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Electric Kiwi and Haast support end of Tiwai contract type market rorts

Electric Kiwi and Haast Energy Trading (Haast) support the Authority's urgent Code amendment and proposal to introduce a permanent ban on Tiwai-type contracts.

We note Meridian has reported in its 2022 Annual Report that "it's clear Meridian's current contracts comply". If Meridian is correct then it would indicate there are deficiencies or loopholes in the Code amendment that need to be plugged.

The Authority needs to stamp out discriminatory practices and other abuses of market power to build trust and confidence electricity market and regulatory settings can be relied on to promote competition for the long-term benefit of consumers.

We agree with MBIE's warning that the electricity sector needs to "maintain its social license to operate" and "If people lose trust in the market and market participants, perhaps because of pricing or reliability, then the political process may explore alternatives to the current market. Such alternatives exist and are being used in other jurisdictions".[1] The sustainability and durability of market settings requires that where there are market or regulatory failures they are addressed in a commensurate and timely manner.

What does Meridian mean by "sharp" versus "fair" and "sustainable" pricing?

Last year Meridian defended its Tiwai contracts on the basis that the pricing was "sharp" but "The price per apple for a million applies is a lot less than the price per apple for a bag of apples".

Meridian was extremely critical of the Authority for raising concern the contracts were priced too cheaply.

Meridian claimed the Authority was "incorrect" and "If companies that need a lot of electricity cannot sign commercially competitive deals, they simply cannot survive". The Meridian WMR submission repeatedly dismissed the Authority analysis as "speculative", with Hansen (on behalf of Meridian) alleging that "A static and myopic approach has been used for a dynamic relationship" amongst other unsound criticisms.

Now that NZAS has decided it wants to continue to operate in New Zealand beyond 2024, Meridian has shifted its language from justifying current pricing as being "sharp" to wanting the new pricing to variously be "fair" and "sustainable". Meridian's statements remind us of the Telecom CEO infamous admission they were "not being straight up" with customers and "used confusion as its chief marketing tool".

[1] MBIE, Investigation into electricity supply interruptions of 9 August 2021, 2021: https://www.mbie.govt.nz/dmsdocument/17988-investigation-into-electricity-supply-interruptions-of-9-august-2021

The intervention is likely to aid Meridian in negotiations

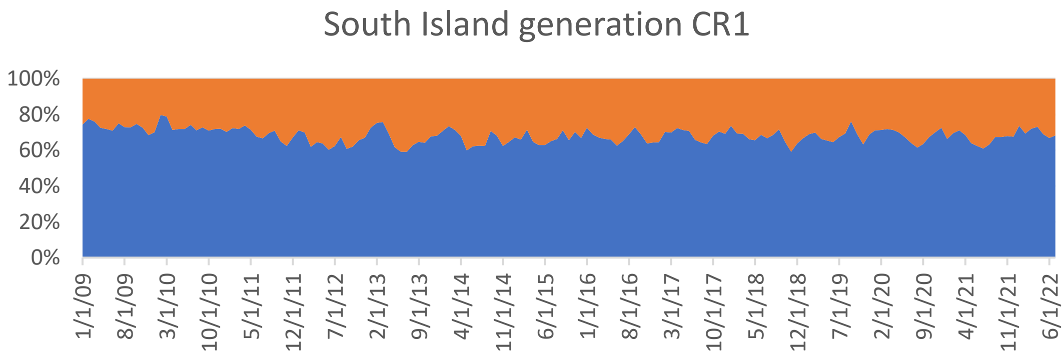
One of the ironies of the Authority intervention is that, despite Meridian's protests that the current Tiwai price is above "opportunity cost", the intervention is likely to help Meridian's negotiations with NZAS and bolster the price they receive in any new contract. It seems clear from "Meridian's contention that Rio Tinto's 9 July 2020 announcement to the ASX was 'cheap talk'" that Meridian considers it came out on the wrong side of negotiations with Tiwai last time round.[2]

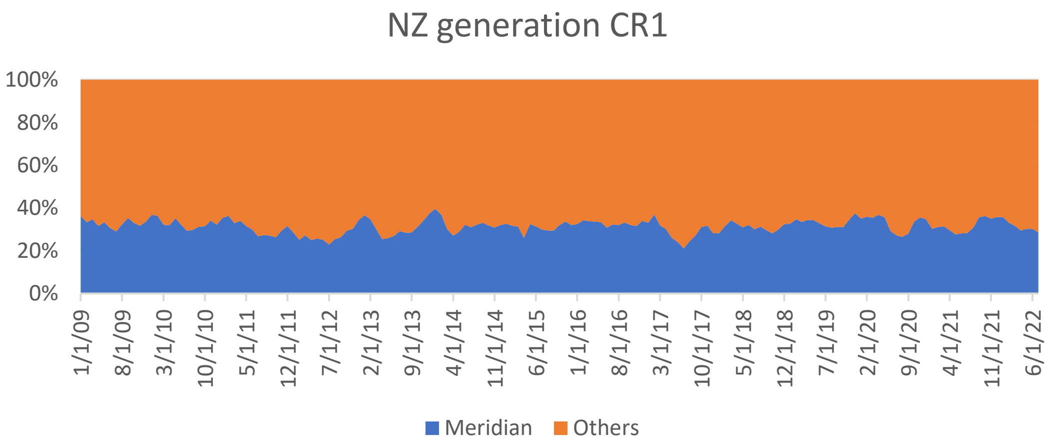
The wholesale market is concentrated; particularly in the South Island

The joint independent submission highlights that the Tiwai problem is a substantial market power/market concentration problem which accords with the Authority's observation "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."

The scale of the market power problem can be measured using standard market concentration statistics such as HHI and Concentration Ratios which make clear that the market is concentrated or highly concentrated and there hasn't been any real improvement in the last decade.

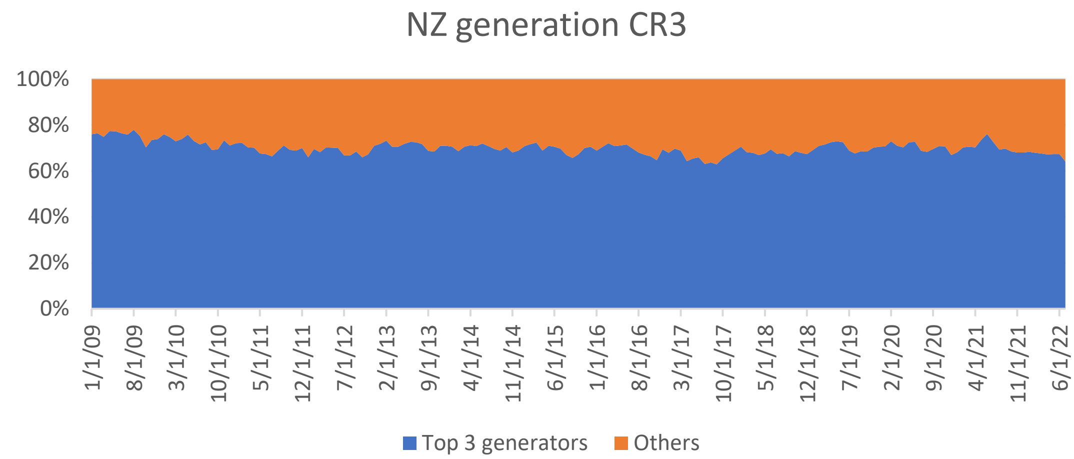
The following graphics highlight the size of Meridian in the South Island and relative to the rest of the market.

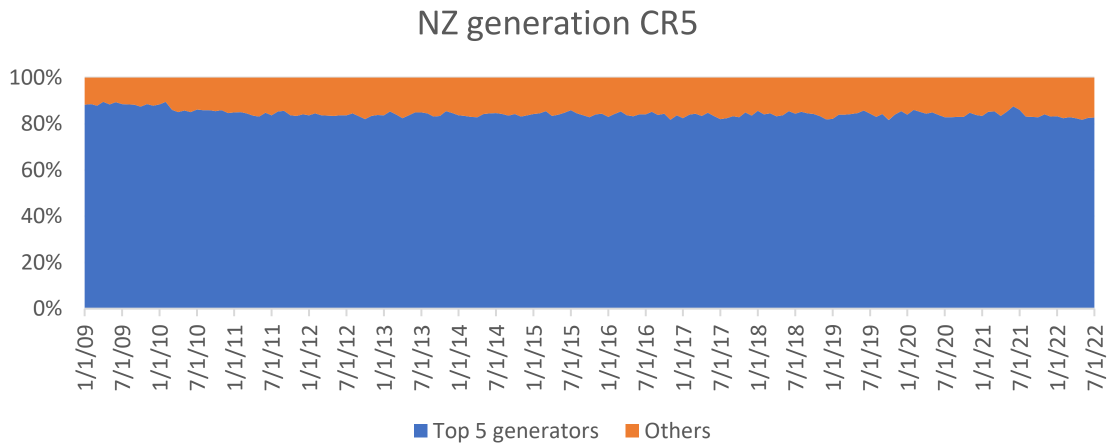




[2] Carl Hansen (on behalf of Meridian) made similar comment stating: "giving notice on a contract is considered to be another phase of the negotiation process" and "… giving notice can be part of hard-ball bargaining".

The following two graphics highlight the high level of market concentration and dominance of the 5 large, incumbent generators in the wholesale market.





Meridian's comments on how it can raise spot prices through its decisions on hydro-storage are prescient

The level of market power in the electricity market can also be inferred from the conduct and attitude of firms with substantial market power. The WMR and latest inefficient discrimination papers detailed, for example, clear evidence of dumping (e.g. the December 2019 UTS) and that the impact of the Tiwai arrangements added over $860m to wholesale prices.

Many of the statements Meridian has made, particularly about what it considers to be acceptable conduct, are also prescient. This can be seen, for example, in Meridian's UTS, MDAG 100RE and WMR submissions.

The independent joint submission notes comments Meridian has made about other generators engaging in economic and quantitative withholding, and that "Meridian … always offers all available generation while pricing some generation capacity at high prices so it is not expected to be dispatched" i.e. Meridian statements make it clear it engages in economic withholding but thinks that's OK.

Our submission to MDAG on the 100RE consultation noted Meridian's WMR submission (including Meridian's consultant reports; particularly that of Axiom)[3] indicates the strength of its substantial market power and the control it has over spot prices.

Meridian made it clear in its WMR submission that the decisions it made about storage management is "a driver of high offer prices" but tried to justify "the spot prices observed in the wholesale market over the period" on the basis that they "reflect … prudent storage management decisions in response to gas market issues". Axiom similarly commented that "managing scarcity" can have a "strong influence … on … "expected spot prices".[4]

While Meridian (and Axiom) tried to artificially distinguish between exercise/use of market power and the purported purpose that "offers that [Meridian considers] were required to deliver prudent storage management", the key take-away from the submissions is that Meridian's size and market power means it has control over security of supply and spot market pricing. This is far removed from outcomes that could be expected in a workably competitive market or where substantial market power is not being used or exploited.

The Brattle Group (on behalf of Meridian) has also previously enunciated that Meridian offers its generation plant to ensure its generation meets its retail customer demand and prices high beyond that. The Brattle Group could not be much clearer that Meridian engages in economic withholding and this results in higher (above workably competitive) spot prices:[5]

> Meridian has, over the past several years, consistently employed the same bidding strategy. It typically offers its hydro generation into the pool in three main groups of tranches. The first group is offered at or near $0/MWh to ensure that it is picked up by the market, and is intended to be roughly equal to Meridian's contracted load requirements. This usually represents the majority of Meridian's hydro generation capacity. In the second group, Meridian offers a smaller amount of generation based on the availability and opportunity cost of water at various prices (typically less than $350/MWh).

It is not surprising questions are being raised now by the Government, the Electricity Authority, other market participants, consumers and other stakeholders about whether prices are too high. The Authority's WMR work indicates that, in addition to the impact of the Tiwai contracts, there is $38/MWh of price uplift that cannot be explained by legitimate cost and market conditions. The latest wholesale market review consultation reconfirms these findings. Meridian's various statements only serve to add fuel to the fire.

Concluding remarks

Electric Kiwi and Haast support the Authority's intervention, including urgent Code amendment, to sought out the long-standing problems with Tiwai electricity supply contracts.

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[3] Meridian, Meridian submission: Review of competition in the wholesale market, 22 December 2021: https://www.ea.govt.nz/assets/dms-assets/29/Meridian-submission.pdf

[4] Axiom's submission highlights well that if Meridian has significant or substantial market power and adopts a "conservative" approach to hydro storage it can result in substantially higher prices. A principal proposition of Axiom's is that the "'scarcity management' strategies" of "different generators" "have the potential to result in prices that exceed the generators' operating and maintenance costs". What Axiom (and Meridian) fail to acknowledge is that this is only possible if a generator has significant or substantial market power, otherwise their individual decisions would not impact spot prices.

For example, Axiom used an example where there is a 98% probability that there will be enough existing generation capacity to meet an additional unit of demand, the short run operating and maintenance cost of the marginal generator in that scenario would be $10/MWh, and the opportunity cost to customers who consequently miss out (due to scarcity) at time t would be $10,000/MWh (the assumed VoLL).

Axiom noted: "With these simplifying assumptions, the expected spot price at time t would be: (98% x $10/MWh) + (2% x $10,000/MWh) = $209.50/MWh". Using this example, if Meridian is gross pivotal and adopted a conservative approach to dry-year management assuming a 4% probability of shortage, the SRMC would nearly double to $409.60/MWh.

[5] The Brattle Group, New Zealand Electricity Authority's Preliminary Decision on UTS, 18 August 2020.

The negative market consequences of the Tiwai contracts should be seen as a symptom of the over-arching market concentration/substantial market power problems in the electricity market; exacerbated by Meridian's size and dominance and the type of behaviour that it seems to think is acceptable. The longer this kind of behaviour persists the more damage will be done to trust and confidence in the electricity market and existing regulatory settings.

Yours sincerely,

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