

23 July 2020

Vince Hawksworth
Chief Executive
Mercury

By Email
vince.hawksworth@mercury.co.nz

Dear Vince

Information request regarding internal transfer pricing

The Authority is continuing to progress its work to support competition and confidence in the wholesale electricity market. As we presaged in our letter to you on 29 November 2019, the Authority wants to understand the internal transfer pricing of electricity between the generation, wholesale and retail arms of your business. Understanding internal transfer pricing practices is an integral part of advancing our response to the D3 recommendation from the Electricity Price Review ('Make generator-retailers release information about the profitability of their retailing activities'). The Authority has committed to the Government to deliver on the Electricity Price Review recommendations as a priority.

We are seeking your cooperation to provide additional information about internal transfer prices and pricing methodologies to better assess;

- the role internal transfer prices play in your business objectives,
- how your internal transfer prices are determined,
- how they relate to public forward and spot prices, and
- how such pricing contributes to your wider commercial strategy, hedging, and contracting with other parties.

The information received will be used to assess whether current internal pricing practices and public disclosures are consistent with advancing competition and confidence in the sector, and to inform decisions which will need to be made by the Authority's Board.

We appreciate that some of the information you provide may be commercially sensitive and it will be treated accordingly within the Authority. Any public reporting that draws on the information provided will be on an anonymised basis. Ultimately, the Board may decide that greater public transparency is required for internal transfer prices and practises, on an ongoing basis, which will be addressed via subsequent consultation.

With these objectives in mind, we are asking you to voluntarily provide information and data by 7 August 2020 on the questions laid out in the appendix to this letter. If you need additional assurance that this request is for a fit and proper regulatory purpose, we can arrange for our Board to formally approve a request via s.46 of the Electricity Industry Act. Please confirm by 31 July 2020 that you will provide this information on a voluntary basis.

Murray Nash (Murray.Nash@ea.govt.nz) and Christie Smith (Christie.Smith@ea.govt.nz) are leading this project on behalf of the Authority and are available to discuss this information request further. Please advise us of who in your organisation will be responsible for responding to this request. Once the information has been received by the Authority my staff

will make arrangements to meet with your staff in person to discuss the information provided, between 10 – 21 August 2020.

We appreciate your assistance in making this information available to the Authority.

Best regards,

A handwritten signature in black ink, appearing to read 'J. Stevenson-Wallace', with a stylized flourish at the end.

James Stevenson-Wallace

Chief Executive

Electricity Authority
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Appendix: Information/data request for internal transfer pricing

1. To confirm that we have correctly identified information that you have made publicly available, please provide the publicly available documents that discuss and/or report your internal transfer prices, for the last three financial years.
2. Please describe the role of internal transfer pricing in your business.
 - a. What role do these prices play within the generation, wholesale, and retail segments of your business?
 - b. How do internal transfer prices influence your retail (and commercial/industrial) pricing?
3. Please describe how internal transfer prices contribute to the risk management and business strategies for each segment.
 - a. Please provide any documentation setting out the strategy you use for cost/price hedging for generation, wholesale, and retail arms.
 - b. Please describe how internal transfer prices are relied upon by your retail business to manage the risk profile of the cost of its electricity.
 - c. Please describe what other products or contracts are used by your retail business to hedge its exposure to price volatility.
4. Please describe the characteristics of the commercial terms of your internal pricing agreements.
 - a. How are internal transfer prices set or negotiated?
 - b. How frequently are internal prices reset?
 - c. Are there ratchet clauses that update internal transfer prices as circumstances evolve?
 - d. Are agreements for fixed or variable volumes? (Or some combination.)
 - e. To what extent are internal transfer prices guided by base, peak and super peak profiles?
 - f. How do seasonality profiles affect your internal transfer prices and volume commitments?
 - g. What term/horizon is embodied in your internal transfer prices?
 - h. Are prices set pre or post transmission losses?
 - i. Are transfer prices determined locationally (e.g. at different GXPs)?
 - j. Are your transfer prices granular contracts in other dimensions?
 - k. What other characteristics are important for your transfer pricing? (E.g., hydrological conditions, outages, other.)
 - l. How do the commercial terms and structures (term, variability, peaks, transmission losses, margins etc.) provided for in your internal transfer pricing arrangements differ to those readily offered to independent third parties, including independent retailers?
5. For the previous three financial years, please provide the internal transfer prices for each month (acknowledging that these transfer prices may be flat across multiple months depending on how internal transfer prices are determined).
 - a. Please also specify the methodology and workings used to determine the internal transfer prices, so that the derivation of prices is transparent and can be replicated.
 - b. Please make explicit any linkages to historical, public (e.g. ASX) forward prices.
6. To what extent have internal transfer prices for the current financial year (2020/21) and for financial years 2021/22 and 2022/23 already been agreed, for some portion of retail demand? If internal transfer prices have already been agreed, please explain how these prices have been determined.
7. Please provide any additional information that you consider relevant to our analysis of internal transfer pricing.