terms" and detailed how this was a result on vertical-integration. The EPR Panel observed, for example, that:

> Vertical integration … can hinder competition because independent generators and retailers will find it hard to compete if vertically integrated companies refuse to deal with them or do so only on unfavourable terms. Some independent companies have said there are discriminatory pricing terms. The Electricity Authority, for example, investigated claims that vertically integrated companies were systematically discounting prices to commercial and industrial consumers below prices to retailer competitors in the contract market. The Authority found prices to be lower in 12 per cent of the contracts for which it had data … at face value 12 per cent seems sufficiently high to warrant concern.
>
> …
>
> Another drawback of vertical integration is that it can result in less use of contract markets – where companies buy and sell electricity ahead of time to lessen their exposure to wholesale price volatility. Vertically integrated companies have no inherent need for contract markets, whereas independent generators and retailers rely on them heavily. If large portions of the generation and retailing sectors have little use for contract markets, there will be low liquidity and muffled price signals, making it difficult and costly for independent companies to manage electricity price risks. An effective contract market, in contrast, supports ready access to contracts on reasonable terms, and sends clear price reference points for buyers and sellers.

The Authority, in contrast, "sees vertically integrated businesses as a feature of the New Zealand market and not a problem per se". If the Authority disagrees with the EPR Panel's assessment of the problems with the hedge market and contracting it should explain why.

We do not consider that the HME paper "assessment criteria" or so called "trade-offs" are helpful

The assessment criteria needs to help determine the extent to which different market-making options would help promote competition and more efficient operation of the electricity market. The assessment criteria in the HME paper is unhelpful for this purpose:

- **The assessment criteria should have a specific focus on promotion of competition.** If the Authority's hedge market reforms are going to help promote competition and more efficient operation of the electricity market to the long-term benefit of consumers, the relevant tests should include the extent to which the different market-making options would: (i) enable non-integrated participants to manage wholesale electricity market risks, and (ii) address the problem that vertical-integration between retail and wholesale is limiting access to risk management products for non-vertically integrated participants.

- **The assessment criteria should also include the time it would take to implement** (which, for example, should rule out options that would require legislative changes) **and the potential for the market-making scheme to evolve and adapt over time to meet access seekers' needs.**

- **The role of "assessment criteria" should be to help assess different options,** and design choices, **not to pre-determine a particular option**. It is not appropriate to include the "benefiaries-pay" funding option in the assessment criteria.

- **The HME paper's position on "beneficiaries-pay" is inconsistent with the Authority's position that "exacerbators-pay" is preferable to "beneficiaries-pay"**. The preference for exacerbator-pays over beneficiaries-pay is is a long-held position the Authority has held since 2012.[12]

An effective contract market is critical to mitigating the potential adverse effects of vertical-integration and short-term generator market power

Electric Kiwi and Haast agree with the EPR Panel that "An effective contract market is critical to mitigating the potential adverse effects of vertical integration and short-term generator market power".

[12] https://www.ea.govt.nz/dmsdocument/12978-decision-making-and-economic-framework-for-tpm-decisions-and-reasons

The Authority can draw directly on the work that its Market Development Advisory Group is doing on the high standard of trading conduct for evidence of the generator market power problem, for example:

Figure 1: Proportion of time large generators are gross pivotal at an island level across all trading periods (Source: Electricity Authority)

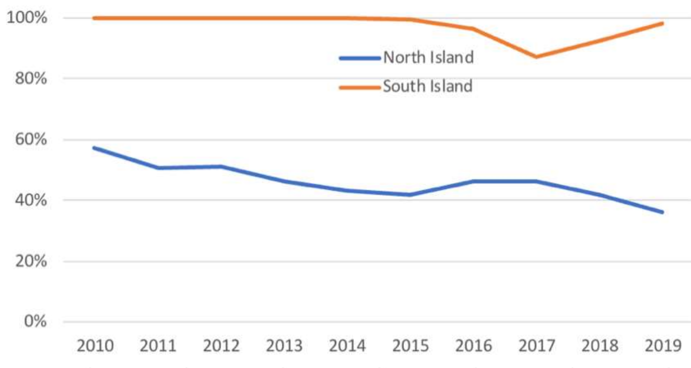


Figure 2: Proportion of time large generators are net pivotal at an island level across all trading periods (Source: Electricity Authority)

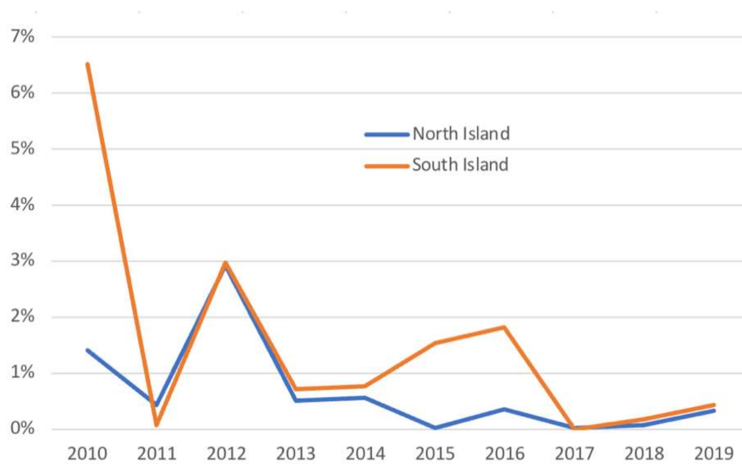


Figure 3: Proportion of time large generators are gross pivotal at an island level across all trading periods (Source: Electricity Authority)

	North Island			**South Island**		
Trader	**2010**	**2018**	**2019**	**2010**	**2018**	**2019**
Contact	37%	32%	24%	17%	8%	8%
Genesis	53%	33%	29%	0%	0%	0%
Meridian	0%	0%	0%	100%	93%	98%
Mercury	37%	33%	25%	0%	0%	0%

Evidence of generator market power should also include HHI and market concentration measures. The Authority has acknowledged in internal communication that “there is very little change since

2010".[13] Again, the absence of this information has resulted in understatement of the size of the problem.

The HHI and Concentration Ratios for the wholesale electricity market have changed very little since the Authority was established, and the HHI has been progressively getting worse over the last two years (see Figures 4 - 7). Since March 2018, the wholesale electricity market HHI has increased by nearly 300 points (14%).

The Commerce Commission defines a "concentrated market" as a market where the three suppliers have a total of 70% or more of the market. The three largest generators have 73% of the wholesale electricity market as at 29 February 2020.[14]

Figure 4: Wholesale electricity market HHI trend [Source: EA EMI data]

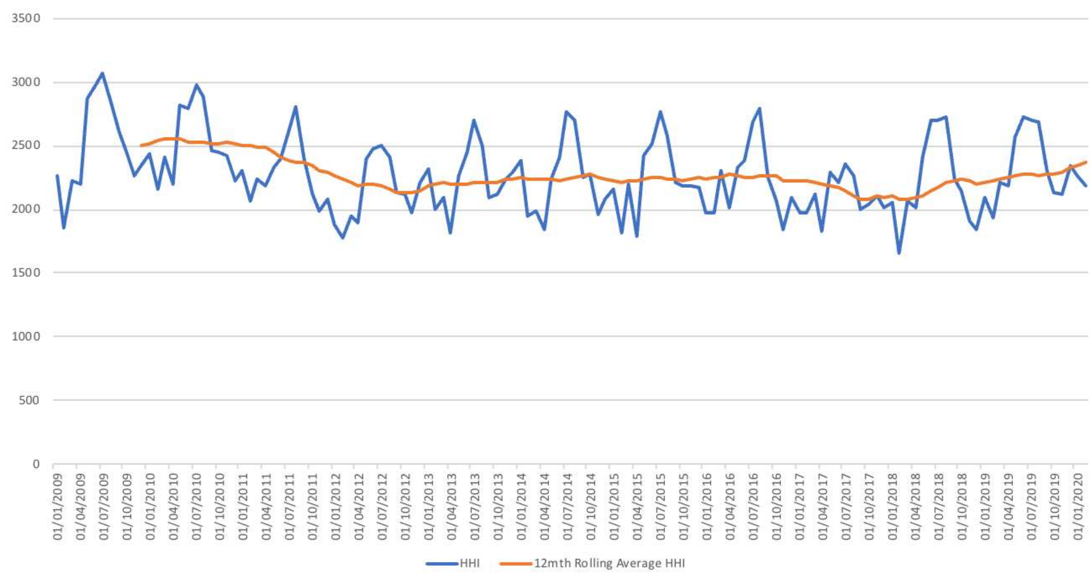
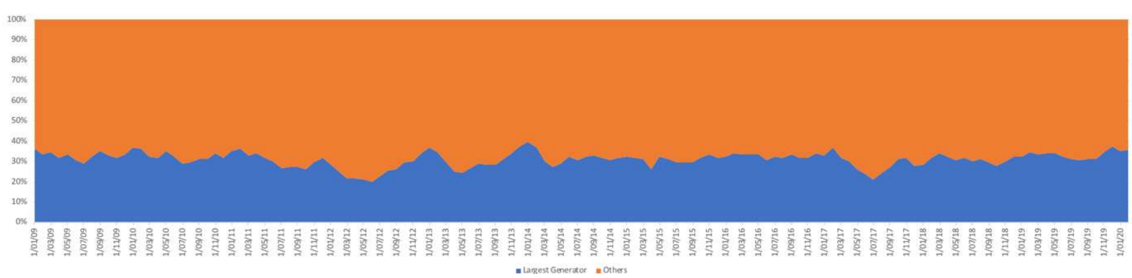


Figure 5: Wholesale electricity market CR1 trend [Source: EA EMI data]



[13] OIA release: 1219633 - Generation HHI_1229212_1.PDF.
[14] Or 70.6% taken as an average over the previous 12 months.

Figure 6: Wholesale electricity market CR3 trend [Source: EA EMI data]

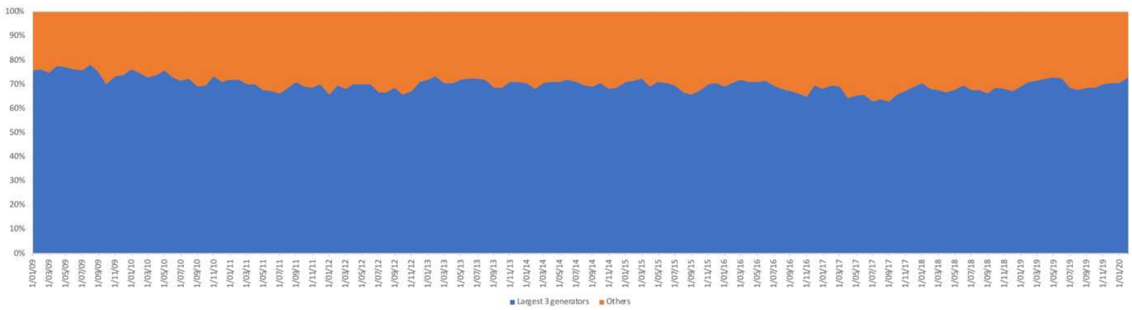
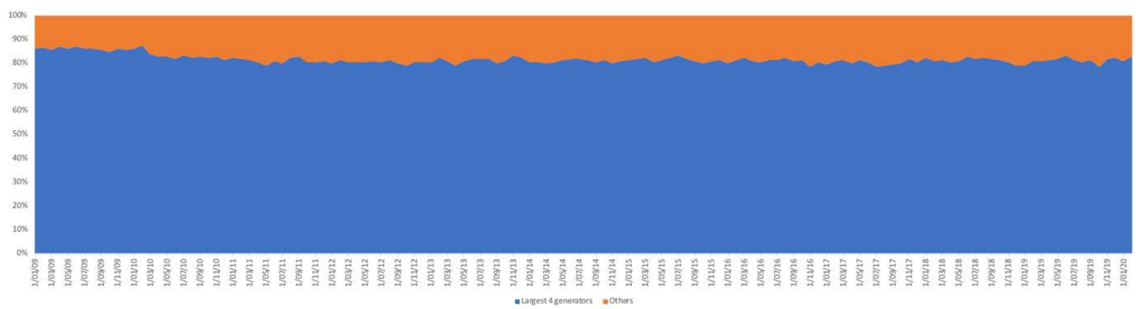


Figure 7: Wholesale electricity market CR4 trend [Source: EA EMI data]



What these market concentration measures show is that problems with generators being able to mis-use or exercise market power can be expected to be an enduring issue in the wholesale electricity and hedge markets.

If the Authority doesn't consider competition is a central benefit of hedge market reform what does it consider is needed to promote competition?

The discussion about competition in the HME Paper is very limited.

Competition isn't included in the HME Paper's assessment criteria, and the only comments on potential benefits of competition in the paper are claims that "All things being equal, competition is promoted equally well under any of the approaches" and "The Authority considers the ability to promote competition may be relevant to distinguishing a voluntary approach from all the other approaches".

While the Authority (Appendices to the HME Paper) acknowledges "Risk management contracts allow smaller and less diversified businesses without generation or large customer books to compete, innovate, and deliver value to customers" it also considers "The futures market has also contributed to an increasingly competitive retail market in New Zealand" and existing ASX market-making arrangements address concerns about large generator-retailers, including suggestions they could impose price or non-price barriers.

The HME paper also downplays problems with current voluntary market making, claiming "Evidence available to the Authority and reiterated by stakeholders suggests that current market making arrangements work well during normal market conditions". This statement is like saying house insurance works well except when your house burns down.

While the HME paper states the current arrangement "may be unreliable (too quick to reduce or even cease at times of market stress and too slow to return afterwards)" [emphasis added], it also states "that to a large extent this is simply the result of the cost, reliability, and service level trade-off under the market making services operating at the time".

If the Authority's suppositions are correct hedge market reform would do little to improve or promote competition in the electricity retail market.

This begs the question if the Authority considers hedge market reform won't address the problems with market concentration in the electricity retail market, what does the Authority consider is needed to address market concentration and promote stronger competition?

Progress on development of competition is too slowi

Our submission on the Authority's 2020/21 levy-funded appropriations detailed the slow progress that is being made in improving retail competition.

Figure 8: Reduction in incumbent electricity retailer market share under status quo

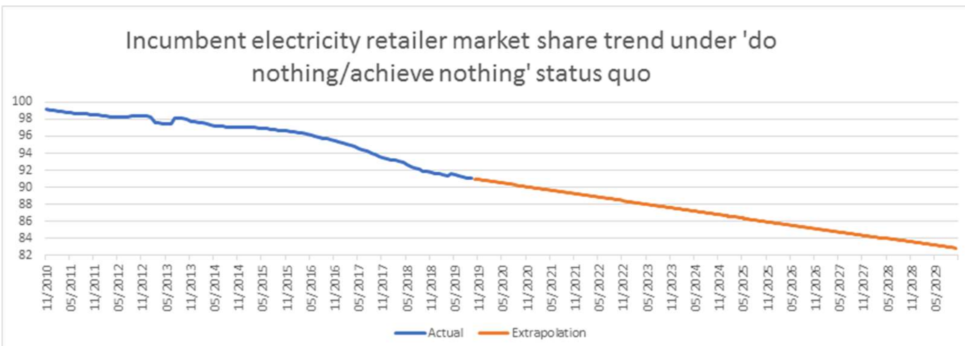
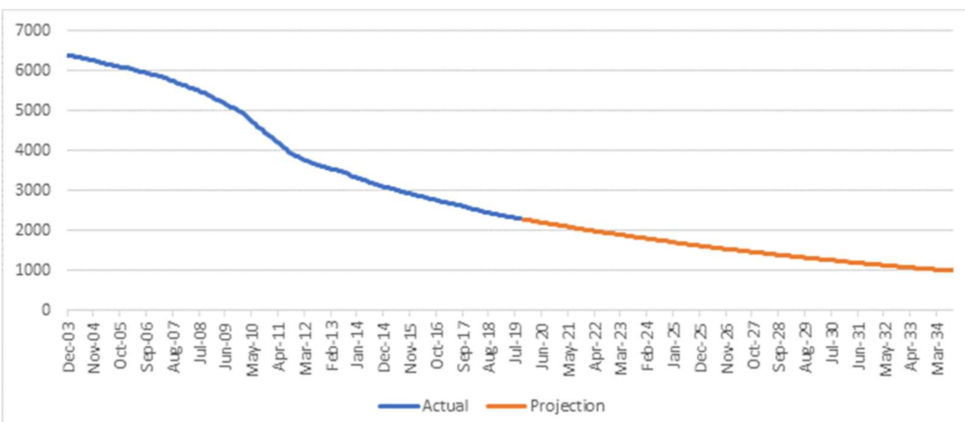


Figure 9: Reduction in the retail HHI under status quo



The Authority needs to ensure the electricity market shifts away from being heavily concentrated and becomes fully competitive if it is going to meet the requirements of its statutory objective.

If more isn't done, based on current trajectories it won't be until 2034 before there are no concentrated retail markets in New Zealand.[15] King Country, Tauranga, Central Hawke's Bay will all take over a decade before they are no longer concentrated, while Southern Hawke's Bay, Buller, North Canterbury, and Waitaki will take around 5 years (2024-25).

The UK Competition and Markets Authority uses thresholds of HHI higher than 2000 for highly concentrated, between 1000 and 2000 for concentrated, and under 1000 for unconcentrated. Under these measures 100% of electricity retail markets in New Zealand are concentrated and 64.1% are

[15] The Commerce Commission uses CR3<70% and CR1<40% as tests to determine whether a market is concentrated.

highly concentrated. On current projections it will be nearly 10 years before there are no highly concentrated retail markets and over 13 years before there are no concentrated retail markets.

Concluding remarks

Given the importance of hedge market reform to the promotion of competition, we are disappointed the substantial concerns raised in response to the October 2019 consultation have not been addressed. We reiterate that:

- The Authority appears to have a bias that no problem, and no competition problem, exists. An examination of standard competition measures (e.g. HHI and Concentration Ratios) clearly shows there is a problem with inadequate competition in the wholesale electricity market and electricity more generally.

- The EPR Panel's concerns that vertical-integration is the root cause of low hedge market liquidity appears to have been rejected by the Authority without any explicit or sound reason.

- The Authority seems to be trying to place the burden of proof on submitters (independent retailers) that there is a problem – but hasn't engaged with the evidence that has been provided, or the guidance provided in submissions about the type of evidence the Authority should procure.

- "While we, and other stakeholders, have provided substantial evidence in various submissions and fora, it is ultimately the Authority's responsibility (with support from submissions). Much of the information required to determine the problem is commercially-sensitive information held by the gentailers i.e. evidence of discriminatory practices and price squeezes. It is the Authority that has the information gathering powers to obtain this information".

- "The Authority does not appear to have had regard to the numerous submissions and evidence it has already been provided, including in relation to the UTS and EPR. It instead attempts to downplay such submissions by depicting them as "identif[ying] high level concerns with the current market making arrangements"."

Yours sincerely,

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