3 December 2018

Submissions
Electricity Authority
By e-mail: submissions@ea.govt.nz

Consultation Paper—2019/20 Appropriations and indicative work priorities

Electric Kiwi and Haast Energy welcome the opportunity to submit on the Electricity Authority's appropriations and indicative work programme for 2019/20. Electric Kiwi has been the fastest growing independent retailer in New Zealand electricity over the past 2 years. Haast Energy has significant wholesale trading interests in New Zealand electricity. Both Electric Kiwi and Haast Energy are controlled by Cumulus Asset Management (Cumulus), a UK based investor.

The submission should be read in conjunction with the Electric Kiwi, Flick Electric, Pulse Energy and Vocus' joint submission. The joint submission, consistent the comments below, reflects the negative impact the vertically-integrated and oligopolistic structure of the wholesale and retail markets has on competition.

Electric Kiwi and Haast Energy have the following comments on the Electricity Authority's work programme:

- We would like the Electricity Authority to adopt a tighter and more focussed work programme which prioritises removal barriers to entry **and growth** of new entrant retailers, and addresses the issues that can arise from retail-generation vertical integration.

- Addressing the two-tier retail market (saves and win-backs), spot market trading conduct and hedge market development (market-making) problems should be the Electricity Authority's highest priority projects.

- The need to prioritise completion of these projects is heightened by worsening market trends, including increases in the gaps between the tiers in the retail market, the deteriorating state of the hedge market, and unchecked mis-use of transient market power in the spot market.

- We want the Electricity Authority to provide firm commitments for when each of projects will be completed. The targets the Electricity Authority is proposing are far too weak and will result in the review processes continuing to take too long. For example, the Electricity Authority doesn't even need to consult on spot market trading conduct or hedge market development in 2019/20 to meet it self-set targets.

- There is ample time for Electricity Authority to complete the two-tier retail market (saves and win-backs) project, and consultation on both spot market trading conduct and hedge market development within the current financial year (2018/19).

- There is opportunity for the Electricity Authority to show leadership and resolve many of the issues the Electricity Price Review is looking at before the Expert Advisory Panel makes recommendations to the Minster of Energy.[1]

- A good outcome would be if stakeholders and the Electricity Price Review gained confidence issues that don't need legislative change to resolve are being dealt with appropriately by the Electricity Authority.

[1] For the convenience of the Electricity Authority, we have included our recommendations to the Electricity Price Review in the Appendix. The joint Electric Kiwi, Flick Electricity, Pulse Energy and Vocus submission does the same.

We want to see the impediments to fully competitive market outcomes removed

Our interest is in ensuring a strong and thriving competitive landscape where retailers operate on a level playing field, and aren't hindered from providing consumers, including those currently missing out on the benefits of competition, competitive prices and service.

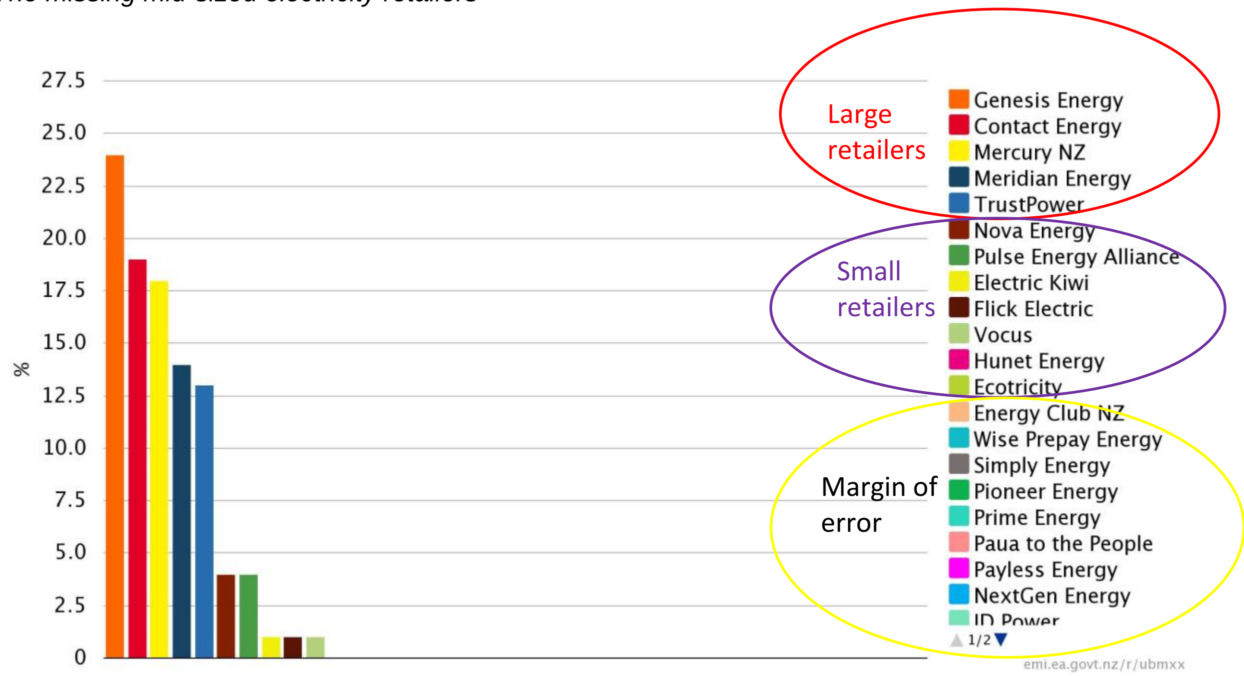
The Economist describes the missing middle class in India as the elephant in the room.[2] In the New Zealand electricity retail market, it is the absence of mid-sized retailers. There are small retailers, including a large tail of retailers with less than 1,000 customers, the 5 largest incumbent retailers, and nothing in between.

Only 5 of the small retailers are big enough to be depicted in the Electricity Authority's graphic of the market (see below).

In the absence of a mid-sized tier of electricity retailers, the New Zealand electricity market will continue to be oligopolistic with high levels of market concentration.

This can and is changing, but the change is too slow.

The missing mid-sized electricity retailers[3]



Electric Kiwi and Haast Energy are frustrated by how little progress has been made on addressing retail competition problems

The Electricity Authority is not giving enough priority to retail competition problems, and they are taking far too long to resolve.

We have tried to engage with the Electricity Authority proactively to assist with getting projects moving, including on saves and win-backs where we proposed a moratorium on early win-backs, as

[2] https://www.economist.com/briefing/2018/01/11/indias-missing-middle-class
[3] As at 31 October 2018: https://www.emi.ea.govt.nz/Retail/Reports/R_MSS_C?Percent=Y&_si=v|3

an interim solution given the lack of progress on the matter, and on details about how the Authority could adopt the Singaporean market-based or market-like approach to market making.[4]

The Cumulus submission last year was clear we want issues of transient market power in the wholesale market, the impact of vertical-integration in retail-generation on competition; hedge market performance and development (this is closely linked to the first two issues); and the two-tier retail market ('saves and win-backs') treated as the highest priorities. Of the issues Cumulus raised last year, there has been one round of MDAG consultation on saves and win-backs and little sign of progress elsewhere. The MDAG consultation was dissapointing; particularly compared to the extensive quantified evidence provided in the ACCC review of saves and win-backs, and subsequently by the Electricity Price Review in its initial Retail Billing Analysis.

Addressing the two-tier retail market (saves and win-backs), spot market trading conduct and hedge market development (market-making) problems should be the Electricity Authority's highest priority projects.

There is ample time for Electricity Authority to complete the two-tier retail market (saves and win-backs) project, and consultation on both spot market trading conduct and hedge market development within the current financial year (2018/19).

We want the Electricity Authority to provide firm commitments for when each of project will be completed.

The targets the Electricity Authority is proposing for these projects, and the projects in the work programme generally, are far too weak and will result in the review processes continuing to take too long. For example, the Electricity Authority doesn't even need to consult on spot market trading conduct or hedge market development in 2019/20 to meet it self-set targets.

If the Electricity Authority needs to halt or cancel other projects in order to progress and complete projects which will promote competition, in a timely manner, we would support the re-prioritisation.

While the Electricity Authority has focussed a lot of attention on vertical-integration issues in relation to EDBs and emerging technology, we would like to see more attention given to vertical-integration issues in the retail and wholesale markets. A lot of the arguments and concerns raised about EDBs have direct parallels with what we are observing with retail-generation.[5]

The outstanding issue of Meridian's mis-use of transient market power in the spot market is illustrative of the Electricity Authority's lack of progress on important projects

Electric Kiwi and Haast Energy are concerned the issues around Meridian's use of transient market power in 2 June 2016, which the Electricity Authority Board confirmed was not of a high standard and breached the Electricity Industry Participation Code, remains unresolved. We acknowledge though one of the problems the Electricity Authority faces, in trying to deal with this problem, is that it is fundamentally a structural problem.[6]

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[4] In Singapore reverse auctions are carried out for market making and the service is provided by willing parties who are remunerated at market rates for the service. This has proved very successful with much stronger market maker performance than in New Zealand and additionally the market making contracts have been a catalyst for new participants entering the market and competing in other parts of the market, particularly retail. A similar approach could yield a strong outcome for the New Zealand electricity market.

[5] One regrettable consequence of the Electricity Industry Reform Act was that it substituted lines-retail vertical integration for retail-generation vertical-integration. The Electricity Industry Reform Act does at least provide precedent for ownership separation, which could be applied to the 5 largest incumbent retailers, as well as how corporate separation and arms-length rules could be applied.

[6] The transitory market power arises from the oligopolistic nature of the wholesale market and the size of the 5 largest gentailers; particularly Meridian. Directing the large gentailers that profit maximising behaviour, when they have transitory market power, is a breach of good trading conduct, cannot address the underlying problem.

This is an area where the Electricity Price Review could assist the Electricity Authority by exploring options outside of the Authority's remit. The reality is that Meridian was left with too large share of the wholesale electricity market when it was set-up.

While the Electricity Authority has undertaken analysis of spot market trading conduct, and identified other examples of some of the more blatant and egregious abuses of transient market power, the work has not progressed adequately since it was handed over to MDAG over a year ago.

The KPI for the spot market trading conduct project could mean it will be well over 2 and a half years after MDAG took responsibility for the project before the first consultation occurs, and 4 years after the June 2016 event.

The timeline of events is provided below:

- 2 June 2016: Meridian (mis-)used its transient market power (the EA uses the term “net pivotal position”) to raise final prices in the South Island in the range of $3,000 to $4,600 per MWh above levels justified by scarcity.

- 16 June 2016: Electric Kiwi submits Undersirable Trading Situation (UTS) complaint to the Electricity Authority.

- 6 July 2016: The Electricity Authority announced it had declined Electric Kiwi’s complaint that 2 June was a UTS, but was launching a market performance review. The decision to decline the UTS was based on subjective judgement that the situation didn’t threaten the confidence in, or integrity of, the market.

- 4 May 2017: The Electricity Authority’s Board considered the allegation by Electric Kiwi that Meridian’s trading conduct on 2 June 2016 breached the ‘high standard of trading conduct’ provisions in the Electricity Industry Participation Code.

- 8 May 2017: The Electricity Authority notifies Meridian that the Authority Board considered its trading conduct on 2 June 2016 was not of a high standard and breached clause 13.5A(1) of the Code. The Board was also of the view that the safe harbours in clause 13.5B(1) of the Code did not apply. The Board warned Meridian “it does not expect a repeat of Meridian’s trading conduct on 2 June 2016 in the future and Meridian’s performance in that regard will be closely monitored. Any further non-compliance will almost certainly result in a higher-level intervention”.[7]

- 20 November 2017: The Electricity Authority Board requested the MDAG include a review of spot market trading conduct provisions in its workplan.[8]

- 18 December 2017: The Electricity Authority completed its market performance review into the high prices on 2 June 2016, which identified a number of examples where transient market power had been used to raise spot prices. The Electricity Authority did a good job of identifying the most egregious abuses of transitory market power in the spot market.

- 30 June 2018: The Electricity Authority issues “Electricity Authority Work Programme 1 July 2018 - June 2019”, with KPI to “MDAG publish discussion paper, if any”. This KPI seems virtually impossible not to meet. If a discussion paper is prepared in 2018/19 it just needs to be published to satisfy the KPI. If a discussion paper has not been prepared the KPI is satisfied anyway.

- 13 November 2018: The Electricity Authority proposes to set a KPI to “**Initiate** development of consultation paper on MDAG recommendations” in 2019/20. The proposed KPI signals that the Electricity Authority intends to meet its 2018/19 KPI by doing nothing and NOT preparing a consultation paper.

Last year, Cumulus made the observation “It is now over 18 months since Meridian’s code breach and we would like to see the matter resolved. There are clear and quantifiable detriments to

[7] https://www.ea.govt.nz/dmsdocument/22116
[8] https://www.ea.govt.nz/dmsdocument/23078-letter-to-mdag-2017-18-work-plan-trading-conduct

consumers and other market participants (particularly stand-alone retailers who don't get the benefit of the higher spot prices). We note Meridian also wants the Electricity Authority to provide clearer guidance about what conduct is acceptable.[9] It is now over 30 months since Meridian's code breach and there is little sign the matter is being progressed.

There are worrying developments which heighten the urgency to deal with retail competition issues

There can be no question there has been improvements in competitive market outcomes over the last decade. This is highlighted by statics measuring the level of market concentration, such as the HHI.

We have acknowledged: "Progress in the hedge market from 2010-2016 was a key enabler of increased retail competition from independent retailers. The Electricity Authority should be applauded for its role in hedge market development in this period. The market making arrangements were the key feature that led to this success. The gentailers agreed to provide this service after the Electricity Authority signalled its intention to regulate if the 4 largest gentailers did not do it voluntarily".[10]

While there has been some progress, it should be recognised the retail and wholesale markets still have strong oligopolistic characteristics. The extremely high levels of market concentration, with the largest three retailers having a market share of 64% and the big-five retailers a market share of 89%, highlight New Zealand has a long way to go before it has a fully healthy and vibrant competitive electricity market.

Vocus has pointed out that on the basis of current trajectories, the electricity market will remain oligopolistic for the next decade and beyond, and the 5 largest incumbent retailers will still have a combined market share of 80% in 10 year's time.

There are also worrying developments which have and are undermining confidence in, and the integrity of, the electricity market. These developments are material and warrant the Electricity Authority refocusing its priorities on addressing retail competition problems with urgency:

- **The two-tier retail market ('saves and win-backs') is a bigger problem than suggested by MDAG consultation:** The Electricity Price Review's initial retail billing analysis makes it clear the size of the "loyalty tax" is substantially higher than $360m per annum. It is notable Mercury dismissed the Electricity Authority EMI calculation that the level of the loyalty tax was $360m in 2017 alone, on the basis the five incumbent retrailers' retail EBITDAF in FY2017 was circa $400m.[11] At the time Mercury made these statements it would have known the billing data it provided the Expert Advisory Panel would show the EMI data substantially UNDERSTATES the level of the loyalty tax.

Table 1: Estimated average savings ($/year) available to consumers from switching

Region	Savings based on 'X'th percentile			Electricity Authority estimate
	10th	5th	1st	
New Zealand	240	280	400	
North Island	230	270	380	195
South Island	250	310	440	242

9 https://www.meridianenergy.co.nz/assets/Investors/Reports-and-presentations/Annual-results-and-reports/2017/Meridian-Energy-Integrated-Report-for-the-year-ended-30-June-2017.pdf, at page 28.

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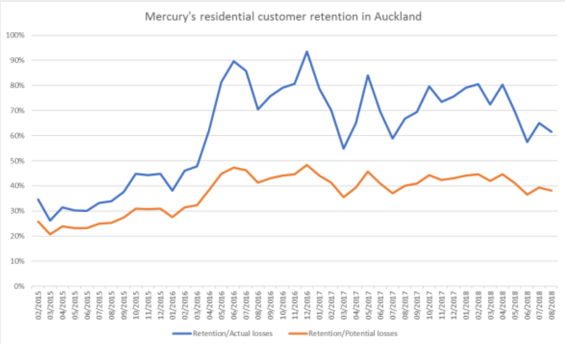
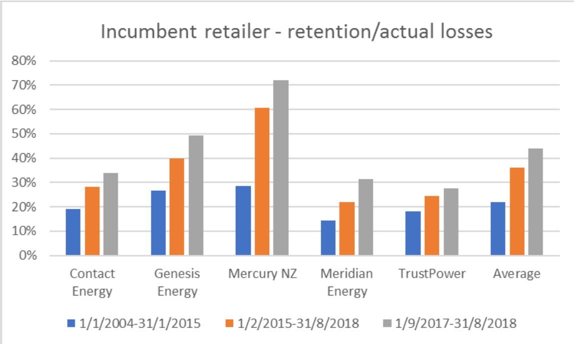
11 Mercury, Customer Acquisition, Saves and Win-backs – Cross Submission, 14 August 2018.

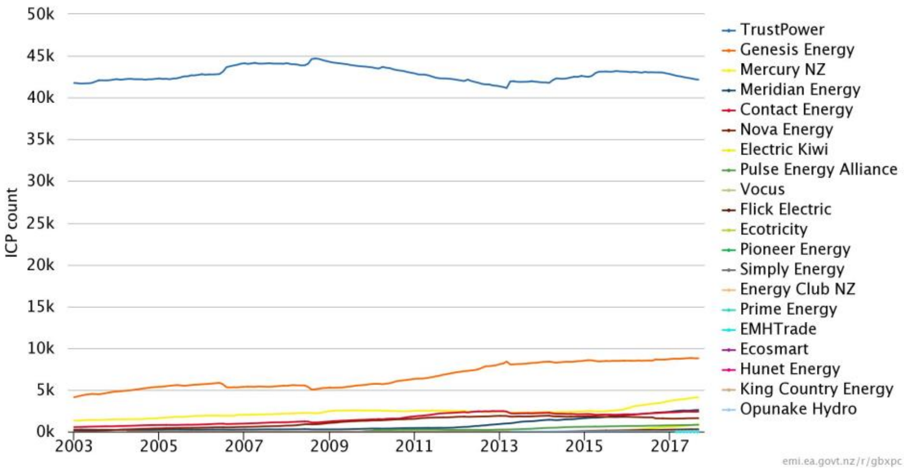
- The incumbent retailers didn't just substitute saves for win-backs after the Saves Protection Scheme was introduced, they increased the total level of saves and win-backs (retention) activity.





- **The regional markets where competition has failed the most have been ignored:** The market situation in Tauranga and King Country have simply been ignored. It is notable Trustpower has more customers in Tauranga now than in 2004.[12]

Trustpower's market share in Tauranga



- **Mis-use of transient market power in the spot market:** The Electricity Authority's review of High Prices on 2 June 2016[13] documented a number of instances where incumbent gentailers have (mis-)used or abused their transient market power (net pivotal position) in the wholesale electricity market to raise spot prices. A troubling part of Meridian's defense was that the practices they employ to manipulate the spot market have been used frequently by themselves and the other incumbent gentailers.

- **Lack of hedge market liquidity is holding competition back:** Cumulus has previously noted, based on participation in many deregulated wholesale electricity markets around the world, that New Zealand stands out as having among the lowest levels of wholesale liquidity relative to its size.[14] The ability of innovative new entrants to enter the market, and gain market share, is severely hampered by the low levels of wholesale liquidity, which is caused by high levels of vertical-integration. We remain of the view that the Electricity Authority should act to improve wholesale liquidity and create a more dynamic and competitive electricity market.

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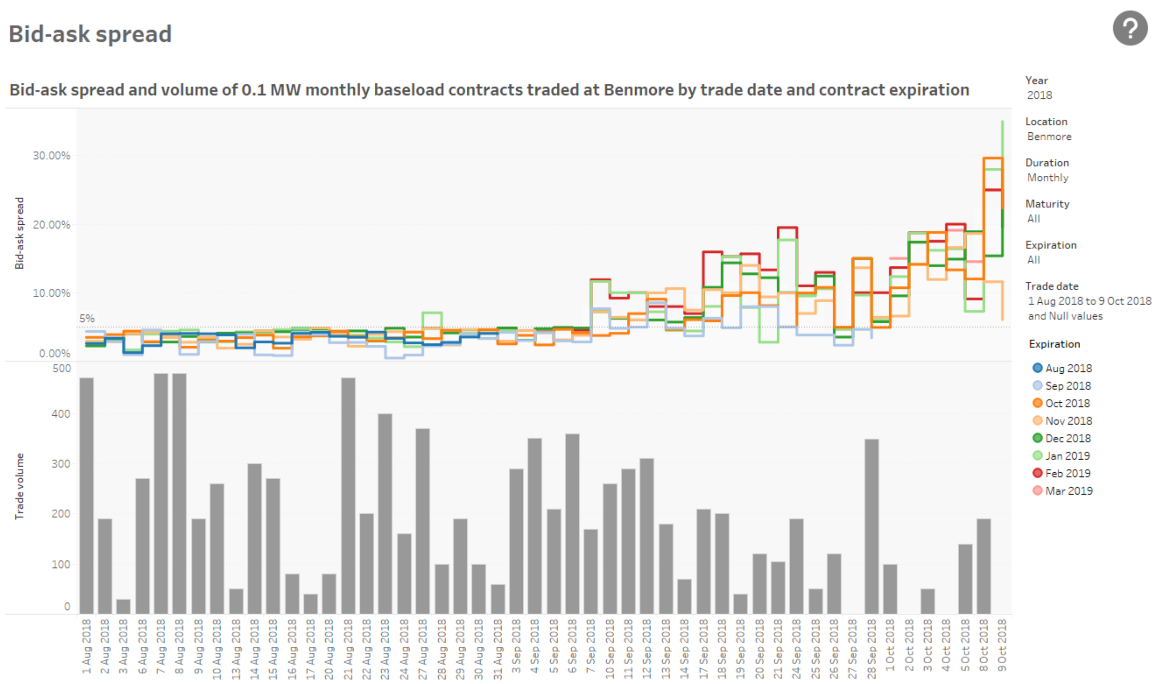
12 https://www.emi.ea.govt.nz/Retail/Reports/R_MST_C?Percent=N&RegionCode=TRG&RegionType=MAIN_CENTRE&seriesFilter=&_si=v|3

13 Electricity Authority, Market performance review: High Prices on 2 June 2016, 18 December 2017.

14 Cumulus, Submission by Cumulus Asset Management on the Consultaiton paper titled – Hedge Market Development: Enhancing trading of hedge products, 14 July 2015, at https://www.ea.govt.nz/dmsdocument/19666

- **Hedge market liquidity is deteriorating:** In the 2017 to present period progress has stalled, traded volumes have stagnated, and spreads have widened sharply. The incumbent gentailers have increasingly tested the appetite of the Electricity Authority to intervene by withdrawing from some of their voluntary market making obligations, and the Authority has not responded forcefully. This has led to progressive withdrawal from the voluntary market making obligations by all 4 of the gentailers in the scheme as they have sensed limited consequences. The market making obligations are now routinely ignored over the front 12 months of the ASX curve, this part of the curve is the most important for hedging and rebalancing for both independent retailers and independent generators.[15]

- The diagrams below show the recent spreads and volume in the monthly ASX contracts as all 4 of the largest gentailers have withdrawn from their obligations over the front 12 months. The contracts for the market making obligations require all 4 market makers to have a maximum of a 5% bid/offer spread.[16]



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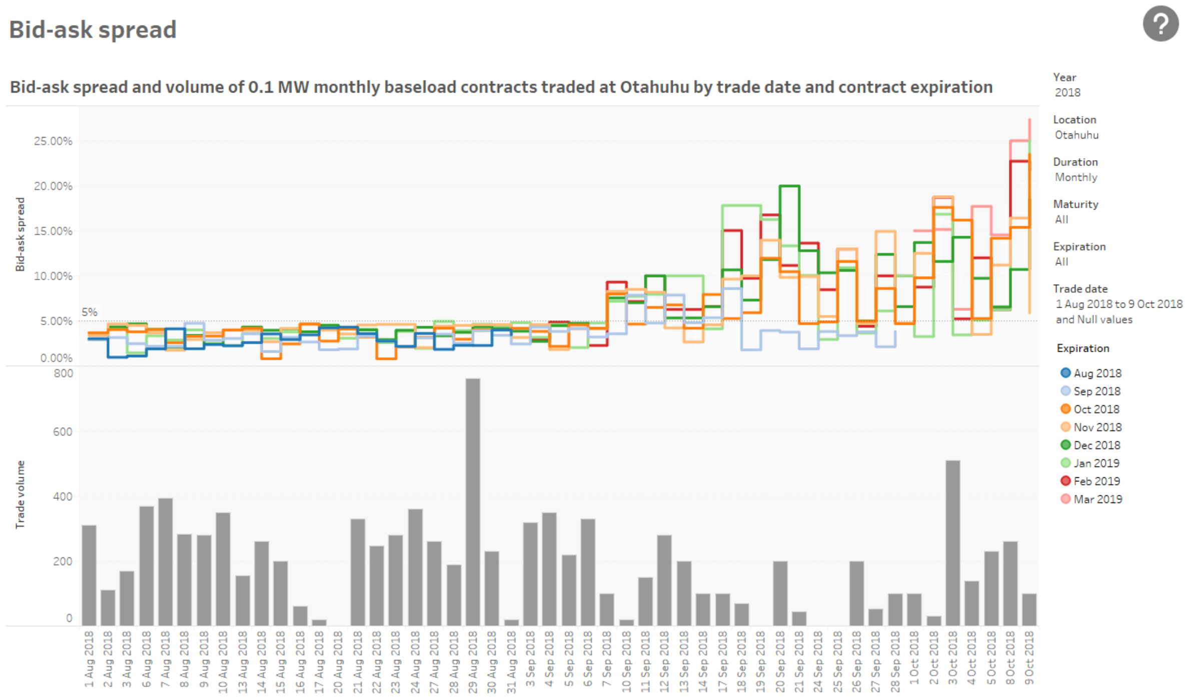
[15] These recent actions by the incumbent gentailers can be understood by the incentives and ability to undermine the hedge market and retail competition which the vertically-integrated incumbent suppliers have e.g.:

- Market making is a cost for vertically-integrated incumbents which they would rather not bear; and

- Market making also increases the competition the vertically-integrated incumbents see in the retail market. If market making collapses and retail competition retreats they will have more market power to extract higher retail prices.

[16] Figures 19 and 20 provided by the Electricity Authority, in response to an information request.



- One consequence of the deteriorating liquidity is that Electric Kiwi has been forced to decline to serve the large group of customers on spot based plans who have been fleeing the high prices and looking for fixed rate offers. While market fundamentals account for a significant uplift in the cost of acquiring additional hedges that would enable us to accept them, the bid/ask spreads routinely exceeding $100 are adding a significant additional component.

- **Conduct of the vertically-integrated incumbent retailers has lead directly to a blanket UTS complaint for the period from 15 September 2018, continuing as at 8 November 2018:** The UTS results from a confluence of factors; including: (i) potential force majeure events impacting gas supply; (ii) failure of market-making in the contacts market; (iii) sustained atypically high spot prices that appear to be at least partly attributable to the coordinated exercise of market power; and (iv) a blatant disregard for disclosure obligations.

- The failure of market-making obligations in the contracts market (a problem well-known to the Electricity Authority) and a lack of transparency exposes independent retailers and industrial consumers to the strategic and coordinated exercise of market power by gentailers with natural hedges. Put simply, without adequate contract cover, retailers and consumers are simply wholesale market price-takers. This is problematic in the best of circumstances, but it is many magnitudes worse when supply constraints emerge.

The Electricity Authority's Annual Report shows worrying signs about the hedge market

In normal market conditions, the hedge market is concentrated with all contracts having HHIs between 2,000 and 3,000.

The rise in quarterly HHIs for buyers and sellers in mid-2018 was a result of the dry winter and market makers on the ASX increase spreads. What it shows is that all that is required to turn the hedge market from a concentrated market to a monopoly position (HHI = 10,000) is a moderately dry winter.

This is reflected in the market statistics provided in the Electricity Authority's Annual Report for 2018:

Figure 13: Hedge market concentration for monthly buyers

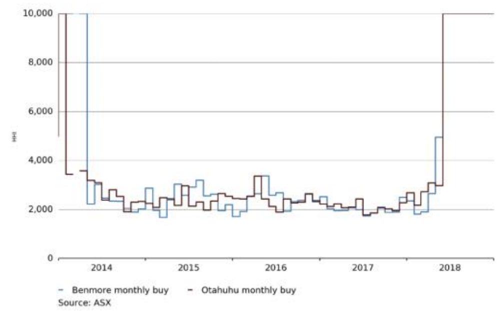


Figure 14: Hedge market concentration for monthly sellers

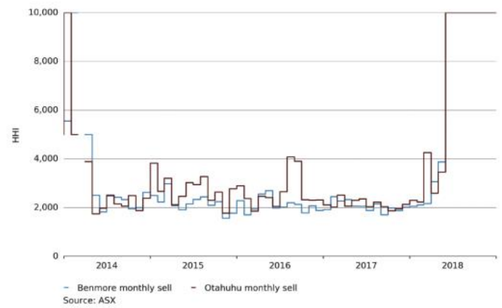


Figure 13.5: Hedge market concentration for quarterly buyers

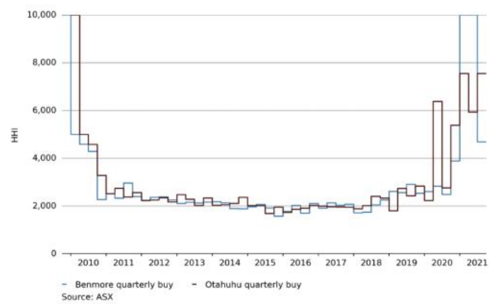
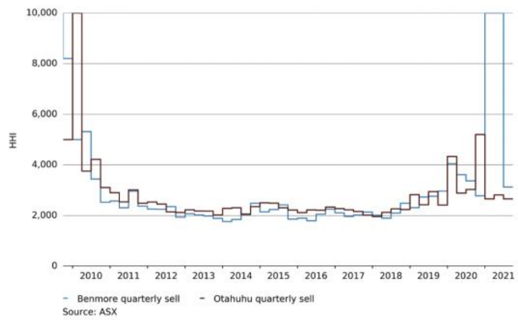


Figure 14.5: Hedge market concentration for quarterly sellers



Concluding remarks

The retail and wholesale markets are presently oligopolistic in nature, with a long-tail of small new entrants. The Electricity Authority's priority should be on ensuring development of fully competitive markets.

Consistent with Cumulus's appropriations submission last year, we would like the Electricity Authority to adopt a tighter and more focussed work programme which prioritises removal barriers to entry **and growth** of new entrant retailers, and addresses the issues that can arise from retail-generation vertical integration.

While the Electricity Price Review could impact on aspects of the Electricity Authority's work programme, there is opportunity for the Authority to show leadership and resolve many of the issues the Price Review is looking at.

We are more concerned about ensuring the impediments to Electric Kiwi and other independent retailers competing in the electricity retail market are removed, than whether it is the Electricity Authority or the Electricity Price Review that resolves them, but there is opportunity for the Authority to beat the price review to the table.

The Electricity Authority could resolve many of the issues the price review is looking at before the Expert Advisory Panel makes recommendations to the Minster of Energy.[17] The indications based on MDAG's handling of saves and win-backs aren't promising, with the signs being the issue will be white-washed by the group, but the Electricity Authority isn't bound to follow Advisory Group recommendations. It is our view the Electricity Authority failed to appoint a balanced group of members to MDAG and the group is dominated by gentailers with no independent retailer

[17] For the convenience of the Electricity Authority, we have included our recommendations to the Electricity Price Review in the Appendix. The joint Electric Kiwi, Flick Electricity, Pulse Energy and Vocus submission does the same.

representation. We note members are appointed in a personal capacity but also that members tend to think in ways consistent with their organisation's interests.

The lack of balance in MDAG seems particularly inappropriate given the key projects of saves and win-backs and trading conduct the Electricity Authority gave the group. These are projects where gentailers and independent retailers have diametrically opposed views and incentives, and the Electricity Authority should have expected the issues would be debated along those lines. We urge the Electricity Authority to consider the balance of Advisory Groups carefully in the future, and to take the current lack of independent retailer representation into account when considering what action to take on saves and win-backs in particualr.

The specific matters we would like addressed, are the same issues Cumulus raised last year and, include:

- Issues with market power, or transient market power, in the wholesale market, including the outstanding matter of Meridian's June 2016 trading conduct, and market performance during the 2017 winter;

- Issues with vertical integration in retail-generation, which haven't received the attention it warrants or the attention there has been on EDB vertical integration;

- Hedge market performance and development (this is closely linked to the first two issues); and

- The two-tier retail market or 'saves and win-backs'.

Yours sincerely,

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Appendix: Electric Kiwi and Haast Energy’s proposed options for the Electricity Price Review

Issues to address	Options which the Panel should consider
Competition issues:	
• Information collection and asymmetry problems	1. Amend the Electricity Industry Act to provide that future electricity inquiries or reviews have information gathering powers.
• The two-tier retail market and the incumbent retailer retention (winback) strategies that underpin it.	2. Ban near-time winback (at least while the incumbent retailers’ retain an incumbent retail customer base). 3. Prohibit use of information from the switching process for another other purpose than facilitating the switch are two changes that are needed.
• The variation in the quality of retail competition across New Zealand.	4. Prohibit the TECT tying dividend entitlement to being a Trustpower customer/replace with entitlement based on geographic location.
• Transitory market power in the wholesale market.	5. Asset Swap 2: Establish a new, generation-only, State-Owned Enterprise “KiwiHydro” by: a. re-allocating some of Genesis’ Tongariro, Mercury’s Waikato River and Meridian’s Waitaki hydro stations, and b. ensuring the re-allocation results in Genesis, KiwiHydro, Mercury and Meridian having roughly equal size generation portfolios.
The impact of vertical integration in retail-generation.	6. Structural separation of Contact, Genesis, Mercury, Meridian and Trustpower’s retail and generation businesses: a. ownership separation (1st best), b. corporate separation with arms-length rules (2nd best), and c. financial separation (3rd best).
• Hedge market performance and development.	7. Adopt a similar approach as Singapore to market making in the hedge market.
• Meter Equipment Provider issues	8. We recommend that all existing metering contracts are required to be cancelled and standardised metering contracts introduced. These standardised contracts should: a. Facilitate economic displacement in the best interests of end-consumers; b. Include minimum service delivery levels for both legacy and smart meter data with clawbacks for non-delivery; and c. Be subject to regular review to ensure relevance as new technology and business models emerge and the metering landscape changes.
Social issues and fairness	
• Ensuring late payment penalties are not-excessive or disproportionate to the cost retailers incur or are banned completely.	9. Ban Prompt Payment Discounts or a. require use of the term “late payment penalty” to ensure fair and transparent pricing with a prohibition on the term “Prompt Payment Discount” or other wording that creates an impression consumers are getting a special deal; and b. “restrict … conditional discounts to be no more than the reasonable savings to the retailer from the condition being met” (ACCC recommendation 33).

Issues to address	Options which the Panel should consider
• Ensuring pre-pay arrangements do not exploit vulnerable and medically dependent consumers.	10. Introduce pricing/debt repayment standards and requirements for pre-pay retail service providers to ensure fair pricing for consumers most in need. 11. Introduce new reporting requirements for pre-pay retail service providers which include the frequency with which self-disconnections occur, and the durations of the self-disconnections. This data should be broken down by customers that are “vulnerable consumers”, “medically-dependent consumers” and all other households.