

21 October 2022

Sarah Gillies  
Acting Chief Executive  
Electricity Authority

Dear Sarah,

## **The Authority action to ban Tiwai-type deals is necessary to protect and enhance the integrity of the electricity market**

2degrees, Electric Kiwi, Flick Electric, Haast Energy Trading (Haast), and Pulse (the independents) welcome the urgent Code amendment. We had recommended the Authority adopt an urgent Code change to reduce the risk the prospective new NZAS electricity supply contracts lock in further price exploitation. As it currently stands, the ban on Tiwai-type deals may be the only substantive change to come out of the wholesale market review.

The independents support the Authority's proposal to make the Code amendment permanent. We also consider the Code amendment could be enhanced to provide stronger protections for consumers and the electricity market; in particular:

- The Code amendment should explicitly prohibit cross-subsidies e.g.:
  - 13.269 Restriction on materially large contracts
  - (1) A generator must not give effect to a materially large contract unless—
  - (a) the materially large contract is subsidy-free; and
  - (b) the net value of the materially large contract to the generator calculated in accordance with clause 13.270 is a positive value; ...
- Proposed clauses 13.269(1)(a) and (b) – along with our proposed subsidy-free clause – should be “and” conditions rather than “or” conditions.
- The Authority should consider adopting an ‘150 MW and/or net 1,314,000 MWh over any 12-month period’ threshold.
- The Authority should consider international precedent for non-discrimination rules to apply to any wholesale market electricity transaction etc, including the non-discrimination and equivalence of inputs requirements in the New Zealand Telecommunications Act, and Condition 17 and 17A of the UK Electricity Generation Licence.<sup>1</sup> MBIE is currently developing a wholesale access regime for the groceries which would require access on “non-discriminatory terms”, “the wholesale offering by major grocery retailers – in terms of access terms and conditions, range and price – is consistent with what would be expected in a workably competitive wholesale market” etc.

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<sup>1</sup> <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20Generation%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

- The Authority should consider developing enhanced continuous disclosure rules for large contracts.

For completeness, we support the proposed voluntary clearance process, and agree “it would be inappropriate for the proposed interventions to apply to contracts such as PPAs which support the transition, to the extent that they result in improved supply of renewable generation, and do not lead to material increases in prices paid by other consumers”.

### **Meridian’s assessment of the urgent Code amendment implies there are loopholes**

We are concerned by statements Meridian has made about the urgent Code amendment in its Annual Report and profit announcement e.g.:

In August, the Authority created an ‘urgent code amendment’ temporarily for 9 months, while it consults on whether these new rules should be a permanent feature for the market. The amendment puts in place some new rules on industrial electricity contracts of 150MWs or more. Meridian will submit on the consultation detail, but it’s clear Meridian’s current contracts comply and we will work with the Authority to ensure all future contracts also comply.

Meridian has also stated there is a “massive gap” between the current contract price and a “sustainable price” (which presumably means it is below cost?).<sup>2</sup>

If Meridian is correct, and the urgent Code change permits the current contract pricing even though it is not “sustainable”, then it would appear there is problem or major loophole in the urgent Code amendment which the Authority will need to fix with urgency/prior to Meridian and Contact entering new contracts with NZAS to ensure the non-discrimination rules are effective.

### **The urgent Code amendment was needed**

The independents support “The Authority ... view that progressing its response to inefficient price discrimination, as quickly as feasible, and ahead of the wider response to the Wholesale Market Review is a priority” and agree the Authority’s “analysis suggests the inefficiency could be very large, the arrangements have material implications for consumer outcomes, and there is a risk of similar arrangements being negotiated in the near term and which could further embed these consequences for decades”.

When the Authority consulted on this matter last year, it made clear it needed to resolve the issue before new contracts are signed, “to provide greater assurance that inefficient price discrimination will not occur ... with respect to any future Tiwai contracts”. Given the large consumer impact of the Tiwai contract (\$863m per annum estimated by the Authority) it is important to ensure the current pricing arrangements do not extend beyond 2024.

The urgent Code amendment was particularly important given the Authority has alluded that its work on this matter might not be completed prior to new NZAS contracts being agreed and it would be reluctant, or potentially unable, to retrospectively intervene once the contracts had been signed.

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<sup>2</sup> <https://www.stuff.co.nz/business/129680732/meridian-says-if-tiwai-smelter-stays-it-should-be-for-at-least-another-15-years>

The Authority had been clear about its view that “It does not appear that the Authority would be able to unwind the existing Tiwai contracts even if they were definitely found to be inefficient”.

We had been very concerned Meridian and Contact (and potentially other incumbent generators) could lock in a new, potential long-term ‘sweetheart’ deal which provides electricity to Tiwai at artificially low prices before the Authority had acted; particularly given Meridian’s posturing that “We would need to see a long term commitment to New Zealand so we are talking, obviously, 15 to 20 years. ... it needs to be at least that”.<sup>3</sup>

The Authority’s clear and decisive action on this aspect of the wholesale market review will help improve trust and confidence and improve regulatory certainty.

### **Cross-submissions should be added to the consultation process and future Wholesale Market Review consultations**

It is regulatory good practice to include cross-submissions as part of consultation processes; in particular, where (i) there is potential large financial implications for consumers or market participants; and (ii) the issue is likely to be contentious.

The initial WMR and inefficient price discrimination consultation are examples where we considered the Authority received unjustified criticisms, including from its ex-CEO, but we didn’t have an opportunity to refute the criticisms due to the absence of cross-submissions as part of the consultation process.

### **We reject Meridian’s criticisms of the Authority**

We do not agree with Meridian’s criticisms of the Authority in its December 2021 submissions. For example, Meridian claimed “The Authority’s analysis ... is flawed and makes several incorrect assumptions”, “is based on untestable assumptions”, “The Authority has made no attempt to understand the impact of gas market uncertainty on hydro storage management and security of supply” or that the peer reviews show “there is no evidence market power has been exercised”. The Inefficient Price Discrimination paper patiently details why Meridian’s various modelling criticisms etc lack any merit.

Our main take-out from these submissions is that Meridian continues to consider behaviour that would reasonably be seen as an abuse of substantial or significant market power as normal market conduct. The Meridian submissions reinforce the need for stronger regulatory intervention, including consideration of options such as structural reform and break-up of Meridian.

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<sup>3</sup> <https://www.stuff.co.nz/business/129680732/meridian-says-if-tiwai-smelter-stays-it-should-be-for-at-least-another-15-years>

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## Summary of the independents' views on the inefficient price discrimination ban

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- Meridian couldn't it put it better that "Preserving what is good about the market system we have today while aligning behaviours and encouraging market outcomes towards what is achievable should be the goal for regulatory efforts".<sup>4</sup>
- **The independents support the urgent Code amendment. Permanent** adoption of the urgent Code amendment should prevent new contracts being locked in with NZAS which continue to deliver poor environmental and climate change outcomes, and higher electricity prices for all other businesses and households. **What happens with Tiwai is critical to New Zealand's climate change aspirations and energy affordability for Kiwi households and businesses.**
- **We also support the Authority's proposal to make the Code amendment permanent. The Code amendment could be enhanced** to provide stronger protections for consumers and the electricity market; in particular:
  - The Code amendment should explicitly prohibit cross-subsidies e.g. "the net value of MLC is positive – ie, the direct value to the generator of the contract exceeds the value of the generator's best alternative e.g.

13.269 Restriction on materially large contracts

(1) A generator must not give effect to a materially large contract unless—

(a) the materially large contract is subsidy-free; and

(b) the net value of the materially large contract to the generator calculated in accordance with clause 13.270 is a positive value; or ...

- Proposed clauses 13.269(1)(a) and (b) – along with our proposed subsidy-free clause – should be "and" conditions rather than "or" conditions.

While theoretically Tiwai could on-sell the electricity and make a profit on the margin between the contract price and the market value of the electricity (including more profitability than using the electricity itself) under the draft proposals there are likely to be other considerations; including that contract negotiation is not a one-off game and what Tiwai does with the electricity it purchases may impact the amount (and price) of electricity Meridian et al are willing to offer in future negotiations.

Ultimately, we would query under what conditions it would be efficient to offer NZAS a subsidy, or to price below the net value of the electricity supplied, regardless of whether there is provision for resale. As the Authority has noted: "If the value of the contract to the generator is less than the value of the generator's best alternative, it is reasonable to presume that the generator's decision to supply is motivated by rent seeking".

- The Authority should consider adopting an '150 MW and/or net 1,314,000 MWh over any 12-month period' threshold.
- The Authority should consider international precedent for non-discrimination rules etc, including the non-discrimination and equivalence of inputs requirements in the New Zealand

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<sup>4</sup> Meridian, MDAG engagement, The future of the NZ power system with 100% renewables, 23 August 2021.

Telecommunications Act, and Condition 17 and 17A of the UK Electricity Generation Licence.<sup>5</sup> MBIE is currently developing a wholesale access regime for groceries which would require access on “non-discriminatory terms”, “the wholesale offering by major grocery retailers – in terms of access terms and conditions, range and price – is consistent with what would be expected in a workably competitive wholesale market” etc.

- **The Authority should consider developing enhanced continuous disclosure rules for large contracts.** The nature and size of the Tiwai contract is such that it can substantially impact forward prices, including but not limited to the ASX futures, OTC hedge markets and long term price paths, used for generation investment decisions. The ‘will they stay, or will they go’ uncertainty is likely to have caused generation investment to be delayed exacerbating the supply and pricing issues in the wholesale electricity market over the last several years. There can also be considerable information asymmetries in the market with Meridian and Contact, and the contracting parties, having considerable information advantage over other market participants, including over matters such as the likelihood of exit and potential duration of any new contract.<sup>6</sup>

Both the buyers and sellers of very large electricity contracts have a duty of care to minimise the potential impacts to security of supply and market price efficiency by doing all they reasonably can to ensure such contracts are negotiated and/or extended in a timely way and of significantly long duration and to minimise doubt in the wholesale electricity market.

- **The proposed non-discrimination prohibitions are cautious and limited compared to international precedent:** While we expect the Authority will receive submissions claiming the intervention is heavy-handed and will chill investment incentives etc,<sup>7</sup> it should be recognised the New Zealand electricity market will have relatively narrow limited non-discrimination prohibitions; particularly compared to international precedent.
- **Meridian’s assessment of the urgent Code amendment suggests there may be loopholes it can take advantage of:** According to Meridian there is a “massive gap” between the current contract price and a “sustainable price” yet “it’s clear Meridian’s current contracts comply” with the urgent Code amendment. If Meridian is coaxed correct there must be some problem or loophole in the urgent Code amendment which the Authority will need to fix with urgency/prior to Meridian and Contact entering new contracts with NZAS to ensure the non-discrimination rules are effective.
- **The problem is a market concentration/substantial market power problem:** The NZAS contracts are a product of the Smelter’s large size relative to the rest of the electricity market and the size and substantial market power of the incumbent electricity generators; particularly Meridian. The wholesale electricity market is concentrated or highly concentrated based on Electricity Authority and Commerce Commission benchmarks, and international regulatory precedent.
- It is important to be clear the \$860m monopoly pricing<sup>8</sup> exists because the large, incumbent generators have and exercise substantial market power and the over-pricing will occur regardless of what price(s) the incumbents agree with NZAS.

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<sup>5</sup> <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20Generation%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

<sup>6</sup> For example, price changes preceded the 14 January 2021 announcement that the Tiwai contracts would be extended to 2024.

<sup>7</sup> Hansen (on behalf of Meridian) has already attempted to do so.

<sup>8</sup> The Authority’s estimate in its Inefficient Price Discrimination in the Wholesale Electricity Market – Issues and Options Paper, October 2021

- **Abuse of substantial market power is like an iceberg.** What you can't see is invariably much larger than what you can see and much more of a problem. The December 2019 UTS and the Tiwai contracts are simply the most blatant examples of abuse of market power (e.g. when rainfall levels mean that some hydro dam spill is inevitable it is clear water value is zero), but most of the time it is much harder to determine what the legitimate value of water is and there can be reasonable grounds for different commercial views about the value.

While the Authority considers that potential abuses of significant or substantial market power may have reduced following introduction of new trading rules it is more likely that the abuses are now done in less obvious ways.<sup>9</sup> We agree with the Authority that “the only impact of the new rule may be to temper extreme behaviour”.

- **Behavioural regulation to deal with structural problems should largely be seen as a stop-gap or 2<sup>nd</sup>-best measure.** We consider regulation against Tiwai-type contracts is a pragmatic short-term intervention given the lead-time for structural reform which would ultimately render such regulation unnecessary. We do not share the Authority's reservations about structural reform and consider that much of the Authority objections mirror issues ECNZ raised prior to its break-up.

## The problem definition is correct but should be tightened

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Meridian has claimed the Authority provided a “flawed problem definition and fundamentally flawed analysis of price discrimination” and there was a “lack of evidence of any problem”. We disagree with Meridian entirely but consider the problem definition should be tightened and more overtly grounded in terms of market failure.

The underlying problem the Authority has described is a problem with market concentration/substantial market power. This should be spelt out more overtly in the final decision paper.<sup>10</sup>

We agree with the Authority that:

“The ‘Tiwai Contracts’ between Meridian Energy, Contact Energy and the New Zealand Aluminium Smelter (NZAS) highlighted the incentives generators may have to subsidise extremely large load customers that could otherwise credibly exit, reduce consumption, not expand or not enter the domestic market. This incentive arises from the increase in aggregate demand, arising from the large user's consumption, inflating electricity prices nationally to such an extent that the higher revenues generators earn from all other (inframarginal) consumers greatly exceeds the cost of the subsidy required to retain the large load user. Such arrangements can be characterised as rent seeking – a situation where an entity seeks to capture more wealth for itself without adding to, and potentially destroying, wealth to society - by way of a sophisticated form of economic withholding.” [footnote removed, emphasis added]

Incentives to subsidise, rent seek or economically withhold only matter if there are market concentration/substantial market power problems. Economically withholding electricity supply won't impact wholesale electricity prices if the generator does not have substantial (Commerce Act language) or significant (trading conduct language) market power – all it would do is harm the generator's revenue. Most of the Authority language is coached in terms of “market power” which, if it isn't significant or substantial, is not necessarily a problem, particularly in markets with non-homogeneous products.

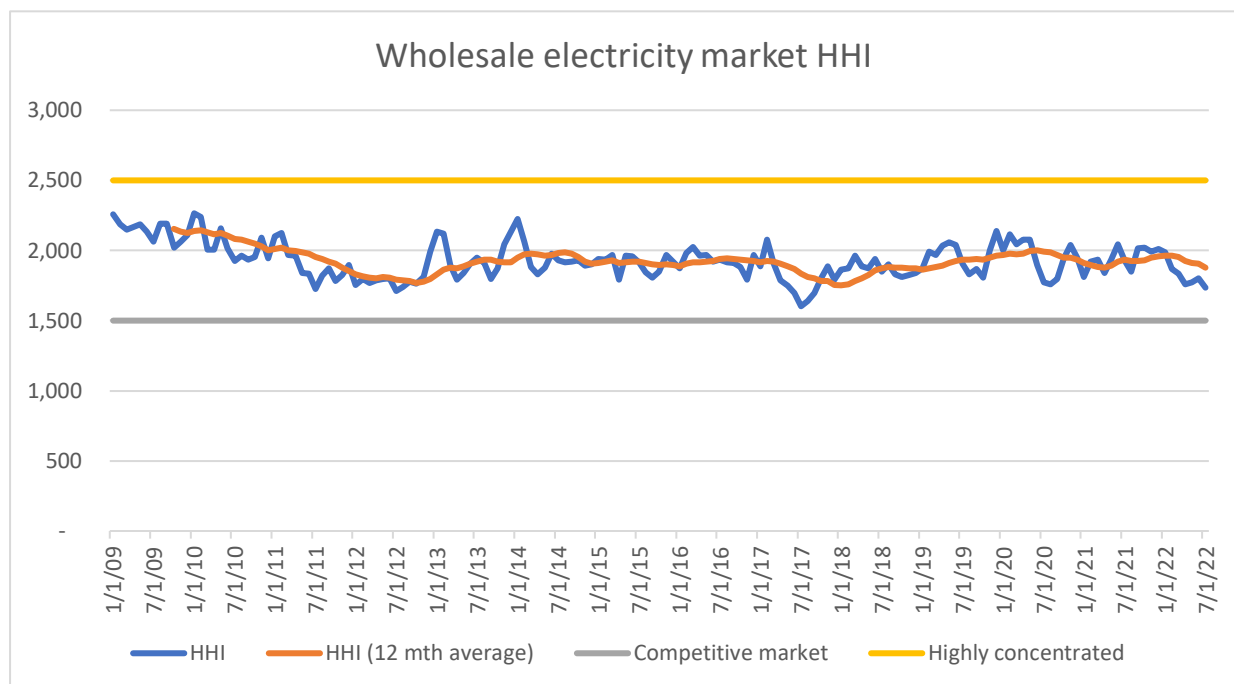
<sup>9</sup> Electricity Authority, Post implementation review of the trading conduct provisions, undated/released 12 October 2022.

<sup>10</sup> The same issue applies in relation to the Electricity Authority, Promoting competition in the wholesale electricity market in the transition toward 100% renewable electricity: Issues Paper, undated/released 12 October 2022.

Generators only have incentives and ability to “maintain” or “inflat[e]” national prices through inefficient price discrimination if they have significant or substantial market power. The stronger the level of market power the higher the extent to which prices can be inflated above workably competitive levels.

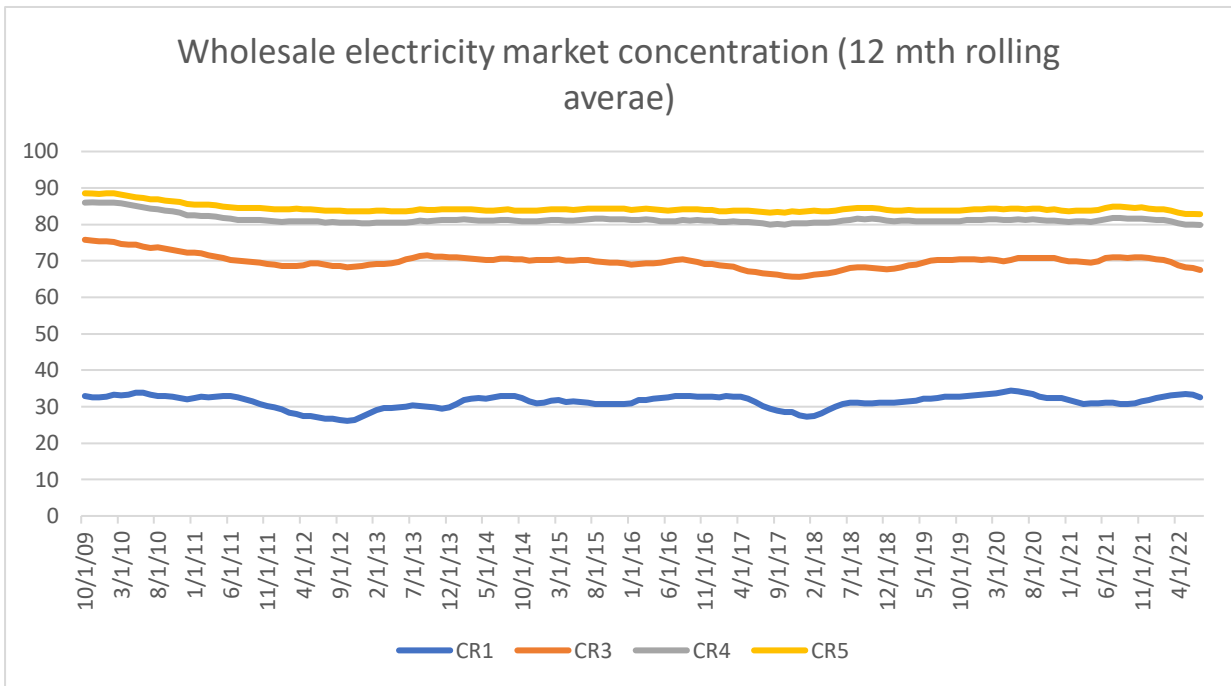
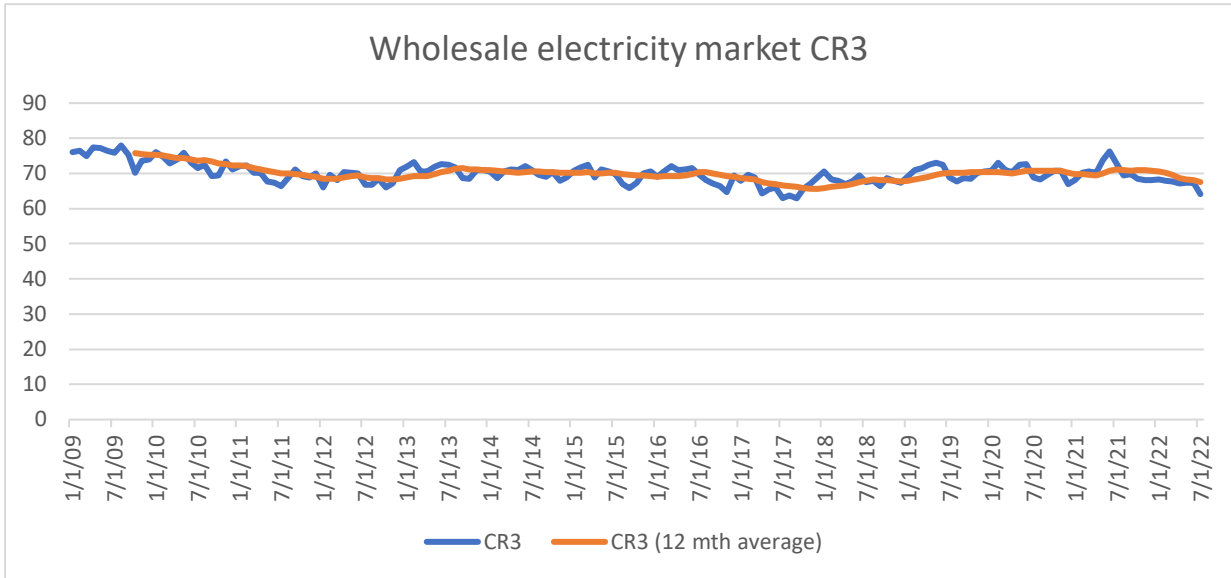
The Authority’s assessment that the NZAS contracts have resulted in wholesale electricity prices \$860m higher than they otherwise would be implies a very very high level of, and (ab)use of, market power. It is important to be clear that unless the large, incumbent generators’ substantial market power is addressed the over-pricing could occur regardless of what price(s) the incumbents agree with NZAS and regardless of this Code change.

While market power and the exercise of market power is mentioned in the consultation paper at various places there is no reference to the strength of the market power (except as implied by the level of price inflation) or whether the market power is significant or substantial (which is what really matters) and there is no mention that the wholesale electricity market meets the Authority definition of a concentrated market (1500-2500 = concentrated, >2500 = highly concentrated<sup>11</sup>), and hovers around the Commerce Commission market concentration threshold (CR3=70%).



<sup>11</sup> Different regulatory agencies use different thresholds and measures e.g. the UK CMA typically regards markets with HHI below 1,000 as unconcentrated, markets with HHI between 1000 and 2000 as concentrated, and markets with HHI above 2,000 as highly concentrated.





The wholesale electricity market concentration rates have essentially flatlined over the last decade. As the Authority has noted HHI is not decreasing and has flattened out since 2012 at around 2000.<sup>12</sup>

### The NZAS contracts are a sophisticated form of dumping

The Authority has touched on the potential for generators to dump water as an alternative way to withhold electricity and artificially rise prices. The 2019 UTS is a good example of this. The 2019 UTS highlights unnecessarily dumping or spilling water is one of the easiest and clear-cut abuses of substantial market power to identify.

<sup>12</sup> Electricity Authority, The Authority's response to submissions on the 2021 Market Monitoring Review of Structure, Conduct and Performance in the Wholesale Electricity Market, undated/released 12 October 2022.

From the perspective of a large, incumbent generator with substantial market power, the NZAS arrangements (even at the subsidised price) has the attraction that: (i) it takes a very large amount of electricity out of the market; (ii) as the Authority has noted: “a contract with relatively short duration (4 years in the current case) over such a large quantum of demand could serve to deter new investment, as there is the risk that prices will fall significantly in the event of an exit”; (iii) Meridian and the other contracted generators at least get something for the electricity (if the water is spilled they get no revenue); and (iv) they have successfully gotten away with such arrangements for a very long-time and likely thought they would continue to do so until NZAS finally exited.

The latest contracts are simply the most egregious example of the arrangements Meridian and the large generators have had with NZAS.

Hansen (on behalf Meridian) attempted to counter the Authority’s 2021 Issues Paper findings that Meridian engaged in inefficient price discrimination by subsidising NZAS claiming without substantiation that “if that is true then it implies Meridian believed it was unable to engage in the more profitable strategy of economically withholding the generation rather than supplying NZAS”. Hansen either fails to understand or ignores that other forms economic withholding, even if they were feasible on the scale of the Tiwai contracts, would result in Meridian receiving no revenue and therefore would not be more profitable.

We agree with the Authority that “Selling electricity below cost to a large industrial user may be a more sophisticated and lower cost way of implementing economic withholding, with the intention of bolstering aggregate prices” and “In contrast with physical spilling, the withholding of electricity in this way generates revenues from sales to the large user (though less than the best alternative price). But, similarly to physical spilling, disposing of water in this way creates potentially significant costs to the generators in the form of breaches of existing (and future) Code and (perhaps more importantly) the threat to generators’ social license, and consumers’ and investors’ confidence in the design and structure of electricity markets”.

### **Meridian has suggested that other generators have engaged in economic and quantitative withholding**

According to Meridian “The Authority does not appear to consider the possibility of economic withholding by thermal generators when considering the lack of thermal commitment over the review period”, “at times some generators simply do not offer all available generation” (i.e. quantitative withholding) and “Meridian ... always offers all available generation while pricing some generation capacity at high prices so it is not expected to be dispatched” (i.e. economic withholding).

It might be useful for the Authority to explore with Meridian the evidence it has which supports their allegation other generators are engaging in economic and quantitative withholding electricity to raise prices.

### **The Authority’s analysis is fundamentally sound**

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While the Authority has been cautious in its language in the consultation paper, we agree with the Authority, in particular, that:

- “A competitive response would ultimately be expected to put downwards pressure on prices as new generation enters the market which would reduce the profitability of the strategy to the generators. However, the quantum of electricity required to enable such a competitive response

coupled with the relatively short term of the recent contracts may, along with other potential barriers to new investment (eg, Resource Management Act), dampen a competitive response and the profitability of the rent seeking strategy could persist for decades.”

- “The ‘Tiwai Contracts’ between Meridian Energy, Contact Energy and the New Zealand Aluminium Smelter (NZAS) highlighted the incentives generators may have to subsidise extremely large load customers that could otherwise credibly exit, reduce consumption, not expand or not enter the domestic market. This incentive arises from the increase in aggregate demand, arising from the large user’s consumption, inflating electricity prices nationally to such an extent that the higher revenues generators earn from all other (inframarginal) consumers greatly exceeds the cost of the subsidy required to retain the large load user. Such arrangements can be characterised as rent seeking – a situation where an entity seeks to capture more wealth for itself without adding to, and potentially destroying, wealth to society - by way of a sophisticated form of economic withholding”. [footnote removed/emphasis added]<sup>13</sup>
- “Subsidising large load customers ... creates the possibility that electricity is not being allocated efficiently. If the resulting increases in spot and forward prices can be sustained due to generators exercising market power without inducing entry, this distorts investment and electrification signals, and enables a wealth transfer from all other consumers to generators. This is unlikely to be in the long-term interests of consumers.”
- “The financial incentives of large generators in New Zealand are such that – in the case of very large contracts, where the price is tied to physical consumption by a designated large load user, and there is a credible threat to consumption – they may sell electricity to the large load user at a subsidy to achieve higher prices on their other generation.”
- “The returns from other generation, to cover any support, will be a function of the size and geographical spread of these generating assets. Individual generators have greater incentives to support these arrangements the larger their generation base.” [footnote removed]
- “... the Tiwai contracts have significant potential to be inefficient, and may be an example of the exercising of market power by generators. Generators had the capacity to maintain wholesale spot and future prices paid by consumers not party to the Tiwai contract, and, as such, had incentives to retain NZAS in the New Zealand market other than the expected direct revenues of maintaining a commercial relationship with NZAS.”
- “As part of an offer tabled by Meridian in early 2020, some generators other than Meridian and Contact offered to provide a “transmission underwrite”, despite these generators not having a direct commercial arrangement with NZAS. A possible, and in this context likely, explanation is that these generators anticipated financial benefits from higher prices for other consumers due to NZAS remaining, because these generators’ transmission underwrite was not backed by any apparent direct revenue generating contracts with NZAS. Participation by these generators in the offer strengthens the proposition that the arrangement was motivated by preserving NZAS’s consumption, even if it meant some generators providing significant subsidies. Presumably generators anticipated these costs would be more than offset by the higher spot and forward revenues they would enjoy from other customers over the life of the contract.” [footnote removed]

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<sup>13</sup> It is worth noting that Meridian did not publish any Stock Exchange earnings guidance when it signed the extended Tiwai contract despite it having circa \$100m p.a. impact on EBITDAF.

- “Generators continue to have a commercial incentive to price electricity on very large contracts tied to consumption at below opportunity cost, rather than risk losing the demand”
- “... generators have rent seeking incentives to provide electricity to very large load users at prices below the opportunity cost of that electricity, because the revenues they earn from higher spot and forward prices as a result of the contract exceed the subsidy.” [footnote removed]
- “The Authority does not think it is appropriate to always rely on the current incentives of incumbent firms to do what is best for wider society.”
- “Inducing NZAS to stay through subsidised electricity will, if NZAS would otherwise have exited, have a cost to society in terms of the marginal cost of the higher cost thermal generation required to satisfy the very large increase in aggregate demand. Concept Consulting modelled the cost of the generation required to support (the highly inelastic) demand of aggregate load users with and without NZAS. This delta is the incremental cost of supply at the system level from NZAS’s decision to stay.”
- “Profit motivated generators [with substantial market power] generally do not face incentives which align with the national interest.”<sup>14</sup>

We suggest these extracts from the Authority’s consultation paper provide a strong and sufficient case for the proposed intervention. The current stop-gap of an urgent Code amendment is appropriate but structural reform needs to be implemented to remove the underlying market failure problem.

## **The assessment of wholesale price impacts is supported by other agencies**

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The independents consider that the Authority’s analysis is robust and fundamentally sound. As we previously noted in submissions, the Authority’s finding that the Tiwai contracts could result in spot prices \$2.6 billion higher than they should be over just 3 years is unsurprising and puts the importance of the review into perspective.

The findings align with Contact and Meridian’s own statements about the NZAS contracts and various other analysis on the impact of the NZAS contracts, including from the Climate Change Commission, Entrust (Scientia Consulting) and MBIE-Treasury, all of which have found there would be substantial medium/long-term wholesale price reductions if the Smelter shut down; with the price reductions being greatest in the short-term.

Transpower’s decision to complete CULWP will simply impact the distribution of those pricing benefits with the price reductions spread more evenly between the North and South Islands.

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<sup>14</sup> We assume the square bracketed text was omitted by error. We do not consider there to be any reason to have concerns about the incentives of generators that lack market power and cannot influence price.

## The Authority should review international best practice for non-discrimination rules

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The consultation paper is very clear Tiwai-type arrangements are an example of inefficient price discrimination, and this is reflected in the new inefficient discrimination rules being highly targeted to large, Tiwai-type arrangements.

What is less clear is where the Authority sees the boundary between efficient and inefficient discrimination, or discrimination which could lesson competition.<sup>15</sup> We consider this to be an area that would be worth exploring further, particularly as it relates to all electricity transactions and not just large contracts.

We consider that it would be useful for the Authority to draw on New Zealand and international regulatory precedent.<sup>16</sup> The grocery reforms may also provide useful precedent for non-discrimination rules. Various of the independent retailer joint and individual submissions, including this submission, have referenced some of the international precedent examples.

As an example, Ofgem introduced an obligation on operators with significant market power not to 'unduly discriminate', and adopted a two-stage test to assess whether a difference in treatment was unlawful:

- Can the difference in treatment between the customers be objectively justified because of relevant differences in the customer's circumstances (eg the cost of supplying to that customer or their creditworthiness)?
- If not, does the difference in treatment have the potential to affect competition?

## The Code amendment deals with a symptom but not the underlying problem

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The Authority's Code amendment restricting certain discriminatory arrangements will address one of the symptoms/adverse impacts of the market concentration/power problem, just as introduction of new trading conduct rules and the Authority's clear decision that spilling water in December 2019 was an undesirable trading situation (UTS) will help.

However, behavioural regulation cannot eliminate structural problems.

The wholesale electricity market is highly concentrated, and the large, incumbent generators have substantial market power, particularly Meridian.

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<sup>15</sup> Meridian claimed, in response to the initial consultation, that "the Authority has defined a set of conditions that rule-out all price discrimination".

<sup>16</sup> We have previously referred to the Telecommunications Act equivalence of inputs and non-discrimination rules. In addition, the Government has recently accounted that the incumbent supermarkets will be required to negotiate wholesale offerings to their competitors on commercial terms, with the proviso that if those prices are not what would be expected in a competitive wholesale market the new Grocery Commissioner will be able to impose additional regulation to force fairer prices.

To deal directly with the problem the extent of market concentration/power in the market needs to be substantially reduced. We consider the ban of Tiwai-type contracts, while needed, should be seen as a stop-gap measure before structural reform could be implemented.

We consequently welcome the Authority’s statements about structural reform in the Inefficient Price Discrimination Paper though they do not align with the Authority’s subsequent WMR comments which seem to strongly oppose structural reform on philosophical grounds:

“Reducing the scale of generators may better align their individual incentives with the interests of consumers - smaller generators experience less revenue uplift from inefficient price discrimination due to their smaller generation base.”

“Inefficient price discrimination may highlight a problem which could lend weight to a need for structural reform and the Authority notes that structural options may be considered as part of the wider wholesale market competition review”.

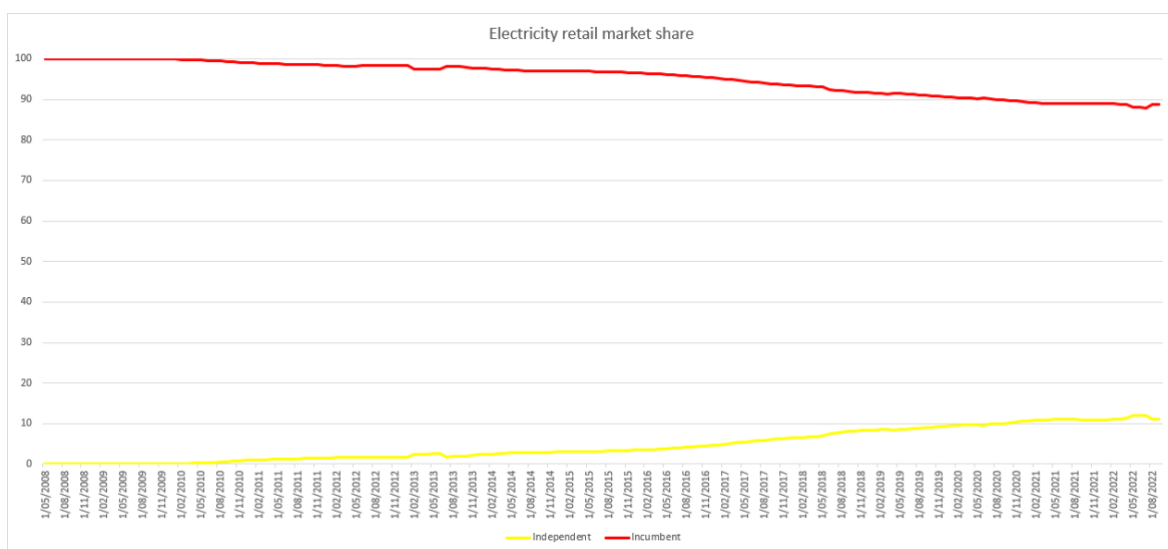
It should be recognised one of the main reasons Meridian was kept large with control over South Island hydro when ECNZ was broken up was (ironically) to enable the NZAS contract to be kept whole. This is far less important now that parties are signing financial, and not electricity delivery, contracts.

## Price squeeze testing is needed to determine wholesale market impacts on closely related and downstream markets

We note the Authority comment that:

“The Authority also sought feedback and evidence from interested parties on other forms of price discrimination that might warrant further consideration by the Authority. Some submitters suggested there were issues with access and pricing of wholesale electricity Contracts For Differences (CFDs) hedges for the independent retailers in the Over The Counter (OTC) market. The Authority was not presented with sufficient evidence of this being a problem such that it warrants further attention at this time. ...”

This statement begs the question that if price squeezes/discrimination by the vertically-integrated gentailers is not a barrier to competition, then what explains why all New Zealand’s regional retail markets are either concentrated or highly concentrated<sup>17</sup>/or the slow growth rate of independent retailers?



<sup>17</sup> Based on Electricity Authority thresholds.

We continue to advocate the Authority undertake orthodox price squeeze/equivalence of Input testing to determine whether the large incumbents are using high wholesale prices and vertical-integration to impose price barriers to retail competition.<sup>18</sup> The Authority is ultimately in the position to obtain the information needed to test the extent to which the barriers to competition/discriminatory practices raised by the independent retailers is an issue in the same way as it has produced its own robust evidence of the problems with the NZAS contracts.

These types of tests are relevant for the Authority in testing whether risk management arrangements are being provided or offered on “reasonable terms”.<sup>19</sup>

The market internal transfer price disclosure requirements will not provide the transparency or data needed to undertake orthodox price squeeze/economic replicability testing.

The Authority should commission a reputable international expert consultancy which has experience in undertaking price squeeze/economic replicability testing and seek advice on the information needed to conduct such tests.

It would require the Authority to compare the Internal Transfer Payments the incumbent vertical-suppliers use to set their retail prices (as opposed to accounting transfers used for financial reporting) with prices that would be reasonably feasible for a prudent and efficient independent retailer to obtain.

Another type of test for economic replicability that exists is whether a vertically-integrated supplier’s downstream retail arm could trade profitably based on the upstream wholesale electricity prices charged to (/faced by) its competitors. The Body of European Regulators for Electronic Communication (BEREC)<sup>20</sup> have noted “By setting either wholesale or retail prices (or both), ... vertically integrated firms ... can define the space (margin) between the wholesale and the retail price level. By setting the margin too small, the [vertically-integrated] operator could potentially squeeze other operators out of the market”.<sup>21</sup>

While the Authority has talked about there being “perceived issues of vertical integration or market power”<sup>22</sup> and a “perception that dominant generator-retailers may increase cost of rivals, limiting competition and increasing their own profitability”,<sup>23</sup> it hasn’t done the analysis required to make any conclusions about whether these concerns are valid or not, including in relation to whether vertical-integration is a problem or not.

## Concluding remarks

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The challenges New Zealand faces in ensuring energy affordability and a successful transition to a low emissions economy are severely impeded by the existing NZAS energy supply arrangements,

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<sup>18</sup> The joint independent retailer submission to the Electricity Authority on internal transfer payments discusses the problems with the transfer payment exercise the Authority has undertaken, including that it is not price squeeze/economic replicability testing and therefore doesn’t provide sufficient basis for determining potential problems with vertical-integration in the retail market: Electric Kiwi, Flick Electric and Vocus, The independents support wholesale-retail transfer price and segmented financial disclosures, 18 May 2021 available at: <https://www.ea.govt.nz/assets/dms-assets/28/Independent-retailers-submission-Internal-Transfer-Prices-and-segmented-profitability-reporting.pdf>

<sup>19</sup> Electricity Authority, OPEN LETTER TO MARKET PARTICIPANTS, 18 October 2022.

<sup>20</sup> <https://berec.europa.eu/>

<sup>21</sup> [https://berec.europa.eu/eng/document\\_register/subject\\_matter/berec/regulatory\\_best\\_practices/guidelines/4782-berec-guidance-on-the-regulatory-accounting-approach-to-the-economic-replicability-test-ie-ex-anteselector-specific-margin-squeeze-tests](https://berec.europa.eu/eng/document_register/subject_matter/berec/regulatory_best_practices/guidelines/4782-berec-guidance-on-the-regulatory-accounting-approach-to-the-economic-replicability-test-ie-ex-anteselector-specific-margin-squeeze-tests)

<sup>22</sup> Electricity Authority, Hedge Market Enhancements Enduring market making approach, Decision Paper, 27 October 2020.





<sup>23</sup> Electricity Authority, Internal transfer pricing and segmented profitability reporting, Consultation Paper Briefing, 29 April 2021. See also Electricity Authority, Internal transfer prices and segmented profitability reporting, Consultation Paper, 8 April 2021.

with NZAS responsible for 13% of electricity demand. These arrangements, along with a wholesale market structure which allows substantial market power to be exercised and incentivises under-investment in renewables, are combining to keep New Zealand’s net zero ambitions out of reach unless reform is enacted.

It should be recognised that the continued operation of NZAS, on the basis of cheap electricity under ‘sweetheart’ deals with Meridian and Contact, is a substantial cause of the current tight electricity supply conditions and the extent to which Huntly has had to operate, burning the particularly dirty coal Genesis is using at unprecedented levels.

The arrangements are presently due to expire in 2024 but there was a substantial risk that if the Authority had not intervened longer-term arrangements could have been locked in, which will perpetuate the economic and environmental harm caused by existing arrangements. The Authority must seriously review the proposed Code amendment to ensure it achieves the outcome being sought.

Yours sincerely,

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