18 January 2021

James Stevenson-Wallace
CEO
Electricity Authority

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

Dear James,

## The Authority's mandatory market-making proposal is vital for promotion of competition

Electric Kiwi and Haast Energy Trading (Haast) support the Electricity Authority's proposed Hedge Market Arrangements (HMA) Code Amendment. We consider mandatory market-making to be one of the most important elements of the Electricity Price Review (EPR) reforms, particularly in terms of the promotion of competition for the long-term benefit of consumers and the Authority's strategic ambition for "thriving competition".

Our views on the importance of mandatory market-making are well documented in submissions to both the Authority and the EPR.

**We support the Authority's transition road-map**

We are supportive of the Authority's 'road-map' whereby it will initially test whether the number of market-makers can be increased through incentive-based mechanisms. We would welcome the opportunity to see the project plan and milestone timing for the project.

We consider the approach the Authority has signalled to be pragmatic and a good way to 'test the water' with the safety that the Authority can fall back on the mandatory arrangements.

The Authority has sensibly and prudently signalled "it is also possible that the Authority decides it is appropriate that physical participants provide market making services indefinitely" and "… each stage in the transition pathway is an opportunity to assess whether each stage contributes to the long-term benefit of consumers. At any stage of the transition, the Authority is able to pause or stop if the proposed change does not contribute to the long-term benefit of consumers".

**Variations to the HMA Code Amendment should be tested**

We suggest the Authority ask Sapere to extend their qualitative CBA analysis to test whether tightening elements of the HMA Code Amendment could be expected to deliver greater increases in competition and long-term benefits to consumers e.g. changing the 90 day/3 strikes rule to 180 or 365 days.

The consultation paper indicates Contact, Genesis, Mercury and Meridian are mandatory market-makers on the basis they are large generators. We have a slightly different perspective that the test should be based on market power and vertical-integration. As the ACCC has noted: "Market making obligations tend to be applied to vertically integrated businesses that may otherwise not be incentivised to participate in trading markets (or at least, not participate enough to foster an active market that other participants can use to effectively manage their risk)".

Given the Authority is using a large size test it might be worth asking Sapere to consider whether the market-makers should be extended to include Trustpower on the basis that they are the 5th largest generator, and substantially bigger than any of the other generators. This would be the simplest (and quickest) option for increasing the number of market-makers.

**We are comfortable with reliance on qualitative CBA**

We agree with the Authority and Sapere that it isn't always possible to do a meaningful quantified CBA, and agree the Sapere report provides sufficient (conservative) basis for the Authority to conclude the Code amendment satisfies its statutory objective. We agree, in particular, that a reasonable basis has been established for the conclusion "the Authority is confident the benefits of the proposal outweigh its costs".

We have similarly supported MDAG in its conclusion it could not reasonably undertake quantitative CBA in relation to the High Standard of Trading Conduct (HSOTC) review. Ultimately, if any stakeholders have a different perspective the onus should be on them to detail what would be a viable approach to quantified CBA. It isn't enough for stakeholders to tell the Authority that they should do a quantified CBA.

We discussed some of our thoughts with Sapere about options for how a quantified CBA could potentially be done. Our suggestions revolved around testing the extent to which mandatory market-making would reduce the barriers to competition from independent and non-integrated retailers e.g. by narrowing the wholesale cost difference between the vertically-integrated incumbent retailers and independent retailers. This type of approach may be more practicable once the Authority has transfer payment disclosure/retail-wholesale financial separation requirements in place, and may be available to the Authority for subsequent steps in the hedge market reform process.

The adoption of transfer payment and retail/wholesale profitability/financial separation disclosure will put the Authority in a stronger position to assess the extent to which wholesale-retail vertical integration is a barrier to competition and could be reduced through (further) hedge market reform.

**We agree with the Authority on the need for mandatory market-making/hedge market reform**

Regardless of the perspective taken to the problem definition, we principally agree with both the Authority and Sapere in terms of the qualitative justification for mandatory market-making/hedge market reform e.g.:

- We agree with the Authority the "mandatory backstop … allows for greater competition in the retail and generation markets".

- We agree with the Authority "Underpinning the issues and opportunities is the desire for any solution developed to deliver efficiency and promote competition for the long-term benefit of consumers. This is enabled by ensuring that market making services support a robust forward price curve and <u>enable efficient risk management</u>" [emphasis added].

- We agree with the Authority "The impact on spread and market making service will have a positive impact on retail prices. Retail prices will be improved through independent retailers having greater confidence in the futures market", but would stress the importance of a more level playing field between vertically-integrated and independent retailers.

- We agree with Sapere that "Any impact of the Code change would manifest itself on the energy component of retail electricity prices" and that "retail prices will … likely [be] better than would otherwise be the case but for the January 2020 change to the voluntary arrangements and its reinforcement through the Code".

- We agree with Sapere that "<u>The benefit of having exchange traded forwards (futures) is greater competition for retail consumers</u> than would otherwise be the case. <u>This comes as a result of</u> greater transparency in forward prices and <u>a better ability for retailers to manage their risks</u>. That competition drives efficiencies that manifest in the pricing offerings to contestable consumers. Some degree of competition benefits would occur amongst existing retailers following the introduction of a futures contract, but <u>it is the enabling of innovative new entrants that exacerbates competition and the benefits that accrue to consumers</u>" [emphasis added].

- We agree with Sapere that "The case for introducing market making arrangements is to provide depth or liquidity to the market. This is especially important for independent retailers who have face [sic] 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 retail books". This issue is heightened to the extent vertically-integrated retailers trade with themselves at less than an arms-length basis e.g. implicitly trading with their own retail business at rates less than they could obtain from the open market or if they were wholesale-only operators.

- We agree with Sapere that "…to the extent that the wealth transfers lead to greater retail competition (by virtue of more confident retail pricing by independent retailers) any efficiency benefits to consumers also qualify as consideration in the case to proceed with the Code change". Market-making reduces the barriers to competition manifest in vertically-integrated retailers internally accessing wholesale prices at less than arms-length rates. This narrowing of the barriers to competition enables independent retailers to offer more price-competitive rates and drive down prices to consumers. To the extent there is a wealth transfer it is principally from the vertically-integrated retailers to consumers.[1]

- We consider the following Sapere conclusion is conservative but principally safe for the Authority to rely on in making the proposed Code amendment: "…we are confident that any impact would be positive to the extent that independent retailers will either continue to compete on price as they do today or be bolder in their competitive offerings, armed with the confidence they get from the measure. It is reasonable to expect that the change to the voluntary scheme and the regulatory backstop will lead to retail prices (including those offered by vertically integrated firms due to competition) that would be lower than would otherwise be the case".

One area where we didn't agree with Sapere was in relation to its assertion the independent retailer responses reflected "their commercial benefit from changes in market making (spreads and consistent presence in the market) and not to how that would translate to the long-term benefits of consumer". This may have been inferred from the survey question "If the Authority proceeds with its proposal to introduce mandatory market making permanently will it give you the confidence to change your behaviour especially regarding your retail pricing?" We would not <u>change</u> our pricing approach, which is to consistently provide better value and service to consumers than incumbent retailers. What mandatory market-making will do is to increase confidence that independent business models can thrive in the New Zealand market and hence provide confidence to <u>continue to grow</u> our retail businesses for the benefit of New Zealand consumers.

**Prima facie illustration of the vertical-integration problem faced by the electricity retail market**

As an illustration of the prevalence and impact of vertical-integration in the retail market, it appears that the South Island markets are becoming more tightly geographically vertically-integrated:

- In 2000, Contact and Meridian were the two largest retailers in just 4 of the 16 South Island network reporting areas. This has now risen to 7 and is likely to become 12 in the near to medium term.

- In 2000, either Contact or Meridian was the largest retailer in 8 of the network reporting areas. This has now risen to 11 and likely to become 13 in the near to medium term.

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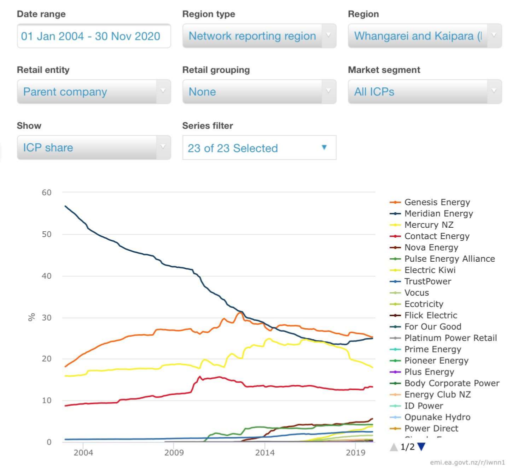
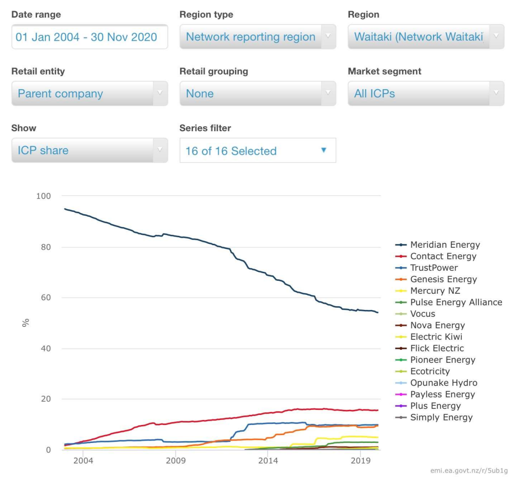
[1] Similarly, we do not wholly agree with the Sapere comment "We do not consider that reducing costs to independent retailers qualifies as a benefit for the long term interests of consumers. We only see a benefit that qualifies for the CBA where some of the gains to the independent retailer are passed on to consumers".

The contrast between the Waitaki retail market, where the incumbent Meridian has strong vertical-integration, and the Whangarei/Northland retail market, where the original incumbent Meridian has weak vertical-integration, highlights well the adverse impact vertical-integration can have on retail competition. Waitaki is one of the least competitive retail markets in New Zealand.




**Concluding remarks**

We welcome the Authority's decision to adopt mandatory market-making as part of the EPR reforms. As the Authority is aware, we and most other stakeholders consider this to be one of the most important reforms for unlocking retail competition and ensuring a (more) level playing field.

We have delivered $30 million of cost savings to our customers so far, and the Authority reforms will enable us to compete more aggressively and unlock even larger benefits and savings to our customers, both existing and future new customers.

Yours sincerely,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