octopus energy

22 December 2021

Submissions
Electricity Authority
Via reviewconsultation2021@ea.govt.nz

To whom it may concern,

Electricity Market Monitoring Review

We appreciate the opportunity to express our concerns about the performance of the New Zealand Electricity Market. Octopus Energy Group is a successful entrant retailer and energy technology innovator in the UK market. We are expanding into liberalised energy markets internationally. Our perspective is given as a potential entrant to the New Zealand retail market, this perspective is informed by observations of the New Zealand market and experience in electricity markets internationally.

In the energy future we are driving for we see retailers playing an increasingly important role in enabling demand side innovations that deliver real benefits to consumers and allow economies to transition to a low carbon future. An example of this from our UK business is using technology to manage demand more dynamically with products such as the 'Intelligent Octopus' tariff. We are helping our customers make their demand profile more flexible. This has practical benefits in a market with increasing amounts of renewable energy. This is also important because it means the demand curve will be increasingly elastic and more responsive to changes in price. This provides competition at the margin and a check on the supply side of the market.

Retail market monitoring

The Electricity Authority has a responsibility to promote competition and monitor performance of the markets. This responsibility is not limited to the wholesale market, it includes the retail market.

Given the Electricity Authority's responsibilities, why has it not considered the retail market as part of this review? Or at a minimum, considered the interplay between the two? Retail markets are dependent on the functioning of a workably competitive wholesale market in order for them to operate efficiently. Retail competition is not effective if firms can not secure wholesale terms on a level footing with vertically integrated firms, this prevents entry and growth. We believe the Electricity Authority has been remiss in not considering the implications of the wholesale market on retail competition.

"There has been a concern in some sectors that vertically integrated companies could create a barrier to competition in retail by subsidising returns in their retail businesses, placing a margin squeeze on all retailers, while the subsidiary retailer is supported by the generation business. These issues have been addressed in the Electricity Price Review. This present review does not cover competition in the retail market. But the Authority has recently decided to mandate the disclosure of internal transfer prices by

large generator/retailers, and retail gross margin by some retailers, with the aim of increasing transparency." Electricity Authority Summary Paper.

Further, given the Electricity Authority notes a concern of a potential margin squeeze surely this warrants investigation and consideration. A margin squeeze will wipe out independent retail competition.

"Generator-retailers are considered by some to be making excessive profits and favouring their retail arms to undermine competition, but we lack the information to properly test this belief. At a minimum, expanded reporting will fill the information gap that fosters suspicion and undermines market confidence. If there is a real competition problem that requires correcting, separate reporting should help uncover it."
Electricity Price Review, Final Report ,21 May 2019

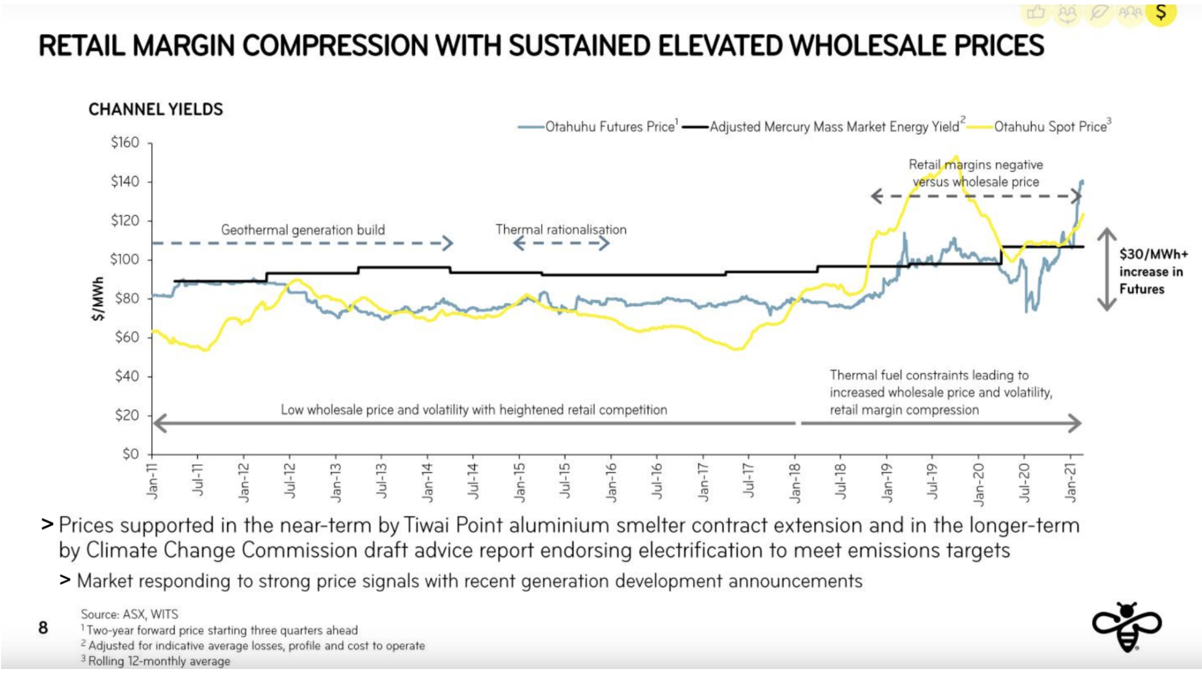
The suggestion that the issue has been addressed and doesn't warrant consideration can't be correct. The Electricity Price Review did not implement changes to mitigate the damaging effects of margin squeezes. The Electricity Price Review touched on the issue of vertical integration and recognised the potential for a margin squeeze, in response it recommended a disclosure regime to improve the ease of monitoring. The implication is that the Electricity Authority would act on a problem as it's detected. In the paragraphs that follow we illustrate the problem which the Electricity Authority should have detected and acted on.

Part of the Electricity Authority's role is to communicate what it sees as unacceptable conduct. Our understanding of the market is that a position in wholesale is not intended to be used for advantage in the retail market, this was confirmed in our conversations with Electricity Authority staff in March. As a result we're concerned by the inaction to date, we're also deeply concerned that integrated participants seem to think using their wholesale position to advantage their retail business is perfectly acceptable.

The Electricity Authority needs to act on an observable and persisting competition problem. We reiterate our previous recommendation that code changes akin to the licence conditions for vertically integrated participants in the UK market be adopted here. The essence of the UK licence conditions is that trading between integrated businesses occurs on an arm's length basis, cross subsidies and preferential treatment of the integrated firms retail business are explicitly prohibited.

Foreclosure of independent retail competition

Margin squeezes can often be challenging to detect but the margin squeeze occurring currently is so extreme that it is publicly observable through the comparison of retail tariffs and tracking wholesale prices. It has also been commented on by large vertically integrated firms and struggling independent firms alike. Our resulting conclusion is that the New Zealand retail electricity market is foreclosed to independent retail competition as a margin squeeze persists. This foreclosure is illustrated in the chart below where retail margins have been negative versus wholesale costs since mid 2018:

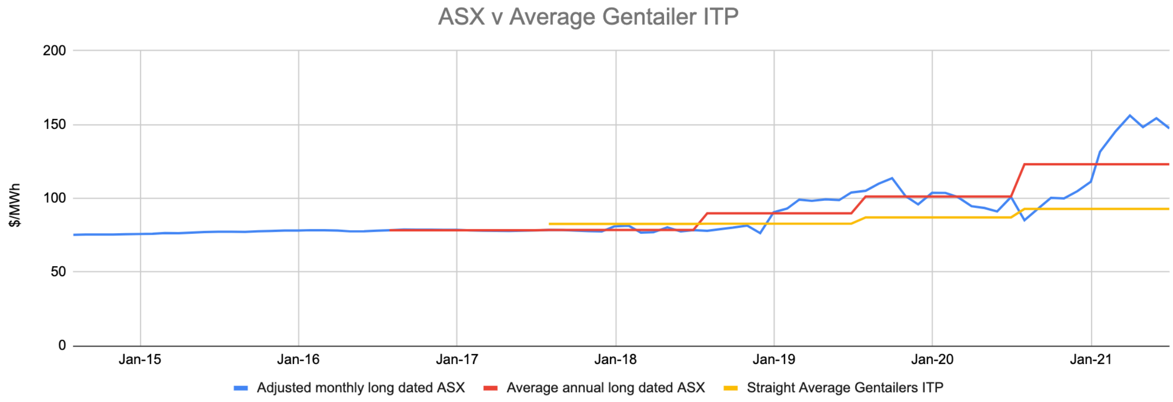


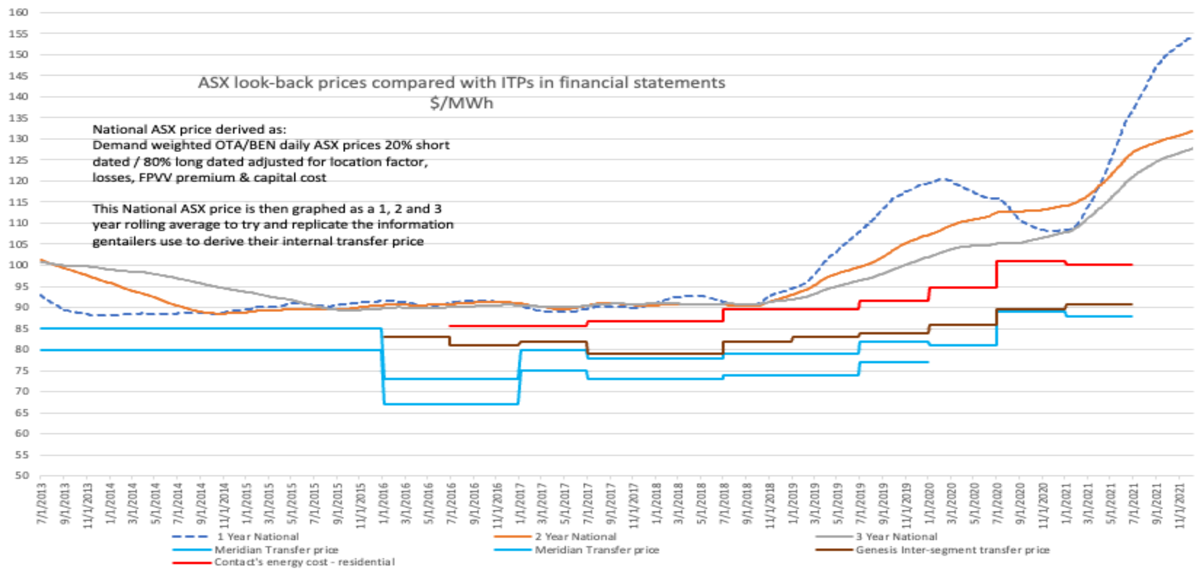
Mercury Energy Half Year Results Presentation
https://issuu.com/mercurynz/docs/mercury_hy2021_results_presentation_final?fr=sM2VlNTE4MTY2Nzk

This retail compression and negative margin is further evidenced by our calculations using public data from the EA, EMI and the MBIE QRSS. Since the 2018 FY retail pricing excluding networks have increased by 12%, whereas ASX has lifted 57% through to the end of the June 2021 FY. Independent retail hedging is based on ASX pricing, a market that has been persistently high since 2018 and nowhere near levels that gentailers price their retail arms at.

	FY18	*FY21*	*% Change*
*Average annual long dated ASX**	*$78.55*	*$123.12*	*57%*
QRSS (Energy and other component)	*$164.58*	*$183.90*	*12%*
*Average Gentailer ITP***	*$82.58*	*$92.79*	*12%*

** Monthly long dated OTA ASX adjusted by location and profiling*
***https://public.tableau.com/app/profile/electricity.authority/viz/ITPbenchmarks/ITPbenchmarks*





ASX prices and published ITP data

Tiwai is a red herring

We're concerned that the Electricity Authority has narrowed in on the Tiwai Contracts. We agree that the existence of Tiwai increases demand which generally increases prices and that there may have been an inefficient price struck, but it's a one off contract, whereas the paper highlights misuses of market power that have pervasive and ongoing impacts on all energy consumers. We believe the Electricity Authority should be focusing its attention on the behaviours that have caused most market participants, other than the gentailers, to state that they have lost confidence in the market and in the Electricity Authority's ability to regulate it for efficient outcomes.The concerns as identified:

- Economic withholding
- Offers above cost
- Offers not reflecting underlying supply conditions
- Steeper supply curves
- Subdued price separation between islands

This appears to be a classic oligopoly scenario where the competitive dynamic has broken down and firms are tacitly able to increase price. We believe intervention is required to restore the appropriate competitive dynamics and mitigate the inefficient use of market power that is occuring. One suggestion we have is that generators with potential market power be required to annually auction a proportion of their firm production for years into the future. They should also be required to purchase required contracts for their own retail businesses through this auction to ensure arms-length, non-discriminatory contract trading. This would remove their ability to influence price while ensuring price is determined competitively.

The tragedy of this market failure for New Zealand is it is happening at just the time when energy users need to be making low carbon investment decisions, the electricity market should be able to provide a cost effective solution for this. The unfortunate reality is this currently isn’t the case.

We look forward to the Electricity Authority taking the necessary steps to sure up retail competition and ensure an ongoing role for independent retailers in the NZ market.

Regards,

Ari Sargent
Managing Director - Octopus Energy NZ