



22 December 2021

Submissions  
Electricity Authority  
P O Box 10-041  
Wellington 6143

By email: [reviewconsultation2021@ea.govt.nz](mailto:reviewconsultation2021@ea.govt.nz)

**Dear James**

**Re: Review of competition in the wholesale market from January 2019 until early 2021 and an issues paper on inefficient price discrimination**

Flick appreciates the opportunity to submit on the Electricity Authority's (Authority) review of competition in the wholesale market and the issues paper on inefficient price discrimination.

Flick is a signatory to the joint independent retailers' submission and supports the commentary and recommendations in that submission.

Our focus in this submission is on the issues paper and the proposed solutions to address inefficient price discrimination – see section on Solutions – but firstly we comment on the Authority's detailed structure, conduct and performance analysis in the Information Paper.

### **Summary**

Switching trends in the retail market over the past 18 months are concerning with the 'big five' moving from a net loss of ICPs in the 6 months to November 2020 of 36,806 to a net gain in 6 months to November 2021 of 5,400. During this time Flick, Electric Kiwi and Nova were the 3 nominees for Energy Retailer of the Year based on innovation, growth and customer service. This indicates that the highest performing retailers are losing in market due to the exertion of market power which is difficult to identify outside of extreme market circumstance.

**We strongly recommend that the Authority:**

- **recommends structural separation of Gentailers to the government; and**
- **urgently amends the Code to include rules that prevent price discrimination and cross subsidies**

## Structure, Conduct and Performance analysis

We commend the Authority for the detailed analysis provided in the Information Paper on the “Market Monitoring Review of Structure, Conduct and Performance in the Wholesale Electricity Market since the Pohokura outage in 2018.

It is very difficult to identify bad conduct in the generation market and may only really be pinpointed at the extremes – such as the unnecessary spill in December 2019. Flick supports the Authority’s ‘structure, conduct and performance’ framework for investigating and ensuring achievement of the statutory objective to promote competition.

At a high level, Flick is concerned that of the 20 observations analysed only 10% were green; twice that were red, and the majority (70%) were orange. We urge the Authority to continue collecting and analysing the information needed to determine whether these observations could be green, or red.

The Authority’s analysis has clearly identified “*evidence to suggest that prices may not have been determined in a competitive environment*”.

We highlight the Authority’s key observations<sup>1</sup> in order of significance from our point of view:

- i. The market is dominated by a few large firms, with Meridian needed to meet demand over 90 percent of the time.
- ii. Meridian has been gross pivotal in the South Island 90% to 95% of the time in 2019 to 2021.
- iii. Some offers do not reflect underlying conditions.
- iv. Steeper supply curves in recent years suggest an increased incentive and ability to economically withhold.
- v. Offer prices have increased since the Pohokura outage, and there is often a large proportion of offers above cost (regardless of the cost estimate used) for some generators. However, these observations could be consistent with gas supply uncertainty.
- vi. Differences in price between the North Island and South Island have been subdued over the review period when storage has been high. This suggests some generators may have been economically withholding so the price they pay to cover their retail books in one island is not much higher than the price they receive for their generation in the other.
- vii. The Lerner Index (the mark-up of price over cost) is sometimes high, so these offers above cost appear to be resulting in prices above costs, although this result is sensitive to the cost estimate used.

The Authority’s conclusions on the performance of the wholesale market from January 2019 to early 2021 more or less confirms the concerns raised in the 2018 UTS complaint.

Flick submits the Authority’s focus on the Tiwai agreement is a focus on the symptom and not the cause. The Authority observed “*some evidence to suggest that generators have an increased incentive and ability to exercise market*

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<sup>1</sup> Page iii of Information Paper

*power, and may have been doing so over the review period*"<sup>2</sup>. This is a statement of the cause. The Authority has analysed whether there has been a sustained exercise of market power.

The ongoing existence of the incentives and ability to abuse market power will continue to stunt independent retail which operates on tight margins while consistently delivering the highest customer satisfaction, new innovations and has kept a lid on prices.

In addition, the Authority has focused on presenting the inefficient pricing of Tiwai as an impact on all consumers. We suggest high prices due to economic withholding and exercise of market power has not, and may never, directly impact residential consumers<sup>3</sup>. Parties buying directly from the spot and hedge markets since 2018 have been directly negatively impacted – that is commercial and industrial customers and independent retailers.

The Authority concludes the issues "arise from the scale of Meridian's generation (particularly in the South Island), not because of vertical integration"<sup>4</sup>. Flick submits vertical integration is relevant to decisions made in relation to the Tiwai contract. While the generation business was able to recover the estimated \$20/MWh lower price on 40% of Meridian's output from higher wholesale prices on the remaining volumes<sup>5</sup>, vertical integration means that this would not impact Meridian's retail business because these activities do not purchase electricity from the wholesale market but are supplied electricity from the generation business at an internal transfer price (of \$88/MWh in FY21). The Authority should consider whether an independent generator would survive financially a \$100m hit to EBITDAF or selling electricity below the Authority's measures of cost for three years?

Flick supports a deeper review of Meridian's profitability.

## **Solutions**

Any solutions clearly must address the incentives and ability to exercise market power.

The first-best solution is structural separation. Trustpower promoted structural separation as the first-best solution during debate about improving liquidity in the wholesale market. It is now implementing vertical separation. The

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<sup>2</sup> Page ii of Information Paper

<sup>3</sup> Meridian Investor presentation of 1HFY21 result page 15 Neal Barclay (CEO: "I think we all look beyond the immediate wholesale market. .... So I think long-term, I would not expect to see significant change in retail pricing in this country because the underlying economics won't take you there."

<https://www.meridianenergy.co.nz/assets/Investors/Reports-and-presentations/Investorpresentations/2021-Interim-Results-Livestream-Transcript-with-QandA.pdf>

<sup>4</sup> Paragraph 5.143 of Information Paper

<sup>5</sup> Estimated at \$100m lower EBITDAF. Note Meridian's Generation spot revenue increased \$927m or 73% in FY21 compared with FY20 despite a 10.8% decline in generation volumes.

government already has ownership control of three of the four remaining gentailers.

The economic efficiency arguments supporting vertical integration disappear when gentailers can exercise market power.<sup>6</sup>

Vertical separation in the NZ telecommunications sector has delivered strong benefits for NZ consumers. Increased competition following vertical disintegration of Telecom NZ has seen total retail telecommunications nominal revenue increase by only 1.8% in 9 years from 2010/11 and 2019/20 or a compound average growth rate of 0.2% while there has been \$15.7 billion of investment over those years. Spark (ie Telecom) market share has fallen to 40% in each of the fixed and mobile markets.<sup>7</sup>

We understand structural reform is outside the mandate of the Authority and Flick submits, based on the evidence the Authority has revealed, it is incumbent on the Authority to recommend structural reform to the Government.

However, structural reform will take time and the Authority must address the incentives and ability to exercise market power immediately.

In the short term, Flick submits the Authority must amend the Code to include rules that prevent price discrimination and cross subsidies. These rules can replicate rules already in place in other jurisdictions. For example, a condition of the license for electricity generators in the UK<sup>8</sup> is:

**Condition 17. Prohibition of Discrimination in Selling Electricity**

6. The licensee shall not, and shall procure that any affiliate or related undertaking of the licensee shall not, sell or offer to sell electricity to any one purchaser or person seeking to become a purchaser on terms as to price which are materially more or less favourable than those on which it sells or offers to sell electricity to comparable wholesale purchasers. For these purposes regard shall be had to the circumstances of the sale to such purchasers including (without limitation) volumes, load factors, conditions of interruptibility and the dates and duration of the relevant agreements.
7. For the purposes of paragraph 6, references to selling or sale of electricity
  - (a) do not include sale by way of supply to premises; and
  - (b) include entering into or disposing of the benefit of a contract, which has (or taken together with any other arrangement has) the commercial effect of selling

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<sup>6</sup> See Richard Meade Phd of [Cognitus Economic Insights](#) analysis of vertical integration [Vertical Integration and Market Power in Electricity markets](#) (Feb 2007) and [Vertical Integration vs Vertical Separation in an Imperfectly Competitive Industry, such as Electricity, with Retail, Wholesale and Forward Markets](#) (Oct 2012)

<sup>7</sup> [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0030/247377/2020-Annual-Telecommunications-Monitoring-Report-Revised-version-16-March-2021.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0030/247377/2020-Annual-Telecommunications-Monitoring-Report-Revised-version-16-March-2021.pdf)

<sup>8</sup> See <https://epr.ofgem.gov.uk//Content/Documents/Electricity%20Generation%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

electricity, by conferring rights or obligations (including rights or obligations by way of option) in relation to or by reference to the sale, purchase or delivery of electricity at any time or the price at which electricity is sold or purchased at any time, and purchaser, purchasing and purchase shall be construed accordingly.

**Condition 17A. Prohibition of Cross-Subsidies**

6. The licensee shall procure that the generation business shall not give any cross subsidy to, or receive any cross-subsidy from, any other business of the licensee or an affiliate or related undertaking of the licensee.

Introducing these provisions in the Code would be a no regrets change with no unintended consequences. Given the scale of detriment the Authority has already identified in inefficient price discrimination we suggest this can be achieved using the urgent Code change provisions.

The Authority can monitor adherence to these rules through the Hedge Market Disclosures and disclosure of internal transfer prices (ITP). However, the Authority will have to apply more resources to monitoring compliance with these requirements. In addition, Flick submits the ITP disclosure provisions would have to be amended to improve the ITP measurement and the timeliness of the publication of ITPs.

Participants are required to disclose details of risk management contracts within 10 business days. But there is a **lag of up to 23 months** from the time an ITP is determined to when it is required to disclose. The Authority indicated gentailers determine ITPs (based on historic and future prices) in November/December for the next financial year starting 1 July (8 months) and this price is not required to be disclosed until within 3 months after the end of the financial year (30 September or 12 months plus 3 months).<sup>9</sup> This massive time lag makes the ITP information meaningless.<sup>10</sup> In November/December at the same time as determining the ITP the gentailer is developing its business strategy for its retail business based on the internal transfer price. This strategy is implemented during the 12-month financial year. A lowball ITP means the gentailer's retail business can offer lower retail prices / acquisition benefits during the financial year. Further, by the time the actual ITP for one financial year is disclosed the business is nearly five to six months into operating with the ITP determined for the next financial year.

The purpose of disclosing the ITPs and gross profitability is to understand if all retailers are operating on a level playing field – if the electricity cost for gentailers' retail businesses is available to / can be replicated by an independent retailer. Disclosing this information 23 months after the fact has no value.

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<sup>9</sup> Note, the volumes sold by the gentailer at this internal transfer price are irrelevant because it is a fixed price charged for any volume the gentailer's retail business sells.

<sup>10</sup> Some companies already disclose ITPs in their financial statements with more regularity than the Code requires.

Further, this lag offers a significant window of opportunity for gentailers to behave in ways that would be poor for retail competition.

Flick recommends the Code be amended to require disclosure of ITPs before the start of the financial year for which it applies. This would be an essential change to ensure the Authority can monitor the non-discrimination and no cross-subsidy rules.

#### *Other options*

Flick strongly submits the status quo is not a feasible or viable option. The Authority's sound analysis has revealed economic inefficiencies in the wholesale market that is limiting the promotion of competition.

As discussed above, amending the Code to include non-discriminatory pricing and no cross-subsidy rules is our preference of the options within the Authority's legal construct.

Flick submits the Authority prioritise work on implementing non-discriminatory / no cross-subsidy pricing as well as supporting government to determine the most efficient option for structural reform. In our view, the other options in the Issues and Options Paper<sup>11</sup> will not address the ongoing existence of the incentives and ability to abuse market power.

We welcome further engagement on this topic.

Yours



**Steve O'Connor**  
Chief Executive

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<sup>11</sup> In paragraph 6.12 of the Issues and Options Paper (namely: Prohibit use-it-or-lose-it clauses; Electricity Authority pre-approval of large contracts; Require public offering of all (or some percentage of) hedge contracts; Require large hedges to be traded publicly; Extend trading conduct provisions beyond the spot market to hedge markets; and Hybrid of non-discriminatory pricing and pre-approval of contracts).