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Submissions
Electricity Authority
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SUBMISSION ON WHOLESALE ELECTRICITY MARKET

The Electricity Retailers' Association of New Zealand ('ERANZ') welcomes the opportunity to provide feedback on the Electricity Authority's twin documents' Market Monitoring Review of Structure Conduct and Performance in the Wholesale Electricity Market - Information Paper' and 'Inefficient Price Discrimination in the Wholesale Electricity Market - Issues and Options Discussion Paper' from October 2021.

ERANZ is the industry association representing companies that sell electricity to kiwi households and businesses. Our members supply over 90 per cent of New Zealand's electricity. We work for a competitive, fair, and sustainable electricity market that benefits consumers.

Summary

The Electricity Authority ('the Authority') documents are a mix of caveated findings that draw no conclusions there is a lack of competition in the wholesale market, with bold statements that all household consumers could be paying $200 too much per year for their electricity because of the aluminium smelter at Tiwai. As a result, decision-makers feel pressure from the wider public to search for solutions to problems not proven to exist.

This unfortunate situation results from pressing ahead with no publicly agreed terms of reference to guide the review and set stakeholder expectations of what it would cover. The review would have benefitted from market participants feeding into the process earlier.

The review ends up narrowly focusing on the Tiwai smelter and the long-running debate about its future operation in New Zealand. The whys and wherefores of the smelter are open to different interpretations, but its function in the market and the reaction of market participants are consistent with a reasonably well-performing market.

In fact, the wholesale market outcomes over the last few years is explainable by well-known supply and demand drivers, leading to the pipeline of new renewable generation projects growing recently. Furthermore, New Zealand's transition to a zero-emissions electricity system will challenge how we operate and require fit-for-purpose regulatory improvements to maintain a secure and affordable supply. In particular, the consenting process for new projects is burdensome and needs urgent fixing to ensure a wide variety of generation types and owners can access the market.

ERANZ supports the government's numerous existing wholesale market workstreams that continuously seek to improve market settings. Particularly those coming out of the Electricity Price Review's recommendations. This work should not be underestimated. Ultimately, ERANZ submits that the Authority should focus on fostering competition in the market to meet its objectives for the benefit of customers.

Terms of reference

ERANZ is surprised at the process for this wholesale electricity market review. It is an extensive review of an essential part of our electricity market yet has no public terms of reference. The Authority published a 146-page review document and a 64-page issues and options paper without significant input from the sector. One consequence of this process is a misalignment between the Authority's focus and options for interventions and industry expectations.

The review's findings are inconclusive and, as a result, there is no specific problem definition supported by evidence requiring further options analysis by the Authority to solve. Like others, ERANZ is puzzled by the review's extensive focus on the supply contract to the Tiwai aluminium smelter. We were expecting it to have a broader focus – and to be something we could work on with the Authority.

Instead, the Authority is looking into ways to insert itself into contract negotiations to ensure future contracts are "efficiently priced". This is a significant development in the debate around market regulations with no input from participants. A regulatory change like this is disproportionate to the issues the Authority has stated and, potentially, outside of the Authority's intended role in regulating the market.

Narrow focus on Tiwai

The Tiwai smelter is a major consumer of electricity, employer in the Southland region, and export earner. Tiwai's future is the source of lengthy and ongoing debate across New Zealand's political, public policy and economic spheres. The Authority is not well placed to consider wider effects outside of the electricity market.

The review's more challenging findings relate to Tiwai and, in particular, the much-reported conclusion that households may be paying an extra $200 per year for power to subsidise the electricity the smelter consumes. The Authority repeats this statistic in its public statements creating a public appetite for action before firm conclusions are tested and affirmed.

Whatever price the smelter can command from the market might be frustrating for others, but it takes no more or less electricity than before. Even if the smelter does close, it is not entirely clear that electricity bills would fall. Treasury concluded in 2019 that it was "uncertain" whether, or for how long, retail prices would fall if the smelter left.
Most of the electricity provided to the smelter would be marooned in the lower South Island because of transmission constraints.

Once the problem of constrained transmission is fixed, the smelter's closure could introduce other dynamics into the market, such as the closure of the Huntly Power Station, while delaying investment in new generation.

Feedback from stakeholders suggests the report's narrow focus on Tiwai caused confusion, particularly in light of the Minister's subsequent decision to ask officials to reopen the findings of the Electricity Price Review. This re-review by MBIE is primarily considering vertical separation – we will seek to engage with these officials as they consider their work.

Wholesale market performance

This winter, we have had a period of higher than usual wholesale power prices, mainly due to gas shortages and low lake levels – which has been challenging for some businesses. These elevated prices came on the back of a period of higher-than-usual prices since late 2018. More recently, rainfall has helped significantly ease water shortages and wholesale prices – with spot electricity prices now sitting considerably below their 10-year average.

Retail customers are insulated from wholesale price volatility because retailers stand between customers and the wholesale market and smooth retail prices over time. In fact, the latest residential price per kWh is at its lowest level since 2012, after inflation.

However, commercial and industrial customers not on a fixed price, and those coming off contract, have faced elevated prices due to the drivers described above. For industrial consumers that manage their own spot price exposure, futures prices have also been elevated for the same reasons. The market has responded to these supply issues, including by suppressing some demand due to higher prices.

The review's analysis of the actual functioning of the wholesale market is somewhat vague. Although it found that underlying conditions may explain increases in electricity prices since 2018, it could not be sure. The review states:

> *"It is not possible to definitively conclude whether all of the increase in prices is due to underlying conditions [including concerns about a lack of gas supply] or if some of the increase is due to prices not being determined in a competitive environment."*

ERANZ submits there is unclear evidence of a problem from the Authority's analysis; rather there was a perfect storm of gas production facility constraints combined with low hydro inflows which appear to explain the outcomes in the wholesale market.

Transitioning to higher renewables

The major challenge New Zealand needs to navigate in the coming years remains our climate change transition – how we gear up to deliver the electricity sector of the future and how we support consumers through this change.

Tiwai's continued operation, or not, is an essential consideration as New Zealand makes the transition to a zero-carbon electricity sector. Introducing more renewable generation into the mix will change market behaviour, such as dispatching hydro, which will not necessarily fit historical models of how our market works.

ERANZ supports the work of the Authority's Market Development Advisory Group and their work on price discovery in a future wholesale electricity market under 100% renewable electricity supply.

Given New Zealand's need to increase renewable electricity generation and reduce emissions, regulatory interventions that increase uncertainty in the wholesale market's operations would be counterproductive.

The announcement of Tiwai's four-year extension prompted a flurry of investment in new generation – but the government could do more to remove barriers that stop the building of new, cheap, renewable generation.

The Authority's review makes a nod to this – but it should be more assertive. Just like New Zealand's housing market, regulatory settings and infrastructure rules can prevent otherwise worthwhile projects from going ahead – and that is part of the reason forward supply costs are higher than the marginal cost of new renewable generation.

ERANZ submits the Authority should look beyond strict wholesale market settings and push for improving dynamic efficiency. We acknowledge some of these issues are broader than the Authority's remit - we support joined up thinking across regulators and government to collectively remove barriers to entry for new generation. For example, changing the Resource Management Act to recognise the value of renewable projects – currently challenges in getting a consent under the RMA can hamper efforts to build the infrastructure we need to transition to a low carbon economy and meet demand. ERANZ supports greater transparency around how government departments and agencies are working together so industry participants can see how everyone is working together to ensure policy cohesion.

ERANZ supports the government establishing a National Energy Strategy as part of the Emissions Reduction Plan. Developing such a strategy needs an experts from the electricity, gas, distributors, transport and process heat sectors working in collaboration with policy makers and regulators to integrate all the work underway.

Existing wholesale market workstreams

The Authority's review of the wholesale market should be read in conjunction with the significant amount of reform the government has already undertaken in this space over recent years. The sector is still digesting and implementing an extensive reform programme from 2019's Electricity Price Review ('EPR').

The EPR identified gaps in the information disclosure rules for the wholesale electricity and gas markets. Following this, the Authority decided on a suite of reforms to improve the availability of thermal fuel information in December 2020. However, these have not resulted in an increase in thermal fuel information disclosure to the market.

The EPR found the voluntary hedge market did not always work as effectively as it could and impacted the ability of independent retailers to manage their exposure to volatile spot prices. The Authority decided on an enduring approach to market-making arrangements in August 2020. As a first step, the Authority implemented a Code amendment to include a permanent mandatory backstop in April 2021. In November 2021 the Authority noted that:

> *"Trading activity in ASX futures products has, over the past two years, increased significantly. Trading in the period of late 2016 to 2019 was often in the range of 2,000 GWh per month. Now, in 2020 and 2021, futures trading has increased to a range between 4,000 GWh to over 8,000 GWh per month. For context, this is about twice as much electricity as is actually consumed each month in New Zealand."*
>
> *…*

> *"Over the same time period, October 2016 to September 2021, open interest has increased nearly 470 percent from 3,472 GWh to 19,809 GWh."*
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> …
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> *"Generally, more volume, both through increased trading and increased open interest in the hedge market creates more opportunities for generators, retailers, and large consumers to effectively manage spot price risk."*[1]

The EPR recommended requiring vertically integrated companies to release information about internal transfer pricing and the profitability of their retailing activities to assist market participants and others in assessing generator margins. The Authority is now mandating the annual disclosure of mass-market internal transfer prices by integrated generator retailers, the methodology used to derive them, and retailers' disclosure of retail gross margin reports.

The EPR suggested that the Authority expand its wholesale market monitoring to include periodic comparisons of wholesale contract prices with new-generation costs. The first comparison report was published in August 2021.

The EPR found that the Authority's compliance framework cannot respond proportionately to complaints and code infringements and is bound by overly prescriptive procedures. As a consequence, the Authority consulted on its Compliance Strategy last month.

The Authority is also progressing the EPR's recommendation for increasing the Authority's information gathering powers so it can undertake any review, study or inquiry requested by the Minister of Energy and Resources, regardless of whether the request relates to the Authority's statutory objectives.

The Authority has also recently introduced new trading conduct rules, which will directly address any exercise of market power.

Finally, the Authority introduced new rules this year requiring generator spot price offers to be consistent with those made where no generator could exercise significant market power.

Fostering competition

Taken together, the reforms listed in the previous section show a market continuously improving. ERANZ submits the Authority's ultimate driver should be to foster competition to ensure all market participants continue to act rationally for the benefit of consumers.

There are opportunities to use this review to drive additional competition in the wholesale market by making it as easy as possible for new generation, distributed energy resources, and new large users to be built and utilised.

Given the importance of this topic, we invite the Authority to undertake further consultation by allowing another round of submissions once this first round of submissions are published.

[1] https://www.ea.govt.nz/about-us/media-and-publications/market-commentary/market-insights/market-insight/

Thank you again for considering our submission. We are available to discuss our submission further if required.

Yours sincerely

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