Major Electricity Users' Group

14 December 2022

Andy Doube
General Manager Market Policy
Electricity Authority
By email to reviewconsultation2022@ea.govt.nz

Dear Andy

Wholesale Market Competition Review

1. This is a submission from the Major Electricity Users' Group (MEUG) on the Electricity Authority issues paper "Promoting competition in the wholesale electricity market in the transition toward 100% renewable electricity," 12 October 2022.[1] Attached is a report from Mike Hensen, Senior Economist, NZIER, "Wholesale market review – Comment on thermal generation," 14 December 2022. The NZIER report is to be read as part of the submission from MEUG

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Members may lodge separate submissions.

3. Key themes in this submission:

   a) The review could be improved by first, in addition to scenarios to achieve 100% renewable generation, consider scenarios with some thermal generation because those are expected to be lower cost. Second to have a robust analysis of large vertically integrated supplier behaviour, the retail market should be considered.

   b) The actions proposed by the Authority in the paper stem from the conclusion that while there may have been exercise of market power to date, that need not be considered in the next few years. Instead, market power only needs to be considered as we get much closer to 100% renewable electricity. MEUG disagrees and recommends the cause and effect of market power needs to be understood if a robust policy response is to be implemented. To not do so means it will only be by chance that the actions proposed will be an optimal policy response.

   c) MEUG recommends an update of the market competition review be undertaken in April 2023 as outcomes on key uncertainties and parallel work start to crystalise. The caveat being that a future update be modified to address a) and b) above.

[1] Document URL Document URL at EA web page

4. MEUG cannot stress enough the urgency to address the underlying issue of market power because of the persistence to date and forecast continuation of high prices. If with each new quarter high futures prices persist and there is no downward shift in future prices, then lack of confidence in the market and the Electricity Authority will accelerate and the impetus to consider structural or regulatory governance changes will gain traction.

Chapter 2 Competition for the long-term benefit of consumers

Qu. 1: Do you agree that a key competition issue in the transition toward 100% renewable electricity is that it weakens competition during extended times when intermittent generation cannot run?

5. Refer NZIER report attached.

Qu. 2: Do you have any comments on the contents of this chapter?

6. Refer NZIER report attached.

Chapter 4 Investment in net new renewable generation

Qu. 3: Do you have any comments on the impediments to generation investment?

7. The scope of the review does not consider scenarios where some small level of thermal generation is maintained to support increased interruptible generation. The review should be extended to consider those scenarios and therefore if there are impediments to sustaining low-cost flexible thermal generation.

8. MEUG agrees with the suggestion in paragraph [4.50] and [5.10] that the need for flexible supply and demand to integrate with an increasing proportion of highly variable renewable generation be revisited later. Those themes are considered in the recently published MDAG options paper.[2]

9. An impediment to be considered is the effect of unexpected and poorly designed government and regulatory interventions on the confidence of investors for new generation and flexible thermal supply. Examples from the recent past include the ban on new offshore oil and gas exploration announced April 2018, and the large investment in investigation work for a pumped storage project at Lake Onslow in July 2020.[3]

Qu. 4: Do you agree that the lag in investment is not due to anticompetitive behaviour to slow down investment and discourage entry, or can you provide instances or other evidence to the contrary?

10. No. This question unnecessarily assumes the cause of market power has been anti-competitive behaviour to impede new generation entry. In the following paragraphs of this response MEUG recommends the Authority:

[2] Refer https://www.ea.govt.nz/assets/dms-assets/31/MDAG-Options-paper-brief-overview-7-Dec-22.pdf
[3] For ban on petroleum exploration refer Prime Minister's media release 12 April 2018 https://www.beehive.govt.nz/release/planning-future-no-new-offshore-oil-and-gas-exploration-permits

a) Continue work on the difficult task of estimating the cause and effect of market power, where the latter is an estimate of year-on-year economic profits; and

b) In addition to the work on mitigating entry barriers for new renewable generation, consider from the analysis of economic profits in the preceding sub-paragraph a), the overall behaviour of the large vertically integrated suppliers including the interaction between generation and retail.

11. The issues paper is clear there has been market power. MEUG agrees.

12. Identifying the cause and effect of market power is described as "difficult." MEUG agrees with the Authority this is difficult. However, as we explain later in response to this question, there are analytical tools used that the Authority should consider.

13. The issues paper proposes to cease new work on causes and effects of market power because it is difficult, and instead focus on barriers to entry into the generation market. MEUG agrees with the Authority that ensuring new entrants are not hindered is the standard primary response across all sectors of the economy to mitigate persistent market power. However, without an understanding of the effect of market power, that is the extent and duration over prior years of economic profits, a sole focus on barriers to entry in the generation market may miss aspects of the market where changes could be beneficial.

14. Hence MEUG recommends the Authority both continue mitigating barriers to entry to the generation market and resume work on estimating the cause and effect of market power.

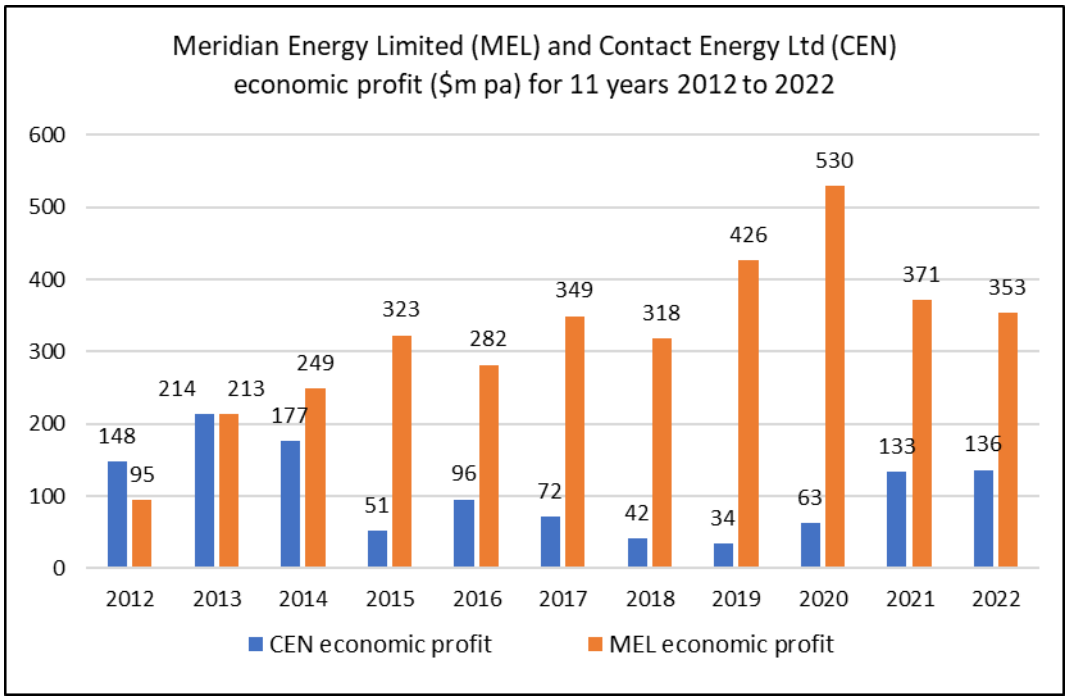
15. A core function of the Authority should be to monitor market power issues in the relevant market. This is standard OECD practice for economic regulators.[4] MEUG supports the Authority monitoring various Herfindahl-Hirschman Index (HHI) metrics for sub-sectors of the industry and continuous improvement of the weekly monitoring of offer behaviour. The former is indicative only and provides no measure of the effect (value) of economic profits. The latter is valuable in comparing offer behaviour against estimated Short Run Marginal Cost (SRMC) thresholds. Monitoring against estimated SRMC thresholds may identify anti-competitive behaviour on a trading period basis but it is difficult to extrapolate that to economic profits on a year-by-year basis. SRMC analysis does not consider the opportunity cost of capital, such as return on and return of capital invested.

16. The shortcomings in using SRMC thresholds for monitoring can be overcome by using Economic Value Added (EVA) analysis to compliment the SRMC analysis. EVA or similar analytical frameworks are used by the Commerce Commission for market studies and for regulating monopoly economic profits.

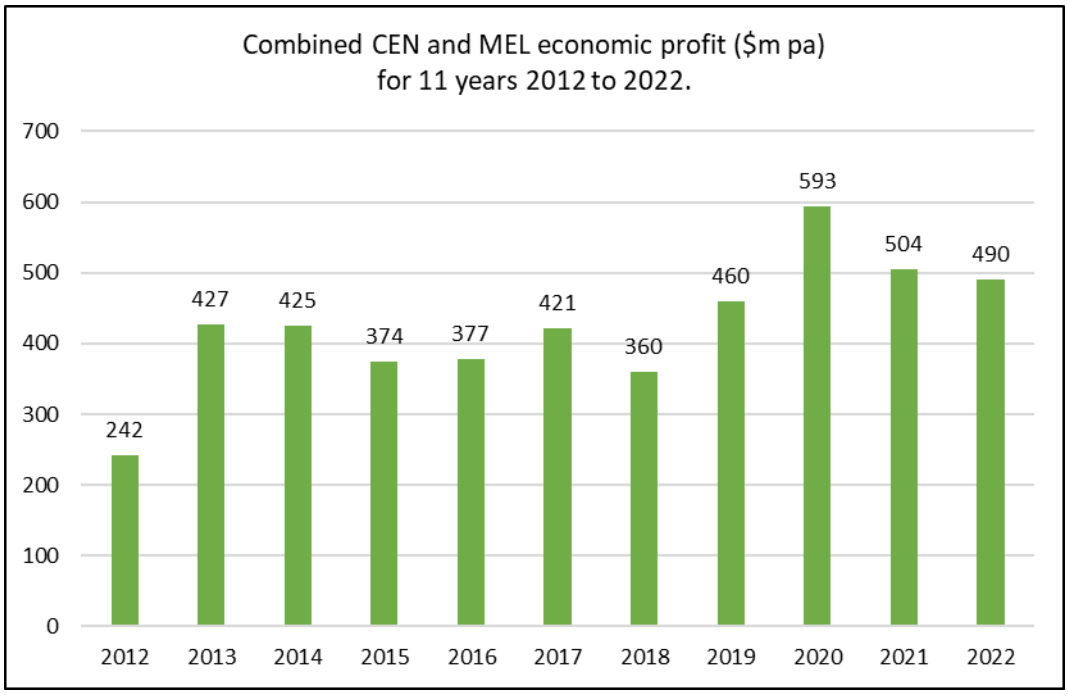
17. Appended to the submission are the annual updates for the MEUG/IWA analysis of economic profit trends for Contact Energy (CEN) and Meridian Energy (MEL) using the financial statements for the last 12 years to give results for the eleven years to 30 June 2022. Those updates were published in October 2022. The analysis in those appendices is not repeated as those appendices should be read as part of this submission. The two charts below represent those analysis.

[4] Refer https://www.oecd.org/daf/competition/methodologies-to-measure-market-competition-2021.pdf.

18. CEN and MEL economic profit trends are presented on the same chart below to allow a comparison of and differences in trends:



19. The second chart combines the economic profit trends of CEN and MEL to illustrate aggregated economic profits over time, i.e., a measure of the effect of market power:



20. MEUG notes the above combined economic profits represent a subset of the industry. EVA analysis of Mercury Energy and Genesis Energy would have to be made to estimate the economic profit trends over time for the industry. If Mercury and Genesis had sustained economic losses over the last eleven years, then those would partly offset the persistently high economic profits observed from the analysis of CEN and MEL.

21. However, as on most relevant metrics, such as sales volume and market capitalisation, the combination of CEN and MEL exceeds the combined metrics for Mercury and Genesis, therefore the economic profits for the industry over the last eleven years will likely be positive and material. The key unanswered policy questions are therefore how large has been the industry economic profits to date and is there a trend that may be relevant for the next few years?

22. Two further comments on the results to date for CEN and MEL:

    a) The level of combined economic profits is very high and, apart from 2012, above $360m per year, i.e., more than around $1 million per day for the last 10 years. The Commerce Commission market study into the retail supermarket industry found excess profits of around $1 million per day. Hence, subject to any offsetting economic losses from Mercury and Genesis, it is likely the effect of market power by the four large vertically integrated electricity suppliers is around the level found by the Commerce Commission in the retail supermarkets market study.

    b) The recent trend of high economic profits pre-dates the large step increase in electricity price from late 2018 onwards.

Qu. 5: Do you have any comments on the role and impact of carbon pricing on investment and wholesale market competition or the other contents of this chapter?

23. Refer NZIER report attached.

24. The narrative in box two on the impact of carbon prices on electricity prices and generator earnings correctly notes the prime role of pricing greenhouse gas emissions by way of the Emissions Trading Scheme (ETS) is to provide a "market-based mechanism to set the economy onto a least-cost path to reduce emissions."

25. The paper has a discussion and analysis of windfall gains from carbon pricing. MEUG agrees "it is not a clear-cut exercise to determine how much of this should be counted as 'windfall gains'". It would be helpful if the Authority published the detailed calculations for the graph on page 26 to assist discussion on this complex issue and to allow a reconciliation with the analysis by NZIER in the report attached.

26. We have a concern the graph on page 26 may be misleading as the estimated windfall gains bear no relationship with the EVA results by MEUG/IWA. For example, the estimated gross "windfall gains" for Meridian Energy from carbon pricing, reading from the graph, have doubled from around $400m in 2020-21 to around $800m in 2021-22. Compare that with the MEUG/IWA estimate of economic profits of $371m in 2020-21 and $353m in 2021-22. Not only is the magnitude of the results quite different, especially for 2021-22, the trend is opposite with the EVA decreasing by 5% compared to a doubling of the estimated windfall in the issues paper.

Chapter 5 Implications and options

Qu. 6: Do you agree with the Authority's overall conclusion that it currently considers that continued reliance on the current conduct-based measures to mitigate the exercise of market power remains broadly appropriate in the transition toward 100% renewable electricity?

27. No. See reply to Qu. 4 above on the reasons why MEUG believes the question of the effect (i.e., quantum of economic profits) of market power to date should not be left un-quantified and hence the Authority's proposed actions cannot be assumed to address the root cause of potential sustained material market power to date.

Qu. 7: Do you agree with the objective and evaluation criteria set out in this chapter?

28. The review should be extended to consider scenarios where some thermal generation is retained because those are likely to be lower cost as discussed in response to Qu. 3.

29. A robust analysis of large supplier behaviour cannot be made without considering the retail market as discussed in response to Qu. 4. Accordingly, the review should consider the behaviour of the large vertically integrated suppliers, i.e., both generation ad retail operations. At an operational level we are aware of detailed concerns raised directly with the Authority on the initial set of Internal Transfer Pricing disclosures. MEUG shares those concerns. The gross margin disclosures have yet to be published. Those may also have issues about behaviour of the large vertically integrated suppliers. Another indicator of the complex interrelationship between the generation market and retail market is the recent issue of access to ASX clearers. The focus proposed in the wholesale market review issues paper to focus on entry to generation barriers only will potentially miss anti-competitive behaviour in the related retail and hedge markets.

Qu. 8: Do you have any comments on the contents of this chapter?

30. In the appendix to this submission are detailed comments on the thirteen proposed actions lists in Table 6, Summary of proposed package of actions.

31. Paragraph [5.15] notes "The analysis is preliminary, subject to feedback and some options may require more detailed regulatory assessment and cost benefit analysis." MEUG agrees with this statement. The first step for an economic cost benefit analysis is to clarify the problem or opportunity and the counterfactual for the analysis. The Treasury cost benefit guideline states Step 1: Define policy and counterfactual: "The economic impact of a policy or project is measured against a 'no decision' counterfactual. It is important to be clear as to what the counterfactual is."[5] For several proposed actions the first step of describing and quantifying and describing the market failure policy problem compared to either the status quo or a counterfactual of the future if no action is taken has not been adequately described.

[5] Refer Treasury guidelines https://www.treasury.govt.nz/sites/default/files/2015-07/cba-guide-jul15.pdf

Chapter 6 Options to address market power

Qu. 9: Are there any other options that would promote wholesale electricity market competition in the transition that you consider would be more effective and efficient?

32. Yes. There have been poor levels of confidence in the market by the demand side and new independent retailers. Restoring that confidence is needed to facilitate demand side and independent retailer investment in demand side response. A key reason for low confidence is the unsettled questions on market power and excessive economic profits. Hence MEUG's recommendation discussed in response to Qu. 4 to continue work on understanding recent actual and near-future potential market power causes and effects.

33. Leaving questions on market power unsettled creates an information vacuum that parties may exploit with unintentionally misleading or even deliberately opportunistic commentary, analysis and proposals. These all undermine confidence in the market.

34. If the Authority decides not to further investigate recent market power trends, then the Authority should invite the Commerce Commission to undertake a market study on the wholesale and retail electricity markets.

Qu. 10: Do you have any comments on the contents of this chapter?

35. Refer response to Qu. 8 above and the appendix to this submission for comments on the options to address market power considered in this chapter.

Chapter 7 Options to facilitate the entry by new generation

Qu. 11: Are there any other options that would better facilitate efficient investment in renewable generation to promote wholesale electricity market competition in the transition?

36. As noted in response to Qu. 3 and Qu. 7 of this submission, the review should consider ongoing and new flexible thermal generation to support an increasing level of renewable generation.

37. MEUG has no further suggestions, though we are open to considering new ideas given the problem that persistently high futures prices eroding the business case for electrifying existing industrial thermal heat loads.

Qu. 12: Do you have any comments on the contents of this chapter?

38. Refer response to Qu. 8 above and the appendix to this submission for comments on the options to facilitate entry by new generation considered in this chapter.

Next steps

39. MEUG recommends an update of the market competition review be undertaken in April 2023 as outcomes on key uncertainties and parallel work start to crystalise. The scope of that update should include:

a) Two changes to scope. First consider scenarios with some thermal generation out to 2050 because those are expected to be lower cost. Second including the retail market as that is necessary to have a robust analysis of large vertically integrated supplier behaviour.

b) Revising the decision not to consider the cause and effect of market power to date and the risks that may pose for the next few years. MEUG believes the causes and effects recent actual and potential future near-term market power of the large vertically integrated suppliers need to be understood if a robust policy response is to be implemented. To not do so means it will only be by chance that the actions proposed will be an optimal policy response.

40. We suggest an update in April 2023 as by that date submissions on the MDAG paper and possibly the response by MDAG will have been published, the Commerce Commission will have published guidance on the amended s.36 to the Commerce Act that takes effect in April, and final decisions on the NZ Battery project and the issue of changing the code for potential inefficient price discrimination should have been announced.

41. At a more specific level MEUG recommends:

a) The Authority publish the analysis used for the graph on page 26 titled "Gross "windfall gains" (upper est.) from carbon pricing." Publishing the analysis will assist further discussion on the effect of carbon prices on supplier offer behaviour and the effect on prices in the past compared to other evidence including the attached NZIER report.

b) If the Authority decides not to further investigate recent market power trends, then the Authority invites the Commerce Commission to undertake a market study on the wholesale and retail electricity markets.

Yours sincerely

Ralph Matthes
Executive Director

Attachments

- Appendix: Comments on Table 6.
- MEUG update of Economic Profit of Contact Energy Ltd base on the year-ended 30 June 2022 financial results, 11 October 2022.
- MEUG update of Economic Profit of Meridian Energy Ltd base on the year-ended 30 June 2022 financial results, 11 October 2022.
- MEUG submission to the Commerce Commission, Misuse of Market power Guidelines, 18 November 2022.

Separate attachment: NZIER report, "Wholesale market review – Comment on thermal generation," 14 December 2022.

Appendix: Comments on Table 6

Policy objectives that EA may or are already actioning	EA proposals	MEUG feedback:
To constrain the exercise of market power.	Continue proactive monitoring and enforcement of trading conduct.	Business as usual (BAU) as expect continuous improvement by policy makers. One detail that should be considered was noted in the Concept Consulting report [slide 23], with underlining by MEUG "Some responses suggested independents found it hard to attract interest from major generators, even with apparently attractive projects/power purchase offers –possibly due to cannibalization concerns. It was not possible to definitively test the strength of such claims due to information gaps. However, based on underlying incentives, the concern appears valid and likely merits closer monitoring."
	Investigate ways to accelerate the development of the demand response market.	BAU as expect continuous improvement by policy makers as experience is gained with the new RTP regime and from April the dispatch notification regime.
	Explore better information sharing processes and obligations with the Commerce Commission on concerns about, for example, the misuse of market power.	BAU. The proposal refers to the amendment to s.36 of the Commerce Act that comes into effect April 2023. MEUG expects all economic regulatory bodies to become acquainted with that change, hence BAU. MEUG's submission to the Commerce Commission on the draft guidelines to explain the new s.36 is attached as it is relevant to Authority and Commission work on market power. If EA is reluctant to use an EVA analysis lens to assist policy making, then the EA should ask the Commerce Commission (CC) to undertake a market study of the wholesale market as CC are equipped to undertake EVA analysis.
To facilitate investment in new renewable generation.	Carry out regular monitoring of the investment pipeline and impediments	No major information gap in the market because first, this is undertaken by the Infrastructure Commission at a national level. Second, this is BAU for the System Operator's annual Security of Supply Assessment (10-year forecast). Third new entrant investors have an incentive to advise appropriate regulatory bodies issues they encounter.
	Build the evidence base about the nature and scale of current and emerging issues about access to offtake contracts reported by developers of new generation	Not supported as unnecessarily intrusive, risk of unintended consequences, and may undermine investor confidence as no evidence of market failure.

Appendix: Comments on Table 6 continued

Policy objective	EA will invite:	EA proposals	MEUG feedback
To constrain the exercise of market power	MBIE	Improve disclosure of information on availability of gas for electricity supply	Not supported as unnecessarily intrusive, risk of unintended consequences, and may undermine investor confidence as no evidence of market failure.
To facilitate investment in new renewable generation	MBIE	Bring forward the completion of the Gas Transition Plan, Energy Strategy, and NZ Battery project to reduce uncertainty for new investment in generation	Not supported. MBIE work is across whole energy sector (not just electricity) and as we've seen when analysis and processes are rushed (e.g., Climate Change Commission), then the ideal of having transparency of models used is compromised, and ultimately the quality of decisions and acceptance of the results and proposed actions that follow are undermined.
	MBIE	Produce an annual electricity generation investment opportunities report	No market failure quantified to justify this. Quite the opposite as Transpower have reported a surge in investors.
	MBIE	Look at the merit of providing a one-stop shop for overseas investors in renewable electricity generation	Ditto. There is already a market for consulting advice across multiple disciplines of the law, accounting, economic, government relations, etc, that has assisted investors to date and that will adapt and grow if demand grows. MBIE has no competitive advantage over those parties in the existing market for advice. If anything, MBIE entering the market may have unintended consequences.
	OIO	Publish guidance for overseas investors in renewable electricity generation	Ditto.
	MBIE & MfE	Bring forward work to strengthen national direction for renewable electricity to inform local planning and resource management consenting	This is redundant because already underway with MfE starting consultation on 14 November 2022 on a draft National Policy Statement and National Environmental Standard for Greenhouse Gas Emissions from Industrial Process Heat. Refer https://consult.environment.govt.nz/climate/e87f888f/.
	MBIE & MfE	Investigate merits of pro-competitive conditions on consents for renewable generation	Not supported. Suggesting RMA consenting authorities might delve into such commercial terms and conditions will add uncertainty to applicants.
	Transpower	Publish connection enquiries, connection studies and streamline the application processes	Already underway. Refer recently commenced Transpower web page, refer https://www.transpower.co.nz/connect-grid/connection-enquiry-information.

MEUG update of Economic Profit of Contact Energy Ltd based on the year-ended 30 June 2022 financial results. Published 11 October 2022

Prepared by Ralph Matthes (MEUG) and Garth Ireland (Ireland, Wallace & Associates Limited).

Purpose and background

1. This is the second update of the Economic Profit Analysis (EPA, also referred to as Economic Value Added (EVA) analysis) trends for Contact Energy Ltd (CEN) by adding the financial results (published 15 August) to the existing 10-year analysis (adjusted for revaluations since 1999).

2. An inaugural pilot EVA for 2020 for Meridian Energy Ltd (MEL) was published in August 2021. The pilot study was extended to CEN, with results for 2021 published January 2022. These pilot studies confirmed EVA was feasible. Key background documents are:

   ~ MEUG Q&A on EPA methodology and results for MEL, 14 August 2021, http://www.meug.co.nz/node/1150.

   ~ Pilot EPA of CEN, 28 January 2022, http://www.meug.co.nz/node/1182. Selected analysis details in spreadsheet and .pdf format were also published.

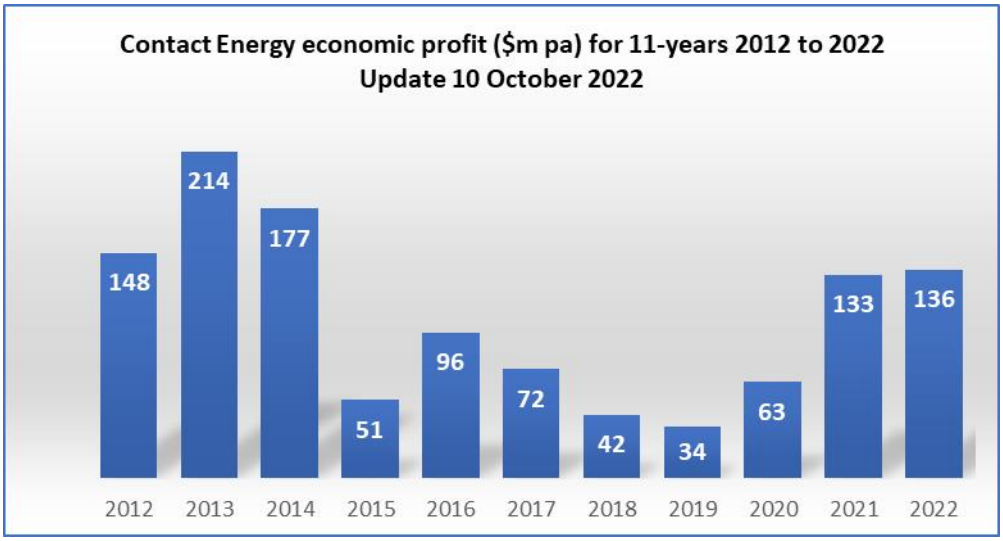
3. A separate EVA 2022 update for MEL has been published today.

4. The last section of this memo has a recap of terms used and relevance to interpreting EVA trends.

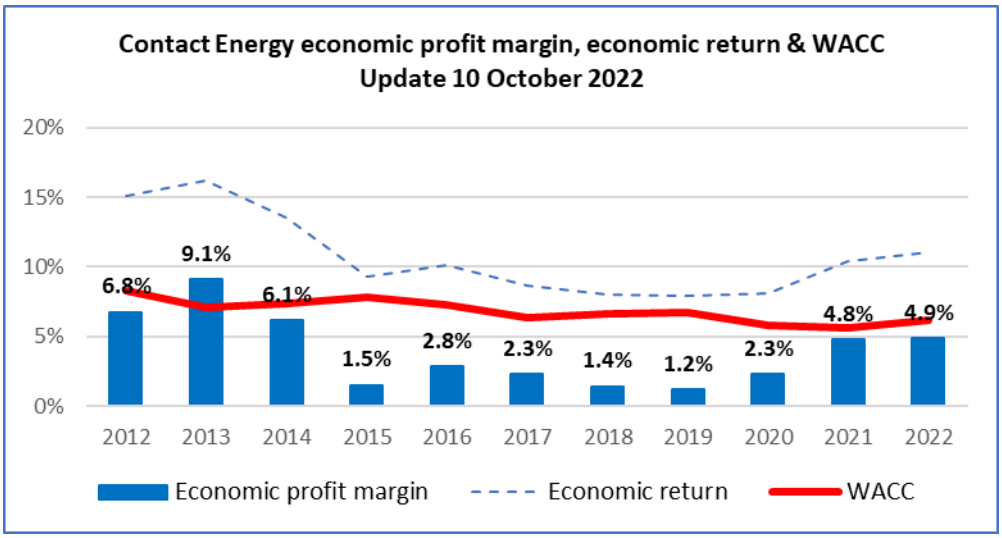
Key results of the EVA 2022 update for CEN

June year end	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
NOPAT ($m)	329	381	390	319	342	273	236	221	225	289	310
Average capital ($m)	2,182	2,347	2,878	3,424	3,380	3,154	2,942	2,800	2,787	2,774	2,800
NOPAT/Average capital	15.1%	16.2%	13.5%	9.3%	10.1%	8.7%	8.0%	7.9%	8.1%	10.4%	11.1%
WACC	8.3%	7.1%	7.4%	7.8%	7.3%	6.4%	6.6%	6.7%	5.8%	5.6%	6.2%
Economic profit margin	6.8%	9.1%	6.1%	1.5%	2.8%	2.3%	1.4%	1.2%	2.3%	4.8%	4.9%
EVA ($m)	148	214	177	51	96	72	42	34	63	133	136

5. The chart below illustrates economic profit trends over the last 11-years.



6. The following shows trends in economic return, WACC and economic profit margin. Economic profit margin equals economic return less WACC.



Commentary

7. Since 2015 the trend has been relatively steady state.

8. For the 2021 reports we found CEN financial results were easier to adapt to the EVA framework than for MEL. That proved to be the same this year with the bulk of the EVA 2022 update for CEN completed within 3-weeks of the financial results being published.

9. Depending on feedback on this update, next steps may include:

   ~ Briefing and answering questions from policy makers.

   ~ Discussing with CEN. This could include comparing this EVA update with the analysis of Return on Invested Capital in CEN's financial results.[1]

   ~ Consolidating the CEN and MEL EVA updates. The 2022 updates use the same model and adjustments to facilitate consolidation. Ideally in future years EVA for Mercury Energy and Genesis Energy would provide an overview of the whole sector. In the meantime, a partial view of the EVA for two large suppliers may provide useful policy insights.

A recap of terms used and relevance to observing EVA trends

10. EVA is the Net Operating Profit after Tax (NOPAT) measured against the economic capital charge. NOPAT is calculated using data from audited financial statements and then adjusted to better reflect "cash returns" on "cash invested" year by year. The economic charge is the Weighted Average Cost of Capital (WACC) times average capital invested.

11. In competitive markets individual companies and the industry in some years will have a positive EVA (earn economic profits), other years a negative EVA (incur economic losses). Over a long period of time cumulative EVA for the industry should trend to zero, whereas individual company EVA can be more volatile and not correlated with average industry trends.

[1] Refer CEN Investor Presentation 15 August 2022, slides 25 and 39, http://nzx-prod-s7fsd7f98s.s3-website-ap-southeast-2.amazonaws.com/attachments/CEN/396941/376502.pdf

MEUG update of Economic Profit of Meridian Energy Ltd based on the year-ended 30 June 2022 financial results. Published 11 October 2022

Prepared by Ralph Matthes (MEUG) and Garth Ireland (Ireland, Wallace & Associates Limited).

Purpose and background

1. This is the third update of the Economic Profit Analysis (EPA, also referred to as Economic Value Added (EVA) analysis) trends for Meridian Energy Ltd (MEL) by adding the 2022 financial results (published 24 August) to the existing 20-year analysis.

2. An inaugural pilot EVA for 2020 for MEL was published August 2021. An update for 2021 was published September 2021. The pilot was extended to include Contact Energy Ltd (CEN) for 2021. These pilot studies confirmed EVA was feasible. Key background documents are:

   ~ MEUG Q&A on EPA methodology and results for MEL, 14 August 2021, (2020 June year) http://www.meug.co.nz/node/1150.

   ~ MEL EPA update, 20 September 2021 (2021 June year), http://www.meug.co.nz/node/1157. Selected analysis details in spreadsheet and .pdf format also published.

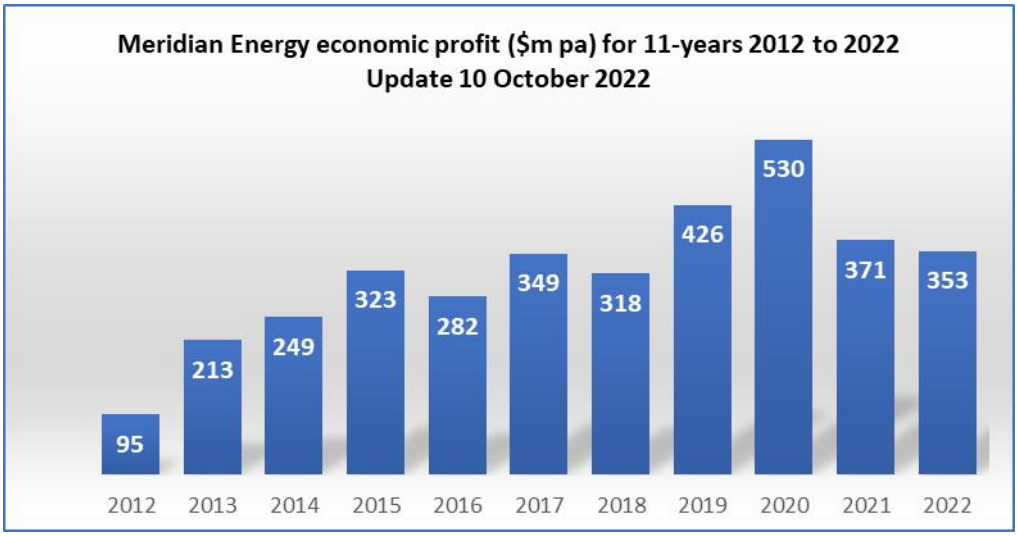
3. A separate EVA 2022 update for CEN has been published today.

4. The last section of this memo has a recap of terms used and relevance to interpreting EVA trends.

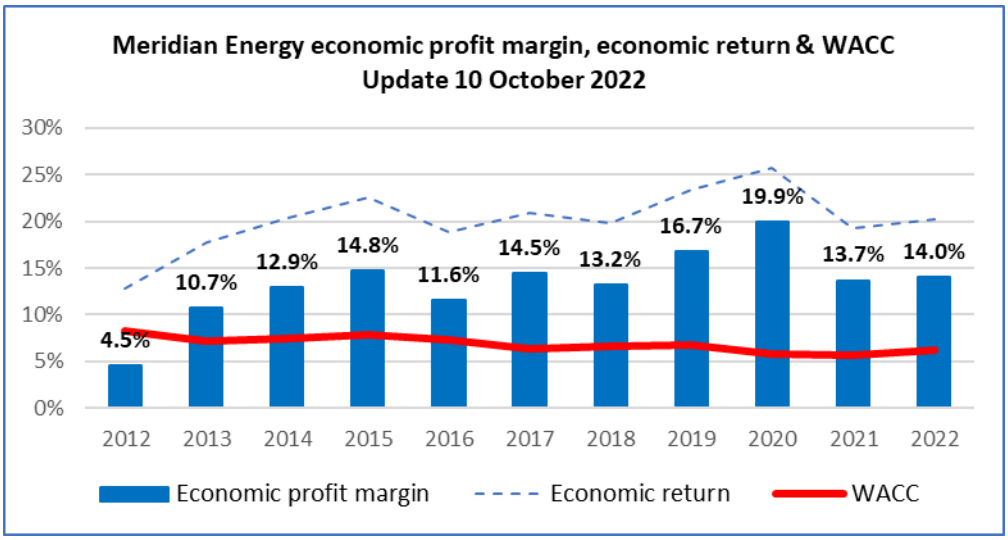
Key results of the EVA 2022 update for MEL

June year end	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
NOPAT ($m)	269	354	391	493	460	504	478	597	684	523	510
Average capital ($m)	2,097	1,994	1,928	2,186	2,439	2,417	2,412	2,546	2,664	2,711	2,523
NOPAT/Average capital	12.8%	17.8%	20.3%	22.6%	18.9%	20.9%	19.8%	23.4%	25.7%	19.3%	20.2%
WACC	8.3%	7.1%	7.4%	7.8%	7.3%	6.4%	6.6%	6.7%	5.8%	5.6%	6.2%
Economic profit margin	4.5%	10.7%	12.9%	14.8%	11.6%	14.5%	13.2%	16.7%	19.9%	13.7%	14.0%
EVA ($m)	95	213	249	323	282	349	318	426	530	371	353

5. The chart below illustrates economic profit trends over the last 11-years. This is a snapshot to parallel the 11-years of the CEN analysis. The MEL analysis, per prior years, starts from 1999.



6. The following shows trends in economic return, WACC and economic profit margin. Economic profit margin equals economic return less WACC.



Commentary

7. The high economic profit trend relative to WACC continued into 2022. The EVA for 2022 of $353m is about $1m per day economic profit for MEL.

8. As we have found in prior years the MEL financial results are complex and time consuming to convert into an EVA framework.

9. Depending on feedback on this update, next steps may include:

   ~ Briefing and answering questions from policy makers. Our focus will be on ensuring there is clarity on revaluation, and related deprecation and equity effects, as those are the key differences between MEL and CEN when calculating economic profit.

   ~ Discussing with MEL. This could include comparing this EVA update with the PwC report to MEL, "Meridian Energy Limited – Economic profit calculations, September 2021".[1]

   ~ Consolidating the CEN and MEL EVA updates. The 2022 updates use the same model and adjustments to facilitate consolidation. Ideally in future years EVA for Mercury Energy and Genesis Energy would provide an overview of the whole sector. In the meantime, a partial view of the EVA for two large suppliers may provide useful policy insights.

A recap of terms used and relevance to observing EVA trends

10. EVA is the Net Operating Profit after Tax (NOPAT) measured against the economic capital charge. NOPAT is calculated using data from audited financial statements and then adjusted to better reflect "cash returns" on "cash invested" year by year. The economic charge is the Weighted Average Cost of Capital (WACC) times average capital invested.

11. In competitive markets individual companies and the industry in some years will have a positive EVA (earn economic profits), other years a negative EVA (incur economic losses). Over a long period of time cumulative EVA for the industry should trend to zero, whereas individual company EVA can be more volatile and not correlated with average industry trends.

[1] Refer https://meridian-production-media.s3.ap-southeast-2.amazonaws.com/public/210929-Meridian-Summary-of-Economic-Profit-calculations.pdf

Major Electricity Users' Group

18 November 2022

Antonia Horrocks
General Manager Competition
Commerce Commission
By email to misuseofmarketpower@comcom.govt.nz

Dear Antonia

Misuse of Market Power Guidelines

1. This is a submission from the Major Electricity Users' Group (MEUG) on the Commerce Commission consultation draft "Misuse of Market Power Guidelines," published 18 October 2022.[1]

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Members may lodge separate submissions.

Understanding s.36 in the continuum with market studies and Part 4 regulation

3. Missing from the guidelines is a commentary on how enforcement of s.36 is part of a continuum that overlaps with market studies and in turn with Part 4 regulation. Adding such a commentary would assist businesses gain a broader view of the issues they might need to consider if the competitive process in their sector changes.

4. Market studies use the same approach to defining the market and market structure metrics as indicators of potential market power as proposed in the guidelines. Market studies also use estimates of sustained economic profit over time using Economic Value Added (EVA) or similar approaches such as ROACE, whereby accounting information is transformed to economic cost and income flows and the opportunity cost of capital employed is taken into account. Part 4 Regulation also uses the EVA framework to determine ex ante regulated price paths and to monitor actual performance ex post.

5. An enterprise being investigated for a breach of s.36 could provide an economic profit analysis as evidence that the company has not earned economic profits and therefore had not misused market power. Hence the value of including in the guidelines a reference to regulatory tools, such as estimating economic profit, that are used in the overall regulatory continuum because they may in some instances be useful for considering a possible breach of s.36.

[1] Document URL https://comcom.govt.nz/__data/assets/pdf_file/0023/295160/Draft-Misuse-of-Market-Power-Guidelines-October-2022.pdf at https://comcom.govt.nz/business/business-consultations/draft-misuse-of-market-power-guidelines/_nocache

Elaborating on “exploitative conduct” and inefficient price discrimination

6. Further explanation and examples of when the new s.36 provisions do not apply would be useful.

7. For example, paragraph [80.2] states "The prohibition does not cover “exploitative conduct,” where existing market power is used against customers." Some examples of “exploitative conduct” in the New Zealand context would be helpful. The term “exploitative conduct” might cover conduct and the treated quite differently in overseas jurisdictions such as Europe or America. More clarity in the guidelines would avert misinterpretation by both overseas and domestic investors.

8. A specific example of the uncertainty around what is or isn’t “exploitative conduct” in New Zealand is the topic of inefficient price discrimination. The Electricity Authority has raised this issue in the electricity sector and proposes pre-emptive interventions to mitigate the risk of large volume contracts leading to inefficient price discrimination. The Misuse of Market Power Guidelines should discuss whether inefficient price discrimination is or is not covered by the change to s.36 to avoid uncertainty in other sectors of the economy that the precedent for interventions proposed by the Electricity Authority might also be considered by the Commission. To be clear MEUG does not support the proposed interventions by the Electricity Authority and is concerned at the precedent it may set for other sectors of the economy.

Yours sincerely

Ralph Matthes
Executive Director