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## Level-playing field measures

### Executive Summary

Action is required to ensure we continue to have a secure and affordable energy supply for New Zealanders.

The Options Paper reflects the Energy Competition Task Force's response to several interconnected challenges associated with navigating the energy transition. Access to and cost of flexible generation at a time when supply is constrained relative to increasing demand as more intermittent renewable generation is developed is particularly important. Currently, flexible supply is predominantly in the hands of market participants who own aging thermal assets and/or hydro generation. Demand for flexible supply is steadily increasing due to a proliferation of intermittent renewable generation.

*Priority issue is independent retailer access to risk management products*

We agree with the Task Force that there may be an issue for independent retailers accessing shaped hedge products that needs to be addressed and support the broader objectives of the Task Force in improving liquidity, competitive prices and even-handedness. In our view, however, it is vital to the overall success of the market that there is a range of different business models (including gentailers, independent retailers, independent generators and flexibility providers) that can vigorously compete and promote the best outcomes for customers.

Instead of the level playing field measures proposed, boosting the existing hedge market will better solve the issue of access to shaped hedge products. Ensuring best practice trading conduct and improving both transparency and liquidity of the hedge market will ensure all market participants can access competitively priced risk management contracts to manage their risks. This will support competition and investment in both the wholesale and retail markets.

*Market-based measures can be scaled to boost the hedge market and deliver better outcomes*

The Authority should continue to build on current market-based initiatives, in collaboration with industry experts. The recently introduced standardised flexibility product (which is now trading) and measures designed to support market participants to transact power purchase agreements are great examples. Likewise, requiring market making could effectively achieve even handedness using a market-based mechanism (as each gentailer is required to both buy and sell in the same market).

Adjusting market settings by deploying targeted, proportionate interventions that are scalable is the most effective way to navigate the energy transition, while delivering the best outcomes for consumers.

Mercury would strongly support the Authority moving to appropriate interventions if it could point to sound evidence that market-based approaches are not delivering the desired outcomes, whether it's workable competition, hedge market liquidity and transparency, or even handedness. One example of how this could be achieved would be by incrementally increasing the scope of market making obligations



beyond base products to include other products that together are sufficient for effective risk management.

Ensuring clarity around the direction of travel and appropriate, well-defined triggers for incremental changes will ensure sufficient certainty to enable us to continue to scale up our generation investment and help maintain security of supply while we continue to compete in the retail, wholesale and futures markets.

#### *Non-discrimination principles won't address the issues*

While the implementation of non-discrimination principles may provide the Authority with data about the notional internal transfer prices and the retail function margin of gentailers, it is not expected to address the risks the Task Force has identified or to contribute substantially to New Zealand's navigation of the energy transition.

In part this is because of the substantial practical difficulties associated with implementation, acknowledged by the Task Force who scored this measure negative for workability. For example, requiring the use of an "economically meaningful portfolio of ITPs" as a benchmark for external hedges is complicated by the fact that Mercury's current approach to ITPs is not meaningful for this purpose and therefore any new approach must be imputed. This approach risks the Authority having to substitute its own judgement for that of the market as well as adding transaction costs to the system which will flow onto consumers.

The non-discrimination proposal is more suited to a traditional network monopoly controlling an essential input that is not economic to replicate. It is not suited to the New Zealand electricity generation market where flexible generation is supplied in competition between four gentailers and others that rely on different fuels.

The possibility of applying a methodology for imputing internal transfer prices that might not satisfy the Authority (or other participants) means there is a substantial likelihood we would move to step 2 (where more prescriptive requirements would be introduced) then to step 3 (where all gentailer-supplied hedge contracts must be traded through a regulated market).

Moving to step 3 is not an incremental increase in non-discrimination measures nor is it a proportionate response to the identified issue; it is a form of gentailer separation and would be a backward step for New Zealand. The inherent efficiencies of retail-generation integration would be lost under this option, which will put an upward pressure on retail prices while stalling the investment in generation.

#### *Process and next steps*

Mercury appreciates the engagement we have had with the Task Force on this consultation to date. Given the complexity of the problem definition and the potentially significant implications for the electricity market participants and design we would expect the Authority to grant a period for cross submissions.

We also look forward to understanding how the proposals in the Options Paper align with the other work of the Task Force, the Authority's work programme and the Ministerial Review. It is crucial that any regulatory interventions are carefully designed to address clearly defined issues, are subject to rigorous cost/benefit analysis and are coordinated with the Task Force's other projects to achieve the Task Force's stated objectives without any unintended consequences.

If the Authority decides to take further steps to implement principles-based non-discrimination measures, Mercury seeks greater clarity on the Task Force's expectations, including meaningful measures of success, and an opportunity to engage on "second order questions" regarding implementation to reduce the risk of further unnecessary regulatory intervention.



## 1. Priority should be access to risk management contracts for flexible supply

Access to risk management contracts underpinned by flexible generation is an important input to both the development of new intermittent renewable electricity projects, such as solar and wind, and the entry and expansion of new retail participants.

Assessing whether owners of flexible generation are misusing substantial market power in a defined market is challenging, particularly in New Zealand's dynamic, hydro dominated energy-only electricity market which features a variety of market participants each with unique combinations of portfolios and risk management strategies. It requires, amongst other things determining the: relevant markets; market structure; barriers to market entry (and exit); the process of oligopolistic rivalry; costs of inputs; and in general the impact of demand and supply side substitutes over time.

Mercury agrees that if there is insufficient competition in the provision of flexible supply and the associated market for risk management products, this could have long-term consequences for competition in the generation and retail markets. We do not consider the work completed by the Task Force to identify a competition risk in the narrowly defined market for shaped hedge products is conclusive and note the Task Force's view that it is difficult to distinguish anti-competitive behaviour from fuel scarcity. This assessment is supported by analysis of scarcity in response to the Authority's Risk Management Review<sup>1</sup>.

The evidence presented does not enable a conclusion that there is a lack of workable competition sufficient for it to be preferable to rely on the proposed non-discrimination measures which, even if they could be made workable, will reduce the incentives to invest or innovate in relation to flexible generation and potentially lead to increased prices for consumers. There is however some evidence of issues with access to risk management products which requires attention (outlined further below). We support the Authority giving priority to addressing this in a robust manner.

Mercury considers the best approach is to take the steps outlined below to improve access to risk management products and enhance transparency and liquidity of the hedge market rather than to pursue the proposed non-discrimination options. These measures can be incrementally strengthened if empirical evidence of competition issues in either the retail or wholesale markets does come to light.

## 2. Mercury supports a transparent and liquid hedge market

We agree with the Options Paper comment: "*Hedge contracts matter – they support the financial viability of new and independent retailers and generators in the electricity sector. They are critical to enabling competition, which will get more power into the system, provide more choice to consumers and put downward pressure on electricity prices.*"<sup>2</sup>

Mercury agrees with the Task Force that the liquidity and transparency of the risk management contracts market, particularly access to peak or shaped products, is crucial given we are transitioning to a more renewable electricity system and flexible generation will continue to be scarce until new investment comes online. A more transparent and liquid market will provide market participants with comfort that prices reflect the scarcity value of the services rather than market power.

The Task Force points to evidence from the Risk Management Review that suggests that the hedge markets should be improved. This evidence included:

- Retailers only receive one offer in response to requests for shaped hedges over a third of the time and it is not clear why some gentailers do not respond to requests for proposals (noting that Mercury responds to all valid requests);

<sup>1</sup> Responding to matters set out in Reviewing risk management options for electricity retailers – issues paper, Sapere, 20 Dec 2024. The report finds that peak demand has been rising faster than investment in peak capacity for some time due to scarcity of physical supply which has occurred as a combination of, among other things, a decline in gas production, weak investment signals for building and maintaining peaking plant as a result of climate policy and energy policy signalling a move towards 100% renewable electricity by 2030.

<sup>2</sup> Level Playing Field measures – Options paper – 27 February 2025 – page 2



- OTC super-peak hedge contract prices trade at substantial premium over ASX baseload prices adjusted for shape and it is not clear whether this is justified; and
- An ongoing gap has developed between the forward curve derived from ASX hedge prices and the cost of new generation build.

Mercury considers there are a range of pragmatic and sensible market-based options that could be pursued by the Task Force to address these issues. These are set out below.

*i. Mandating the OTC Code of Conduct*

Mercury would support the Authority converting the voluntary over the counter (OTC) code of conduct, developed with the help of market participants, into a mandatory code and establishing robust monitoring and enforcement provisions.

This action could be undertaken as a priority. We would expect this action to result in an improvement in market participant's conduct which should contribute to achieving the Task Force's objectives. We also note there is some overlap with the behavioural expectations under the OTC code of conduct and outcomes being sought by the Task Force, in that the code expects participants to be treated consistently.

*ii. Building on Hedge Market Disclosure Obligations*

The Authority should use the revised Hedge Disclosure Obligations to monitor and publish information about flexible contracts trading. This should be supplemented with regular reviews to assess the success of these obligations in achieving desirable market outcomes, with the option to further deepen these obligations, if necessary.

Further sunlight on activity in the hedge market will help build confidence in the arrangements.

*iii. Continuing to develop standardised flexibility contracts (Task Force 1B workstream)*

The liquidity and transparency concerns identified by the Risk Management Review, have in part been addressed through Taskforce Project 1B with a standard super peak product being developed and trading from January 2025. Mercury supports the continued monitoring of trading of the standardised super peak product and ongoing work to introduce more flexibility products to enable all participants to manage their risks, building on the advice of the Standardised Flexibility Product Co-design Group. We note that MDAG envisioned that there would be a suite of standardised flexibility products and that this ongoing work should be prioritised.

Standardised products will not meet everyone's needs. In our experience independent retailers tend to be looking for short 2–3-year duration contracts while independent generators are generally looking for significantly longer-term arrangements to underwrite investment in renewable generation. The introduction of mandated conduct requirements (outlined above) should help ensure confidence by independent retailers and generators that they are getting the best deal to manage their risks when seeking bespoke arrangements.

*iv. Continuing to explore options to support new entrant generation (Task Force 1A workstream)*

Options to enable new entrant generation, such as requiring gentailers to offer firming for power purchase agreements (PPAs), are currently being addressed through the Task Force initiative 1A. Mercury supports exploring the options for supporting new entrant generation, including the Business Energy Council (BEC) led work to encourage corporate uptake of PPAs through developing a standard template, guidelines and advisory services/ education. Mercury has experience with PPAs and encourages market participants to talk to us about more bespoke arrangements over the counter. Mercury will continue to always price these.





v. *Consider introducing market making obligations for gentailers*

Mercury considers introducing further market making obligations on gentailers would be the best market-based approach to improve the credibility, liquidity and accessibility of risk management products to non-integrated retailers and generators. It can be directly targeted to address the main concerns raised in the Options Paper and scaled over time if further challenges are identified.

We note that the success of the current market making arrangements for baseload products has in part been the result of the arrangements being developed via co-design. We strongly support this approach continuing to be adopted for both the introduction of further risk management products and market making obligations.

Any move to market making, would require consideration of the likely costs of market making, and a range of other design features.<sup>3</sup> There needs to be understanding and acceptance that the price of hedge products will be high in times of scarcity and an appreciation of how this new mechanism would fit with existing market making. Any solutions will also need to address the cost of trading of platforms like the ASX and whether using a bulletin board approach initially would enable a speedy response and reduce access barriers.

#### **Summary of Recommendations**

- Make the OTC code of conduct mandatory and take enforcement action as appropriate.
- Use the Hedge Market Disclosure Obligations to monitor and publish information about flexible contracts trading and undertake regular reviews to assess performance of the arrangements and consider deepening these obligations.
- Continue with Task Force 1B standardised flexibility product development workstream. Monitor trading of the standardised super peak product and introduce more products as required building on the advice of the Standardised Flexibility Product Co-design Group.
- Continue with Task Force 1A PPA workstream and support BEC led work to encourage corporate uptake of PPAs including developing a standard template, guidelines and advisory services/ education.
- Consider introducing market making obligations for gentailers for an appropriate shaped product (peak or super peak) and monitor market performance.

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<sup>3</sup>Responding to matters set out in Reviewing risk management options for electricity retailers – issues paper, Sapere, Dec 2024, pg 20. We note “Absent sufficient investment in flexible capacity, regulatory interventions such as market making can risk unintended consequences. If the underlying problem is scarcity of peak supply (as has been the case), an entity subject to market making could be at risk of being caught with a trade that cannot be backed by physical generation and the inability to purchase cover. Unless carefully designed, the result could exacerbate regulatory risk in the market and discourage new entrant investors (who would reasonably be concerned that they would be subject to the same intervention), the opposite of what was intended from the intervention.”



### 3. The proposed three-step progressive approach to non-discrimination won't address the issues

The Task Force puts forward a three-step progressive approach to the implementation of the non-discrimination obligations.

- Step 1 requires the application of principles-based non-discrimination obligations to govern the disclosure of an 'economically meaningful' portfolio of internal transfer prices (ITPs).
- Step 2 is prescribing the methodologies for these.
- Step 3 requires mandating the trading of all hedges by gentailers, particularly between generation and retail functions, via a market trading platform.

Mercury does not consider that steps 1 and 2 will further the Task Force's objectives, with net benefits to consumers more likely to be achieved by the actions listed above. Furthermore, steps 1 and 2 are likely to:

- Encounter practical implementation challenges (and associated compliance costs) which mean they are unlikely to address the issues;
- Encourage significant ongoing lobbying by participants; and
- Put the Authority in the position of having to potentially substitute its own judgement for that of the market around whether "the price is right". This risks chilling investment in flexible generation.

Step 3 is not a progressive escalation of the non-discrimination measures outlined in steps 1 and 2, nor is it a proportionate response to the identified issues. It is a form of gentailer separation, say "*trading separation*", where trading is introduced between generation and retail functions, and represents a backwards step for the New Zealand electricity market.<sup>4</sup> Trading separation of vertically integrated gentailers raises the risk of severe adverse outcomes for the market overall, as it would remove the recognised benefits of vertical integration across the sector and result in increased costs to consumers. Our reasoning is set out below.

#### *i. Practical challenges associated with use of ITPs as the benchmark*

The proposal to use a new, robust ITP methodology as a benchmark for external hedges is made challenging by the fact that an "economically meaningful portfolio of ITPs" as proposed by the Task Force does not currently exist (at least for Mercury) and Mercury's current approach to ITPs is not meaningful for this purpose. Any notional ITP that is established may not provide a directly economically meaningful or relevant measure for informing external hedge offers to others.

The proposal would result in requirements to artificially construct notional internal contracts which will centre on an administered regulatory framework to promote even-handedness (or equivalence).

We acknowledge it could be possible to develop a benchmark, for example based off ASX/listed OTC prices (i.e. to reflect the opportunity cost of internal supply) or some sort of estimate of the marginal costs of self-supply at a point in time, but it would be challenging.

- It will require considerable rule design to "make it work", as recognised by the Taskforce's assessment of workability on page 50 of the Options Paper, and will be less effective in addressing the underlying concerns than improving the contracts market.
- There are also considerable challenges in estimating marginal costs of self-supply in the context of a hydro-dominated market (with highly variable water values) and a circularity in considering

<sup>4</sup> There are many variants of separation, as illustrated in the case of the telecommunications sector by Martin Cave's paper, [Six Degrees of Separation: Operational Separation as a Remedy in European Telecommunications Regulation](#). The Task Force's consultation paper also considers the option of Corporate Separation, where generation and retail are separate legal entities with separate financial accounts and arm's length rules. Trading Separation would be a variant of separation of retail and generation functions.



benchmarking against traded hedge market products when there is a need (and greater value) in focussing efforts in deepening that market.

Finally, we think it is important to recognise the potential risks if any arrangement were to require gentailers to transact at levels below their willingness to exchange risk, which need to be carefully considered. While it is likely to encourage entry of independent retailers, if hedges do not reflect the full costs, it is also likely to support them to adopt risky strategies to compete on price with incumbents following long-term hedging strategies. Incentivising retailer entry and expansion, without by the process of competition testing the new entrant business models, would be detrimental to efficiency in the long run.

*ii. Non-discrimination measures are more easily applied when regulating monopolies*

In other sectors, such as telecommunications and distribution businesses, where similar provisions have been applied access prices are firmly grounded in the relatively stable and readily identifiable costs of building and operating physical assets.

This is a markedly different context to the electricity contracts market in New Zealand, where there are four competing gentailers and merchant generators. It is important to keep in mind that where regulators have imposed access prices on competing firms in other circumstances, say for mobile terminating access services, those prices typically reflect a common and hypothetical benchmark, rather than the individual circumstances of each business as would be the case under the current proposal.

*iii. Risk of losing efficiencies of vertical integration*

As outlined above we think stage 3 amounts to a form of vertical separation and would result in a backwards step for New Zealand.

Vertical integration delivers significant benefits to the sector because it:

- Creates incentives to invest in new generation. We can either buy electricity or invest in building our own.
- Promotes competitive outcomes for the market. Competition between different business models benefits consumers; there will be periods when one model may be more competitive than another.
- Is a lower cost operating model – reducing cost to serve and ultimately cost to consumers.
- Enables us to offer meaningful support to consumers in hardship and provide hedges to social retailers (Toast Electric and Nau Mai Rā) at rates that enable them to deliver on their goal of eliminating energy hardship.
- Allows balance sheets to be utilised to provide security of supply for New Zealand when there are capacity constraints, dry years or fuel shortages.

The Authority's Review of Winter 2024 report highlights the contrasting benefits and risks between vertical integration and relying solely on a hedge market to manage risk, particularly when wholesale spot market prices are volatile.<sup>5</sup> This is not a new issue, the 2009 Ministerial Review also looked into this.<sup>6</sup> We consider it is important that the inherent efficiencies associated with the vertical generation model, including transaction cost savings of not having to impute an internal price to a gentailer's own natural hedge and the benefits this provides for effective risk mitigation, continue to be recognised and enabled as this will ensure lowest cost to supply consumers.

<sup>5</sup> Review of Winter 2024 report, para 1.10: *Despite the very high prices in early August, the overall energy margin for the large gentailers was lower in early August than it was in July and September. These gentailers are vertically integrated, so while generation revenue rose as prices increased, the cost of meeting retail and hedge obligations also increased. Also, a high amount of thermal fuel was being used in August, which increased the cost of generating electricity.*

<sup>6</sup> See the outline of the benefits of vertical integration outlined in: Improving Electricity Market Performance, A Preliminary Review of Electricity Market Performance by the Electricity Technical Advisory Group and the Ministry of Economic Development, (Aug 2009) Volume Two Appendix 20, pg 147.



Finally, separation of a company's generation function would reduce the ability or incentive to invest in generation. Shareholders would be reluctant to fund 100% of an investment if requirements around offering risk management contracts to retailers, including those not willing to take the risk of investing in generation, mean the benefit of that investment is harder to realise.

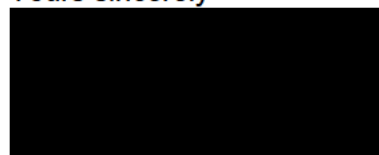
*iv. Other level playing field options*

We acknowledge the Task Force's consideration of various other "level playing field" options as part of its review which it has chosen not to pursue further at this stage. Mercury has not considered those options in detail, however, considers that the suggestions at section 2 above are the better approach for achieving the Task Force's objectives. Mercury does not comment on the assessment of each option detailed in Table 5 on page 50, however, as a general comment does query the weighting given to each of the identified factors.

**Suggested next steps for this work**

- Given the complexity of matters under consideration, to ensure a robust consultation process has been followed a cross-submission period should be held.
- Prior to any next steps on developing a Code change, it would be useful for the Authority to share broader details of the intended sequencing of regulatory interventions given other Task Force initiatives, Authority work programme and Ministerial Review.
- In developing the Code change it will be vital to include details on regulatory risks and the costs and benefits across all steps of reforms given the challenges outlined above (not just step 1). Given the potential significance of shifting to step 3 level interventions in the future, workshops to fully explore the implications will be valuable to ensuring overall benefits to consumers in going down a more heavily regulated pathway.
- Finally, if the Authority decides to take further steps to implement principles-based non-discrimination measures, further clarity regarding the Task Force's expectations will be required, including meaningful measures of success to reduce the risk of unnecessary regulatory intervention.

Yours sincerely



Tim Thompson  
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