

18 January 2021

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

Dear James

The independent retailers support introduction of mandatory market-making

Ecotricity, Electric Kiwi, Flick Electric, Pulse and Vocus (the independents) appreciate the opportunity to submit in relation to the Hedge Market Enhancements Permanent market making backstop Consultation paper.

As a group, we collectively represent 10.06% of the electricity retail market, and 96.8% of the electricity retail market supplied by independent retailers.¹ We are proudly independent entrant retailers who are responsible for delivering New Zealanders choice, innovation and keeping prices down.

We fully support the Authority's introduction of the Hedge Market Arrangements Code amendment to mandate market-making.

While we come to the issue of mandatory market-making with a different lens and perspective to that of the Authority, we agree with the conclusion it will result in stronger competition; particularly from independent retailers. In our view, mandatory market-making is needed due to the detrimental impacts on competition of a combination of market power and vertical-integration. Mandatory market-making would not be needed if the wholesale electricity market was perfectly competitive and there wasn't incumbent retail-wholesale vertical-integration.

Mandatory market-making is vital for enabling independent retailers to (more) fully compete in the electricity retail market. The Authority has articulated well the importance of small and independent retailers e.g.:²

"It is our strong view that consumers benefit from diversity in the retail market. This is not limited to the distinction between independent retailers and gentailers, but also diversity within the independent retailers and gentailers. Whether independent retailers have hundreds or tens of thousands of customers, they are innovation engines in the retail sector, and play a key role in exerting downward pressure on retail electricity prices, encouraging greater consumer participation, and unlocking the benefits to consumers of technology developments. I note that in its final report the Electricity Price Review Panel similarly emphasised the importance of small retailers in ensuring consumers get the benefits of competition in the electricity sector."

[emphasis added]

The backstop permanent Code to mandate market-making is necessary. Over the past 6 months (post COVID disruptions) the 4 market makers have met all of the 4 criteria in their voluntary

¹ As at 30 November 2020: https://www.emi.ea.govt.nz/Retail/Download/DataReport/CSV/R_MSS_C?si=v|4

² <https://www.ea.govt.nz/assets/dms-assets/26/26749Letter-to-all-distributors-Code-change.pdf>

agreement with the ASX only 52.7% of trading periods. Further, the market makers regularly go to the limit of the maximum number of 5 discretionary exemptions per month. Over the last 6 months in 17 of the 24 data points (81%) (4 market makers over 6 months) the 5 discretionary exemptions were used during a calendar month.³ We query how the market makers might perform if there was no backstop Code.

We also suggest the Authority consider the types of hedge market products/risk management tools that should be required to be available, particularly before the Authority attempts to procure incentive-based market-making services. This is something that can and should evolve over time. A challenge independent retailers have is limited availability of products other than base-load. The incumbent market-makers have limited incentives or interest to offer, for example, day-time peak products. We would be happy to individually discuss with the Authority the experiences we have had.

Summary of our views

- We welcome the Authority's ongoing implementation the Electricity Price Review (EPR) reform package.⁴
- We fully support the proposed Hedge Market Arrangements Code amendment. It is one of the most important reforms for promotion of competition and addressing vertical-integration issues presently on the table.
- We agree with the Authority it is "... not ... necessary at this stage to introduce a mechanism for parties' subject to the mandatory backstop to cease being subject to it (and to return to voluntary market making arrangements subject to a mandatory backstop if performance targets are not met)".
- We agree with the Authority the Code amendment "... will benefit consumers because the mandatory backstop enhances market maker performance in the electricity futures market, which ... allows for greater competition in the retail and generation markets". The Authority's December UTS decision lays bare the susceptibility of consumers and independent retailers to the actions of large vertically-integrated generators when they use market power to raise prices and/or manage their own locational and retail risk position.
- We agree with the Authority "The impact on spread and market making service will have a positive impact on retail prices".
- We agree with Sapere that depth and liquidity in the hedge market "is especially important for independent retailers who have face the challenge of managing risk on the whole of their commitments. In contrast, while the vertically integrated generator retailers still actively manage their exposure, it is their net exposure after taking into account their generation and

³ Using data on EMS <https://www.emi.ea.govt.nz/MemberDashboards/Public/820d3008-5daa-4a38-ab00-db8a7ef05fe3>

⁴ Introduction of mandatory hedge market requirements and wholesale/retail financial separation are key EPR projects for addressing vertical-integration problems. The Authority has signalled it will release a consultation paper in March 2021 on disclosure of transfer prices and methodologies, and will seek feedback on whether disclosure of retail electricity profitability would also be value (<https://www.ea.govt.nz/development/work-programme/risk-management/internal-transfer-pricing-and-profitability/development-2/18739/>). We fully support the EPR recommendation that "the Electricity Authority require vertically integrated companies to report separately on the financial performance of their retail and generation operations using a common set of rules".

Financial separation will be particularly important for testing the extent to which vertical-integration is a barrier to competition e.g. it can be used for 'equivalence of input' type tests to determine whether the incumbent gentailers' retail businesses would be profitable (no implicit subsidies) if they had to compete with the same wholesale input costs as independent retailers.

retail books”. Meridian estimates the vertically-integrated incumbents are around 91% internally physically hedged⁵ (in their submission on the preliminary UTS decision and in the context of the hedge market being irrelevant to these companies) so their actual risk exposure is very limited.

- We agree with the Authority a quantified CBA is not practicable in all cases, and have made similar comment in relation to the MDAG HSOTC work. We consider that the Authority can rely on the Sapere report to confirm the Code amendment would satisfy the Authority’s statutory objective. If any stakeholder wants to challenge the Authority position, and the expert advise from Sapere, on the limitations of quantified CBA in relation to hedge market reforms, the onus should be on them to demonstrate how the CBA could be practicably undertaken.
- We support the Authority signalling “it is likely that an obligation to provide market making services in some form, whether directly or financially, will remain for the largest generation and purchasing participants in the New Zealand wholesale market”.

ACCC and EPR investigations provide strong support for the Authority proposals

We consider our views on the need for hedge market reform to be orthodox for markets where there is a mix of vertical-integration and concentration. Our views mirror tightly that of the ACCC, EPR etc. The ACCC Retail Price Enquiry identified, for example, that:

“Vertical integration between retail and wholesale may be limiting access to risk management products for non vertically integrated retailers.”

“Vertical integration in the NEM is likely to have reduced market liquidity as more generation capacity is tied up with retail businesses and reserved to manage risk internally. The big three retailers have acquired the majority of the NEM’s thermal generation capacity, which are natural suppliers of many fundamental hedging products. Without sufficient competitive pressure in wholesale and retail markets, these vertically integrated players may have the ability and incentive to withhold contracts from rival retailers, or to discriminate against them regarding price.”

“The impact of vertical integration on contracting markets is complex but, generally, vertical integration results in an overall decrease in contract market activity by that business. The degree of vertical integration in the NEM may also be limiting the ability of standalone retailers to aggressively win customers as any significant expansion of retail market share will require securing wholesale supply from a competitor.”

“... the decline in standalone generation has limited other market participants’ ability to manage their wholesale market risk and may be creating a substantial barrier to expansion (and more vigorous competition) in the retail market.”

“The ACCC remains concerned about the current combination of vertical integration and market concentration (both in the wholesale and retail markets), and considers that such a combination reduces the likelihood that vertical integration is enhancing competition in these markets. Vertical integration reduces contract market activity, which makes it harder for other retailers to manage their wholesale price risk. The lack of liquidity in contract markets has the potential to become a barrier to entry and expansion for retailers in the NEM (and is already operating as such a barrier in South Australia).”

In a similar vein, the EPR Panel made the following observations about vertical-integration:

“On the minus side, it 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, but it concluded there was no evidence of

⁵ <https://www.ea.govt.nz/assets/dms-assets/27/27238Meridian-Energy-2019-UTS-Preliminary-Decision-Submission.PDF>, at 1st paragraph, page 5.

systemic discounting. We do not have the Authority's data, but at face value 12 per cent seems sufficiently high to warrant concern. We welcome views on this.

"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 has demonstrated mandatory market-making is to the long-term benefit of consumers

We agree quantified CBA is not reasonably practicable in all cases, and have made similar comment in relation to the MDAG HSOTC review.

We consider that the Authority can rely on the Sapere report to confirm the Code amendment would satisfy the Authority's statutory objective. In our view, the Authority should also take comfort that the Sapere report found positive net benefits from the proposed reforms even though their assessment was conservative.

The Authority can also draw on and rely on the EPR. It is relevant mandatory market-making received widespread support from stakeholders in the EPR consultation, including from independent retailers, consumer groups and electricity distributors. The only market participants that opposed mandatory market-making were the incumbent vertically-integrated retailers: Contact, Genesis, Mercury, Meridian, Nova and Trustpower.

The Authority can also draw on the practices and experience of other electricity industry regulators, in relation to hedge market regulation, to help confirm its approach.





Concluding remarks

The EPR reforms the Authority has implemented or is in the process of implementing – including saves and winbacks, hedge market, wholesale information disclosure and retail-wholesale financial separation – individually and collectively have the potential to make a material and substantial difference to the level of competition in the electricity retail markets and, most importantly, for the affordability of electricity for consumers.

We look forward to confirmation of the Hedge Market Arrangements Code amendment in the near term.

We also look forward to engaging with the Authority's project to explore introduction of additional market-makers on a commercial basis. We request the Authority provide full details of its internal project plan as part of this process.

Yours sincerely,

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