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Dear Tom,

The independents support levy-funding for supply of commercial market-making by new suppliers only

Ecotricity, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), Pulse, and Vocus (the independents) welcome the opportunity to submit in response to the Electricity Authority's levy-funding consultation for a commercial market-making scheme.

Hedge market arrangements are a significant determinant of the extent and health of competition in the electricity market, and the size of barriers to competition from new entrant and independent retailers. This is particularly evident with current market circumstances. Addressing the problems with the hedge market is necessary for the Authority to achieve its statutory objective to promote competition, and its strategic ambition of "thriving competition".

We agree with the Authority, for example, that "Consumers benefit from market-making activity" to the extent "it allows retailers to offer consumers deals on their electricity, helping to protect them from volatile spot prices" and "new retailers to manage their price risk". A well functioning hedge market can "[allow] smaller and less diversified businesses without generation or a retail presence to manage their price risk, which reduces barriers to entry, helping to increase competition in both the generation and retail markets".

The Electricity Price Review Panel similarly commented that "<u>An efficient contract market</u> is particularly important for stand-alone retailers and generators, which are a key source of innovation and competitive pressure. Without an efficient contract market, innovators wanting to generate or retail electricity have to enter both of these markets at once" [emphasis added].

The Authority has commented "During times of volatility, it is more important than ever that market participants are well-hedged and have quality risk management tools to rely on". We would rephrase this as it being more important than ever that market participants are <u>able to</u> be well-hedged and have <u>access to</u> quality risk management tools <u>on competitively neutral terms</u>. The ability of independent retailers to grow has been obstructed through issues of access to suitably priced risk management tools.

The Authority has, worryingly, tried to dismiss concerns about hedging arrangements and prices commenting recently, for example, that "some purchasers chose not to hedge" when contract prices for 2021 last year were, with the benefit of hindsight, low, as "not an issue with the wholesale market". To take advantage of those prices, in the way the Authority envisages, would have necessitated buying at the bottom of the market, and required independent retailers (and large industrial users) to be unhedged to purchase volumes at these lower prices and remain within their hedge policy positions or overhedge and operate as a speculator and sell down the overhedged position at a later date. Neither of these actions is consistent with using hedges to manage wholesale market risk in a systematic way. For the Authority's hedging strategy to be successful it would also likely have required insider trading based on information about Tiwai's decision not to exit the market. It is difficult to understand how the Authority expects the "prudent hedgers" they describe to achieve a hedged price significantly below the average contract price in a market the Authority holds up as efficient.

Summary of our views

- The commercial market-making initiative is focussed, at best, on trying to treat the symptoms rather than the cause of the problem, which is the vertical-integration of large incumbent suppliers with market power.

- We don't believe incumbent suppliers should be able to act as both mandatory and commercial market-makers. The results of the RFI reinforce our view that the vertically-integrated incumbent suppliers should continue to provide market-making services indefinitely.

- The $3.6m gap between the median incumbent and new supplier offers cannot be explained by difference in efficiency or cost. The gap, in essence, is a quantification of the lopsided playing field that exists in the current wholesale market due to deficient trading conduct and information disclosure regimes. The Authority's failure to create and enforce rules in these areas is one of the root causes of the problem.

  The best outcome may be to delay tendering of commercial market-making until such time that the Authority is able to establish a reasonably level playing field in which potential new suppliers are able/prepared to compete with the incumbent providers.

- **Q1:** We support an increase in levy-funding if it enables commercial market-making to be provided by a new service provider(s). We also support the Authority position that "if the Authority has underestimated the required appropriation, the Authority retains the right during the procurement process to pause or halt procurement to ensure that any market-making scheme remains in the long-run benefit of consumers".

  The Authority should be cognisant the "maximum additional funding of $14.4m for … 2021/22" would be a significant uplift in current (and historic) appropriation levels. The level implies that if the Authority moved to full commercial provision of market-making it could result in a near doubling of its annual budget. We note MEUG raised concern about the Authority's appropriation proposal to raise funding for 2021/22 by 1.6% higher (+$1,221,000).[1]

- Based on current levy regulations, a 50:50 pro rata split between purchasers and generators is appropriate. We were somewhat surprised the Authority justified this allocation, in part, on the basis it is "fair" given the Authority has been clear fairness is not part of its statutory objective and fairness considerations can "create adverse unintended consequences".[2]

  The need for mandatory market-making and/or a compulsorily funded commercial scheme is because the large incumbent suppliers are vertically-integrated and have market power. We agree with the EPR Panel observations that:

[1] https://www.ea.govt.nz/assets/dms-assets/28/MEUG-submission-202122-Levy-funded-appropriation.pdf
[2] https://www.mbie.govt.nz/dmsdocument/4160-electricity-authority-electricity-price-review-first-report-submission

"An effective contract market is critical to mitigating the potential adverse effects of vertical integration and short-term generator market power. Our view is reinforced by the recent review in the United Kingdom, which concluded vertical integration was not adversely affecting competition, in part because the contract market had sufficient liquidity "for independent firms to hedge their exposure to wholesale market risk in a similar way to vertically integrated firms.""

The so-called "free" provision of mandatory market-making services is efficient and consistent with "exacerbator pays", and the decision-making frameworks the Authority has applied to various pricing issues.[3] The mandatory requirements simply result in provision of services that would be provided on a voluntary and commercial basis absent market power/failure issues.

- **Q2, 3 and 4:** We consider the commercial and mandatory market-making service terms should be the same. Given the Authority has only provided information on the cost of different service settings based on the highest RFI bid, it is not possible to assess the potential cost-service trade-offs e.g. the lowest bids are likely to have different absolute and relative price differences and trade-offs between different service settings. It is possible different bids will be lower for different service points.

- **Q5:** The principal benefit from commercial market-making is increase in diversity of supplier. We infer this is why the Authority has commented "The transition will begin by tendering 20% of the market-making volume to one (or more) commercial provider(s), <u>which could include an existing regulated market-maker in some small quantity</u>" [emphasis added]. That is, the Authority's position is there should be at least one new (commercial) supplier of market-making services.

- The consultation paper infers, based on the RFI, the cheapest commercial market-making option would be from an incumbent supplier rather than a new supplier. However, this is not confirmed and nor is the potential cost difference.[4] While the Authority notes "The difference in the median price from the existing market-maker and the potential new suppliers is approximately $3.6m per annum (including contingency)", based on the information in the consultation paper the difference between the lowest existing market-maker and potential new supplier could be less than this, more or even negative.

- If the outcome of commercial market-making was simply that one of the incumbent suppliers provides both mandatory and commercial market-making services we don't consider there would be any incremental benefits beyond that of simply extending the current mandatory market-making arrangements.

The RFI highlights problems of market concentration and market failure that have not been addressed

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[3] The Authority has stated that "Electric Kiwi/Haast and the independent retailers <u>claimed</u> that the Authority prefers an exacerbator-pays approach over a beneficiary pays approach, based on the transmission pricing methodology decision paper in 2019" and "The Authority acknowledges its preference for exacerbator pays <u>in a small component</u> of the TPM …" [emphasis added]. Notwithstanding these comments, the Authority has applied the decision-making and economic framework for both distribution and transmission pricing and the framework which clearly ranks exacerbator-pays above beneficiaries-pay.

The Authority's pricing principles for distribution pricing are based on exacerbator pays. The Authority's decision paper, More efficient distribution network pricing principles and practice, 4 June 2019, doesn't even make any reference to beneficiary-pays.

[4] It is possible the median bids are the only ones where the potential new supplier bid is higher than the incumbent. We asked whether there was overlap between the range of prices bid by the incumbents and potential new suppliers but the Authority did not provide us with this information citing commercial confidentiality.

The $3.6 million difference between the median price from the existing market-makers and potential new suppliers is substantial.

We do not consider it credible this large gap simply reflects differences in cost or efficiency of the existing market-makers and potential new suppliers. There is no a priori reason to expect the incumbents would be more efficient than new suppliers. As the Authority has noted, "All things being equal, we expect a professional service provider may be more efficient at providing the services than the incumbent providers" and "The market will select the most efficient providers … We have no reason to believe that the incumbent service providers are the most efficient services providers, or that the most efficient providers will be industry participants. Providing market making services at least overall cost will benefit to consumers".

We consider that, as part of next steps, the Authority should investigate the reasons behind the large gap in the median price from the existing market-makers and the potential new suppliers. We consider it is principally explained by problems such as the deficient trading conduct and information disclosure regimes that exist in the current market.[5] These tilt the playing field towards participants with market power and the holders of material information, both of which are overwhelmingly the incumbent gentailers. This is reflected in the submissions we have made in relation to hedge market reform and other competition issues.

The potential new suppliers face analogous issues to those of new entrant and independent retailers that they are trying to compete against suppliers with substantial market power in the market and there isn't a level playing field. The Authority has used the terms "dominance" and "control" to describe their market power, indicating very high levels of market power. The reforms needed to address these issues may be outside of the scope of the commercial market-making project but it is critical they are solved to ensure the full benefits of commercial market-making, and to establish potential benefits beyond those that can be obtained through extension of the current mandatory market-making arrangements.

Insufficient information to comment on price-service trade-offs [Q2, 3 & 4]

The information the Authority has provided on the prices for different service levels is based on the highest RFI bid, and therefore the least likely to be accepted under a competitive tender. While information from the highest bid is useful in providing a conservative ceiling for determining potential (maximum) levy increases it isn't useful for understanding the trade-offs between price and different service levels.

The Authority may have "received robust commercially determined evidence of the cost of different service levels from respondents to the RFI" but the treatment of confidentiality means this evidence isn't available for stakeholders to comment on or to respond to questions 2, 3 and 4 about price-service quality trade-offs.

For example, based on the highest RFI bid there is a substantial (near doubling) in cost from going from a 3% spread to a 2% spread, while the difference in cost between 3, 4 and 5% are relatively modest. It is quite possible the absolute and relative price differences from other RFI bids is substantially different to this, suggesting very different trade-offs.

Other bids will have different absolute and relative price differences and trade-offs between different service settings. It would have been more useful to provide information based on the lowest/most likely to be accepted bid (or an average of the lowest bids). If the Authority is not able

[5] Exacerbated by weak constraints from existing market conduct rules and enforcement.

to provide additional information to stakeholders, it may be useful to engage on a confidential basis and/or to reconsult as part of the Authority's decision on preferred service provider.

The principal benefit from commercial market-making is increase in diversity of supplier [Q5]

The Authority has noted:

> "Potentially an increased diversity of market-makers with different views will help to create a more robust understanding of future prices"
>
> "The addition of commercial market-making service providers should strengthen and support the operation of the hedge market. Introducing commercial market-making providers should help improve the reliability and efficiency of the hedge market, while offering the opportunity to increase the diversity of participants."
>
> "Accessing a wider pool of market-makers will introduce more information to the forward price curve, as well as potentially introducing more efficient providers of market-making services, contributing to greater reliability and greater confidence in the forward price curve."

Similarly, the Authority was also clear in its decision to introduce commercial market-making that "Introducing a commercial market maker would add further value to those who currently benefit from market making services" and "increas[e] the diversity of participants":

Increasing the diversity of market makers was mentioned by submitters, including Fonterra, the independent retailers and the industry forum. Trustpower saw increasing diversity as less important.	The Authority considers there are several benefits to increasing the diversity of market makers, including increased trust and confidence in market outcomes, and improved robustness of the forward price curve. Opening service provision to a diverse group of providers will also facilitate innovation and more efficient providers of market making services.

If the Authority selected one of the existing incumbent, mandatory market-market making suppliers it would not result in the diversity benefits for determining the forward-looking price path the Authority anticipated when making its decision on market-making.

Concluding remarks

We only support the increase in levy if it is to fund a new commercial provider but we don't have confidence / enough information to know if this is good value for money. It may be useful for the Authority to release more RFI information on a confidential basis (consistent with Commerce Commission precedent) so stakeholders can understand the likely cost / service level trade-offs, and the extent to which (or whether) it would cost more to accept a potential new supplier proposal than an incumbent bid.

The $3.6m gap between the median incumbent and new supplier RFI bid cannot be explained by difference in efficiency or cost. The gap implies the median new supplier bid was at least 30-40% higher than the equivalent incumbent and, most likely, substantially more than this. The Authority has not confirmed it, citing confidentiality, but we infer the lowest new supplier bid was higher than the highest incumbent supplier bid.

The gap between the incumbent and new supplier bids, in essence, is a quantification of the cost of the deficient trading conduct and information disclosure regimes. The cost of the Authority's failure to create and enforce rules which level the playing field in the wholesale market is now visible.

Additional costs of this magnitude fall on most independent retailers, large industrials, independent generators and other innovative new entrants. These issues remain significant barriers to the vibrant competition New Zealand consumers deserve.

If the outcome of commercial market-making is simply that one of the incumbent suppliers provides both mandatory and commercial market-making services we see no incremental benefits beyond what could be achieved by simply extending the current mandatory market-making arrangements to: (i) include Trustpower (which would increase diversity); and/or (ii) increase the volume existing market-makers are required to provide.

Yours sincerely,

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