31 October 2022

Electricity Authority
By email: inefficientpricediscrimination@ea.govt.nz

Inefficient Price Discrimination in very large electricity contracts

Meridian appreciates the opportunity to comment on the Electricity Authority's Proposed Code Amendment Consultation paper ("the consultation paper").

Our submission comprises three parts. In Part I we comment on the policy rationale for the Code Amendment. In Part II, recognising that this amendment has already been made under urgency, we suggest changes to the design of the proposal which will improve its ability to achieve the Authority's intent and/or operational efficiency. Then in Part III we comment on several drafting matters.

We would like to put on the record at the outset that Meridian does not believe the Authority has made a particularly convincing case for this Code amendment.

However, setting aside our differences, Meridian considers the Authority's proposal to be broadly workable, subject to the design improvements and drafting clarifications described below.

In terms of the issues the Authority is seeking to address, we consider:

- On-sale provisions are a simple solution to the risk the Authority believes exists of inefficient price discrimination in very large electricity contracts, as these provisions allow contract volumes to be on-sold to the user with the highest willingness to pay;

- The more complex "net value" test proposed by the Authority could be useful by participants who wish to prevent on-sale of all or part of the "un-used MWs" or market position sold by them in an electricity derivative; and

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- An optional clearance regime would provide generators who choose to go through the process with assurance their contracts will not be challenged, or called into question, after the fact. However, we think the clearance regime could be extended to allow the Authority a more wide-ranging discretion to grant clearance where neither the "net value" nor "on-sale" tests are met but the Authority nevertheless considers the relevant contract to be efficient and in the long-term interest of consumers. This is because it is simply not possible for the Authority or anyone else to fully anticipate the nature of every large contract that might be contemplated in future.

At a more detailed level we think the Authority's policy intent would be better achieved if the current Code provisions are amended to:

- simplify disclosure obligations when a contract enables on-selling;
- shorten clearance timeframes;
- insert an ability to withdraw a clearance application;
- clarify the definition of a "materially large contract" (MLC);
- clarify if the new rules are intended to have retrospective effect; and
- remove the risk that a generator is considered to have breached the Code because of the subsequent actions of another generator.

Further detail on these matters is provided below.

Part I: Policy rationale for this Code change

From our perspective, the Authority has chosen to regulate a purely hypothetical problem. This raises questions about whether the Code amendments are necessary, and whether they will result in a net positive impact to New Zealand consumers.

The issues paper focused on allocative efficiency, noting that inefficient price discrimination means the right consumers may not be consuming the right amount of electricity. According to the Authority, this can lead to a situation where the allocation of electricity to different consumers may be inefficient. The review also covered dynamic efficiency and the transition to a low emissions economy. The Authority suggests that if wholesale prices are distorted in some way, then investment in all forms may be distorted. Yet in all this analysis, the Authority

does not provide any evidence that these concerns do actually play out as real problems in the New Zealand electricity market.

At times in the consultation paper the Authority suggested Meridian's contract with the New Zealand Aluminium Smelter (NZAS) might be an example of inefficient price discrimination. Certainly, this issue attracted a lot of attention when the paper was released. However, the consultation paper now advises:[1]

> *"…the Authority did not make any determination [in the initial issues paper] that the current Tiwai contracts were definitively inefficient – it was recognised "that alternative calibrations [of assumptions] can suggest that the arrangements are wealth-enhancing." However, future contracts with similar features to the Tiwai arrangements have the potential to be inefficient and cause significant harm to consumers."*

In addition to the Tiwai arrangements the Authority's latest consultation paper suggests that an earlier "transmission underwrite" offered to NZAS might be an example of the problem it is now solving for. One difficulty with this suggestion is that no contract actually resulted from the transmission underwrite and as such it cannot be an example of real-world inefficient price discrimination. Nevertheless, the Authority states at paragraph 3.7(b) in the consultation that:

> *"…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…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."*

Meridian cannot speak for the generators the Authority refers to, but we note the situation in early 2020 was unique and considerably more complex than the Authority now presumes. In our view it would be imprudent to draw too many lessons from that situation or use it as the basis for longer-term regulation of the sector. In particular, in early 2020 New Zealand entered its first COVID-19 lockdown with a number of commentators predicting widespread and potentially permanent demand destruction and the exit of a number of heavy industries from New Zealand. There were concerns that New Zealand might face massive job losses and

[1] https://www.ea.govt.nz/assets/dms-assets/30/Inefficient-Price-Discrimination-in-very-large-electricity-contracts-Consultation-paper.pdf Paragraph 1.2

that there would be long-lasting impacts on the economy, particularly in the regions. The Enerlytica edition on 18 March 2020 was titled simply 'COVID 19 – Energy Recession' and said:

> *"There is now seemingly total consensus that the global economy has entered recession. With COVID-19 increasingly out of control there is deep uncertainty as to how long the downturn could go on and how deep the damage could be. Markets appear to be factoring at this stage a 1-in-50 year event. Unknown as yet is whether conditions could deteriorate to become a 1-in-100 year event – perhaps therefore approaching the Great Depression in severity…A worst-case scenario could see NZ's largest energy users – each of which ultimately operate in NZ at the discretion of offshore markets and decision makers – permanently exit their NZ operations."*

In the weeks prior, alongside increasingly disturbing news about the growing pandemic, there had been widespread coverage of NZAS's asserted financial difficulties and the potential for imminent closure of the smelter. There had also been considerable speculation as to whether the Government would intervene to assist NZAS, particularly as the Government had arranged an industry workshop led by MBIE and supported and attended by them along with the Authority and Transpower, entitled "NZAS and New Zealand's Renewable Energy Future." The generators referred to by the Authority were asked to attend that seminar and were encouraged to consider what would be necessary to secure such a future.[2]

The combination of unique circumstances, political expectations, and regulator involvement meant there was considerable pressure on industry to resolve the situation. This only increased in the early part of 2020 as the seriousness of the COVID-19 situation became more apparent. In our submission on the October 2021 review of wholesale competition, we referenced these matters noting the broad political support across the Government and the Opposition for the outcome of NZAS signing an extended exit deal. The support for NZAS included the Government's offer to induce them to stay, and efforts by the Authority to ensure that the prudent discount policy would provide some relief to NZAS for their transmission costs.

In summary, it is far from clear that the motivations of the generators party to the transmission underwrite were purely commercial or have any ongoing relevance outside of the unique circumstances of the time. Certainly, the picture now painted by the Authority of generator motivations is in our view inaccurate and anachronistic. Meridian therefore remains of the opinion that the problem definition for this Code amendment is purely hypothetical. The

[2] see https://www.stuff.co.nz/business/119949358/talks-intensify-for-deal-to-save-aluminium-smelter-as-minister-says-shes-not-intervening

Authority has not provided evidence that there has been any actual inefficient price discrimination. It notes there are calibrations of its assumptions that would result in a conclusion that the NZAS contract is wealth-enhancing.

Against this context, Meridian considers the Authority is overstating the risk of future consumer harm from inefficient price discrimination in large electricity contracts. The Authority also overstates the incentives on generators to enter into such contracts and the potential impact such contracts could have on wholesale and retail prices given the dynamic response that would be likely across the rest of the market.

Meridian particularly disagrees with the consultation paper's view that the current Tiwai contract may be a form of "rent seeking" or "sophisticated form of economic withholding".[3] These claims:

- do not align with acknowledgments elsewhere from the Authority that the Tiwai contract could in fact be wealth-enhancing; and
- are not supported by the evidence presented by the Authority.

Part II: Suggested changes to the design of the Authority's proposal

Simplify the disclosure regime

Clause 13.271 of the Code makes it compulsory to disclose information to the Authority about MLCs. We suggest this should be deleted on the basis that it is unnecessary. Participants have the option of whether to "self-assess" such contracts for compliance with the Code or seek the assurance and comfort of clearance from the Authority. Participants that choose to self-assess compliance and not seek clearance take the risk that, if they get it wrong, they may be subject to pecuniary penalties, ordered to pay compensation, and prevented by the Ruling Panel from giving effect to those contracts. There would also be significant reputational harm to the generator involved. Participants would not take these compliance obligations lightly and will know that the Authority has powers to require the provision of any information using its powers under section 46 of the Electricity Industry Act. Requiring participants to make extensive information disclosures in situations where they are comfortable that they comply with the Code seems unnecessary and unduly onerous. At the most, the Authority should require participants to advise the Authority that they have entered into an MLC but

[3] https://www.ea.govt.nz/assets/dms-assets/30/Inefficient-Price-Discrimination-in-very-large-electricity-contracts-Consultation-paper.pdf Paragraph 1.6

chosen not to seek clearance. The Authority could then consider investigating if it had any reason to suspect non-compliance.

If, despite the suggestion above, the Authority chooses to retain information disclosure obligations outside of the clearance regime, then the obligations can be significantly streamlined in situations where an MLC allows for on-selling. The Authority acknowledges that there can be no inefficient price discrimination in MLCs that permit on-sale of un-used MW quantities. If that condition is met, then the MLC will not be prohibited, and clearance will not be required (although a generator may still opt to go through a clearance process).

Meridian's expectation is that the enforcement of this rule should be simple and low cost. This is because the presence (or absence) of "use-it-or-lose-it" clauses is very easy to establish. Importantly, the information that the Authority will need to assess compliance is relatively contained, i.e., the proposed contract itself. This can be contrasted with the more extensive information disclosure necessary for the Authority to assess compliance with the alternative test that "the net value of the materially large contract to the generator calculated in accordance with clause 13.270 is a positive value" (or for the Authority to consider a clearance application on those grounds).

It follows that the extensive disclosure requirements in clause 13.271(2)(d) should not be required in relation to MLCs that allow the sale of un-used MW quantities without the buyer being subject to worse terms (i.e. where businesses choose to rely upon clause 13.269(1)(b)). There is no good reason to require that the generator who is party to such a contract provide the Authority:

> "*…any information or documents, including any financial modelling, that are in the possession, or under the control, of the generator that discuss or show the impact of the materially large contract on the generator's and its related companies' group-level earnings before interest, taxes, depreciation, amortisation and fair value adjustments or on the generator's and its related companies' broader financial performance and strength.*"

This information is irrelevant to the assessment required. Simply providing the Authority with the information at 13.271(2)(a),(b) and (c) should be sufficient.

Meridian also queries whether the information at 13.271(2)(c) needs to be expanded, as it is in the current Code, by clause 13.271(4). The latter seems unnecessary and overly prescriptive. Clause 13.271(2)(c) already requires the generator to provide evidence in

support and we suggest a generator should be free to determine what, if any, additional evidence is relevant to provide to the Authority besides the contract.[4]

These two changes will significantly simplify the disclosure regime for contracts which permit on-selling. They will reduce the costs of all parties and better reflect the Authority's view that these contracts do not raise efficiency concerns.

Broaden clearance regime

As the consultation document notes, there may be scenarios where contracts that restrict on-sale facilitate forms of efficient price discrimination.[5] Such restrictions can have legitimate purposes and lead to efficient outcomes for consumers by giving generators increased certainty regarding the physical load associated with a contract. This in turn provides a degree of certainty, enabling generators to invest.

Meridian considers it likely that most, if not all, of the contracts assessed under clause 13.269(1)(a), where the net value of the MLC to the generator calculated in accordance with clause 13.270 must be a positive value, will go through a clearance application. This is because generators will want assurance that they can legally give effect to such contracts given the subjective judgments involved in assessing whether the value of those contracts is greater than the generators' best alternatives.

We support the concept of a clearance regime for these contracts. However, we think the regime should be broadened further. The Authority should be able to provide clearance in other circumstances where the "net value" or "on-sale" tests are for some reason not satisfied but the contract would otherwise be in the long-term interests of consumers. Such a catch-all is necessary to avoid unintended consequences. It is important that the Authority be alert to the potential for novel contractual arrangements and for the Code to unintentionally restrict efficient contracts as the Authority cannot foresee all future contractual arrangements and cannot know now whether the two tests in the Code will give effect to the Authority's statutory objective in every situation.

Shorten clearance timeframes

In Meridian's opinion, 45 business days for a clearance decision is unreasonably long and would have a detrimental effect on businesses that are trying to enter into contracts. We also

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[4] Remembering that the Authority's section 46 powers are always available if it decides it wants to see other information in any given situation.

[5] https://www.ea.govt.nz/assets/dms-assets/30/Inefficient-Price-Discrimination-in-very-large-electricity-contracts-Consultation-paper.pdf Paragraph 7.30(a)

note that further information requests from the Authority can effectively re-start the clock on the 45 business days for the decision. This could further extend the clearance process.

In our view, the clearance process under 13.269(1)(a) could reasonably be completed within 20 working days. Clearance applications under clause 13.269(1)(b) should be subject to a much shorter timeframe – we suggest 5 working days – given the comparatively simple assessment required to determine whether a contract allows for on-sale.

We note the timeframe for a Commerce Commission merger clearance is 40 working days and clearance for a collaborative activity takes 30 working days. The assessment to be carried out by the Authority under the Code is, in comparison, a much more limited enquiry, particularly for clearance applications under clause 13.269(1)(b). Furthermore, the Authority is an expert electricity market regulator (whereas the Commerce Commission regulates markets in general and needs time to understand the operation of any given market).

Include an ability for parties to withdraw clearance applications

Finally, for flexibility, we also suggest adding a formal ability within the Code for parties to the contract to be able to withdraw an application and then re-file it at a later stage. MLCs may be complex to negotiate with many factors influencing the process and outcome. If the situation changes between the two parties, there may be situations where it would be efficient for this to be communicated openly to the Authority and a clearance application withdrawn, rather than the Authority unnecessarily going through a clearance process and issuing a decision that is no longer relevant.

Part III: Suggested drafting amendments

The definition of an MLC needs to be clearer

One of the key elements of the definition of an MLC in the Code is that it must be a contract that "…relates to the physical consumption of electricity" – clause 13.268(1)(a)(ii). The Code would benefit from more clarity around when exactly a contract "relates to" the physical consumption of electricity in the sense required by the Code.

The test of whether a contract "relates to" physical consumption of electricity could be applied in several different ways. For example (and this is a non-exhaustive list):

- At one end of the spectrum, all derivative contracts could be said to be financial contracts based on notional quantities rather than actual physical consumption i.e. in most situations a derivative contract will not relate to physical consumption.

- At the other end of the spectrum, it could be applied to all derivative contracts that settle based on outcomes in the physical electricity market and interpreted as though all electricity contracts in some way relate to physical consumption, albeit distantly or tangentially. However, if that is the approach taken, then the words in clause 13.268(1)(a)(ii) seem somewhat redundant.

- Alternatively, it could be applied to capture all contracts where the buyer is acting on behalf of, or has some contractual relationship with, a physical consumer or consumers. As an example, a contract for difference (CFD) between two generator retailers may relate to the physical consumption of electricity, given that both businesses have retail exposure and are contracting to help mitigate risks associated with that physical exposure.

- Alternatively, it could be applied to only capture contracts where one party to the contract (i.e. the buyer) has direct control over physical load or is acting on behalf of a person with such control over load. However, even with this formulation, the contract (or absence of it) may have a purely financial impact with no physical impact on supply and demand on the grid because a derivative purchaser may still choose to operate and consume electricity purchased at spot prices in the absence of a derivative contract.

- Alternatively, it could be applied to only capture contracts that go beyond a pure financial derivative and include terms that relate directly to physical consumption, for example, a contractual requirement to consume a certain volume, or demand response provisions that assume or require changes in physical consumption.

Reading the Code, it is far from clear which of the above situations the Authority intends to capture, and which it intends to exclude, or indeed whether it has an entirely different interpretation in mind.

The Authority states in the consultation paper that:[6]

> *The reason for targeting contracts that relate to the physical consumption of electricity is because these contracts can influence prices other consumers can expect to pay in future. The electricity in the contract represents a portion of a generator's supply which is no longer available to satisfy the demand of other consumers.*

[6] https://www.ea.govt.nz/assets/dms-assets/30/Inefficient-Price-Discrimination-in-very-large-electricity-contracts-Consultation-paper.pdf at paragraph 7.10

Meridian's assumption is therefore that the Authority does *not* intend to capture contracts that only distantly or tangentially relate to the physical consumption of electricity. However, given the interpretational difficulties we have set out above, we suggest a fulsome definition be included in the Code (perhaps including examples) to provide more guidance on when a contract will be deemed to "relate to" the physical consumption of electricity.

A final point here is that the drafting of clause 13.268(b)(iv) is particularly problematic. It expands the definition of MLC to include any two or more contracts that are "any other arrangement that is substantially of the same kind" as the contracts described in any of 13.268(b)(i) to (iii) namely:

- any other arrangement that is substantially of the same kind as two or more contracts between a generator and a buyer;
- any other arrangement that is substantially of the same kind as at least one contract between a generator and a buyer and at least one contract between that generator or its related company and that buyer or its related company; or
- any other arrangement that is substantially of the same as at least one contract between a generator and a buyer and at least one contract involving a second generator where the contracts rely on each other or are otherwise interdependent.

With respect, it is almost impossible to discern what the Authority might mean by two or more contracts that are other arrangements that are of substantially the same kind as the ones above. We suggest the Authority should either delete 13.268(b)(iv) or explain it further.

It is unclear whether the Code will have retrospective effect

Clause 13.269(3) of the Code provides that the restriction on giving effect to MLCs does not apply to contracts entered into or modified before the new restrictions came into force on 20 August 2022.

However, it is not clear how this clause operates in combination with the definition of MLC which includes two or more contracts between a generator or a buyer that when taken together meet the definition (i.e. not entered into through a derivatives exchange, relating to physical consumption of electricity, and relating to a net quantity of electricity that equals at least 150MW consumed at a point in time).

It is possible that 13.268(1)(b)(i) is intended to mean "two or more contracts between **the same** generator and buyer". Clause 13.268(1)(b)(iii) suggests as much because it expressly

extends the meaning of “materially large contract” to cover contracts between a buyer and two different generators but only in the situation where those contracts rely on each other or are interdependent. If so, this should be expressed more clearly.

Clarification is required regarding the extent of this possible retrospective application of the Code. Without such clarification there is a risk that any small contract a generator enters into with the smelter will trigger retrospective assessment of the pre-existing smelter contract, which was agreed at a time when these Code provisions did not exist and had not been contemplated.

As noted in the Regulations Review Committee Digest:[7]

> *It is generally accepted that legislation should be forward-looking in its effect. If the legal status of past conduct is altered, there can be no certainty as to the legal status of current conduct. Furthermore, there is an inherent unfairness in changing the law after the event, as people cannot alter past actions to meet the requirements of a new law.*

We recommend the Code is amended to provide that only those contracts entered into or modified after 20 August 2022 can form a component part of an MLC.

One generator should not be at risk of breaching the Code because of the subsequent actions of a second generator

Clauses 13.268(1)(b)(iii) and (iv) of the Code cover situations in which there is at least one contract between a generator and a buyer and at least one subsequent or simultaneous contract involving a second generator where the contracts rely on each other or are interdependent (or any other arrangement that is substantially of that kind).

This formulation could create obligations on the first generator where it may not have sufficient information to understand whether the subsequent or simultaneous contract is reliant on the contract that it has in place or is otherwise interdependent with that contract, and therefore may not have sufficient information to know whether the Code provisions have been triggered.

It may be that, for reasons of ordinary commercial confidentiality and/or to ensure compliance with the Commerce Act, only the buyer is privy to the interdependency and the first and second generators have no visibility of the interdependency or of the potential that they are in breach of the Code.

[7] https://www.wgtn.ac.nz/public-law/publications/regulations-review at chapter 11.

These provisions would also benefit from more clarity regarding which generator would be in breach of the Code. For example, whether it is only the generator that enters the subsequent contract that tips the total volume over the 150MW threshold in the Code or whether both generators would be in breach of the Code.

Concluding remarks

In preparing this submission Meridian recognises that the underlying policy decision has effectively already been made. We have accordingly focussed our efforts on suggesting changes that make the proposed Code amendment more workable and mitigate the risk of unintended consequences. However, we would encourage the Authority to reassess if the provisions are required as the market evolves in the future and act quickly if these Code provisions do in fact result in unintended consequences.

Nāku noa, nā

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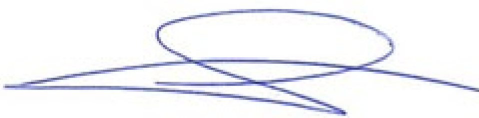

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