

# Internal transfer prices and segmented profitability reporting

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## Consultation paper

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## Executive summary

Internal transfer pricing (ITP) is the term used to describe the accounting practice of pricing transactions within businesses or between related parties. Concerns have been raised that the pricing practices used within integrated generator-retailers for transferring electricity between their generation and retail businesses may be stifling competition. Independent retailers and consumers may be disadvantaged if large generator-retailers, which control the greater part of electricity supply, are providing electricity at below fair market prices to their own retail arms.

Independent retailers have expressed concern that in recent years the ITPs of large generator-retailers are too low and stable, given the volatility and level of spot prices and Australian Securities Exchange (ASX) New Zealand (NZ) electricity futures. The Electricity Authority's own analysis does not support these claims, and indicates large generator-retailers' internal transfer prices are plausible given historical time-series of ASX futures prices and other factors.

The Authority nevertheless recognises the benefits of requiring ITP disclosures by larger generator-retailers may contribute to other stakeholders levels of trust and confidence in the competitive operation of wholesale and retail electricity markets. Consumers benefit from increased trust and confidence in the relevant markets through increased competition – driving more efficient prices and innovative offerings.

The Authority considers that the current voluntary disclosure arrangements do not support confidence in the markets as well as they could. The Authority is therefore proposing to:

- mandate that large integrated generator-retailers should be subject to disclosing ITP practices to ensure the completeness and continuity of reporting
- require minimum reporting requirements to support trust and confidence objectives.

The current voluntary disclosure arrangements have not provided sufficient details on the methodologies used and the composition of the ITP to enable third parties to understand why ITP vary from year-to-year, vary across generator-retailers and vary relative to past and present forward or spot prices.

The Authority is proposing to mandate annual disclosure of mass market ITP information by large generator-retailers. The key elements of the proposal are to:

- mandate the annual disclosure of ITP and practices by generator-retailers that in any of the preceding 12 months:
  - supplied at least 5% of total MWh of electricity sold to the clearing manager; **and**
  - was responsible for at least 5% of the total ICPs registered in the registry.
- require these parties to disclose:
  - their average load-weighted retail ITP (expressed in per MWh terms)
  - sufficient details on how their ITP was determined, to enable a reasonable person to ascertain whether or not the ITP is a fair reflection of the cost of electricity, including the key components and their attribution to the load-weighted retail ITP (expressed in per MWh terms), and an explanation of the methodology
  - the non-price terms of the internal transfer arrangements, eg whether supplied on a Fixed Price Variable Volume (FPVV) basis

- the impact of any methodological change, back-dated for the last three years (when the change alters the current year ITP by more than 5%).
- the purposes for which the ITP is used, including whether it is used or affects retail pricing.

The Authority is aware that electricity is typically supplied within generator-retailers on terms which appear more favourable than the terms that independent retailers can readily secure. Notably, internal supply arrangements within generator-retailers are most often provided on a FPVV basis. Authority analysis shows that independent retailers can effectively hedge through ASX futures at prices similar to what the generator-retailers typically assume for their ITPs, but the ASX hedges are for a fixed volume only. Independent retailers with uncertain growth would find variable volume hedges very valuable.

The Authority does not consider that these differences are evidence of discriminatory practices against independent retailers. The risk to a generator-retailer is potentially much greater when offering FPVV hedges to growing independent retailers, relative to an internal retail unit or commercial and industrial customers - unless the ICPs covered by the contract are specified in advance, or there are tight constraints on the minimum and maximum volumes.

Despite their apparent importance to supporting trust and confidence amongst some stakeholders, ITPs are not a particularly strong mechanism for mitigating potential anti-competitive practices by generator-retailers. An ITP simply allocates costs between the generation and retail arms, which ultimately is a zero-sum game when management is incentivised to create wealth for shareholders across the whole entity.

Stronger metrics for identifying and mitigating anti-competitive practices will relate to contexts where there is potential for firms with market power to extract value directly from third parties. Key channels in this regard are the pricing of wholesale electricity either when sold to the clearing manager or setting forward prices when market making, and revenue pricing practices with respect to retail, and commercial and industrial customers. The efficiency of wholesale pricing and hedge markets are outside the scope of this investigation, but are being addressed by the Authority's wider work, including its response to recommendations of the Electricity Pricing Review (EPR) – examples of this include the Authority's response to EPR recommendation D4 and its review of the high standard of trading conduct provisions.

The Authority also seeks feedback on whether mandating segmented retail gross margin reporting specific to electricity would advance trust and confidence in electricity markets. Gross margin reporting could be instructive on whether some retailers are consistently pricing at below the true cost of servicing and supplying customers. Such reporting could also illustrate whether retail businesses are generating economic returns on investment, and have the financial capacity to hedge at current forward prices. However, unbundling electricity revenues and costs from a diversified retail business is not straight forward, and differences in gross margins can arise for a number of legitimate business reasons. The Authority is seeking guidance and assurances through this consultation process that gross margin electricity retail segment reporting would provide net benefits, and would not introduce ambiguous signals to the detriment of trust and confidence in the sector.

The Authority is considering mandating annual electricity retail gross margin reporting on a per MWh basis by any retailer who in any of the preceding 12 months were responsible for 1% or more of ICPs in the registry. Retailers with less than 5% of all ICPs would be anonymised for reporting purposes.

The Authority is proposing to centralise the reporting of ITP disclosures on its Electricity Market Information (EMI) website, as well as any segmented retail gross margin reporting it may choose to implement.

The proposals outlined in this consultation have both costs and benefits, but the Authority considers that the benefits of the proposals out-weigh the costs. The Authority welcomes feedback on the issues and proposals outlined in this paper.

# Contents

Executive summary	i
1 What you need to know to make a submission	1
What this consultation paper is about	1
How to make a submission	3
When to make a submission	3
2 The Authority is seeking to ensure stakeholders have sufficient information to be confident in the competitive process	4
Problem definition	4
The existing arrangements	4
Issues with the existing arrangements	9
Why the Authority is addressing these issues now	10
3 Regulatory Statement for the proposed amendment	11
Objectives of the proposed amendments	11
The proposed amendment	11
The proposed amendment's benefits are expected to outweigh the costs	26
Benefits	26
Increase retail competition, by reducing barriers to entry and expansion	27
Increase Innovation	27
Reduce search and analysis costs	27
Costs	28
Compliance costs for entities subject to the disclosure requirements	28
The Authority has identified other means for addressing the objectives	29
The proposed amendment is preferred to other options	30
The proposed amendment complies with section 32(1) of the Act	31
The Authority has given regard to the Code amendment principles	32
Appendix A Proposed amendment	33
Appendix B Format for submissions	41
Glossary of abbreviations and terms	44

## Tables

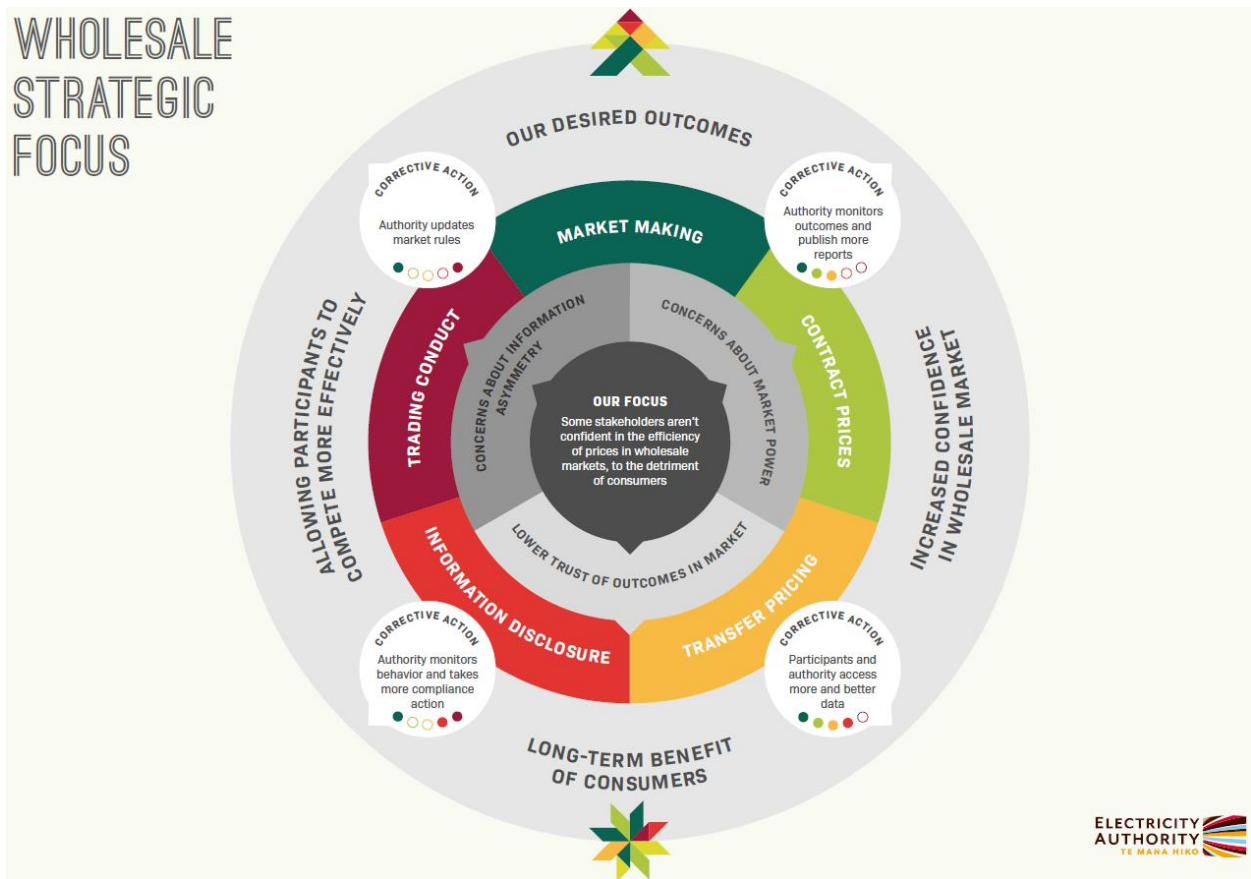
Table 1: How proposal complies with section 32(1) of the Act	31
Table 2: Regard for Code amendment principles	32

# 1 What you need to know to make a submission

## **What this consultation paper is about**

- 1.1 The purpose of this paper is to consult with interested parties on the Authority's proposal to amend the Electricity Industry Participation Code 2010 (Code) to mandate that large integrated generator-retailers publish their ITP and ITP methodology annually. The Authority is also consulting on the merits of segment gross-profitability reporting for electricity retail businesses. This Code amendment consultation provides a formal process through which the benefits and costs of the various elements are identified and scrutinised, to inform decision making.
- 1.2 This consultation process is in response to the EPR's D3 recommendation: "Make Generator-Retailers release information about the profitability of their retailing activities". This initiative, like the Authority's other responses to the EPR's wholesale market recommendations, focusses on increasing trust and confidence in wholesale market outcomes.
- 1.3 The Authority considers that ongoing and regular reporting of the ITP and methodologies of integrated generator-retailers is a cost effective means of addressing concerns raised by some stakeholders and thereby increasing trust and confidence in market outcomes. The Authority is also considering whether mandating retail segment gross profitability would benefit consumers through increased trust and confidence in the relevant markets.
- 1.4 The proposals in this paper are one of several projects the Authority is progressing as part of its strategic focus on wholesale electricity markets. The efficiency of wholesale pricing and hedge markets are outside the scope of this investigation, but are being addressed by the Authority's wider work, including its response to recommendations of the Electricity Pricing Review (EPR) – examples of this include the Authority's response to EPR recommendation D4 and its review of the high standard of trading conduct provisions.
- 1.5 The wholesale markets priority projects, in their entirety, are expected to enhance wholesale market information disclosure, ensure enduring market making arrangements, clarify trading conduct rules, improve disclosure of ITP and more closely monitor contract prices and new-generation costs.
- 1.6 Figure 1 below illustrates the strategic focus of the wholesale markets priority projects and their link with the Authority's strategic ambitions.

**Figure 1: Wholesale strategic focus**



- 1.7 The proposed amendment would require mandatory annual disclosure of ITPs and high level ITP methodologies by large generator-retailers. These large generator-retailers raise potential competition concerns because of their control over substantial amounts of generation.
- 1.8 This consultation is also seeking submissions on the merits of gross-margin reporting for the retail electricity segment, as well as possibly extending to commercial and industrial and generation segments.
- 1.9 The Authority is seeking feedback on:
  - (a) the merits of ITP and gross margin disclosure
  - (b) the merits of voluntary or mandatory disclosure
  - (c) which participants should be subject to disclosure obligations
  - (d) minimum reporting standards
  - (e) requiring generator-retailers to retrospectively apply any methodology changes to previously disclosed ITPs where it has a material impact
  - (f) the merits of separate disclosure for commercial and industrial, and mass-market segments
  - (g) the centralisation of reported information.

- 1.10 Section 39(1)(c) of the Electricity Industry Act 2010 (Act) requires the Authority to consult on any proposed amendment to the Code and corresponding regulatory statement. Section 39(2) provides that the regulatory statement must include a statement of the objectives of the proposed amendment, an evaluation of the costs and benefits of the proposed amendment, and an evaluation of alternative means of achieving the objectives of the proposed amendment. The regulatory statement is set out in part 3 of this paper.

### **How to make a submission**

- 1.11 The Authority's preference is to receive submissions in electronic format (Microsoft Word) in the format shown in Appendix B. Submissions in electronic form should be emailed to [wholesaleconsultation@ea.govt.nz](mailto:wholesaleconsultation@ea.govt.nz) with "Consultation Paper—Internal transfer prices" in the subject line.
- 1.12 If you cannot send your submission electronically, please contact the Authority to discuss alternative arrangements.
- 1.13 Note the Authority intends to publish all submissions it receives. If you consider that we should not publish any part of your submission:
- (a) indicate which part should not be published
  - (b) explain why you consider we should not publish that part
  - (c) provide a version of your submission that we can publish (if we agree not to publish your full submission).
- 1.14 If you indicate there is part of your submission that should not be published, we will discuss with you before deciding whether to not publish that part of your submission.
- 1.15 Please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we did not publish unless good reason existed under the Official Information Act to withhold it. We would normally consult with you before releasing any material that you indicated should not be published.

### **When to make a submission**

- 1.16 Please deliver your submissions by **5pm** on Tuesday **18 May 2021**.
- 1.17 Staff will acknowledge receipt of all submissions electronically. Please contact the Authority [wholesaleconsultation@ea.govt.nz](mailto:wholesaleconsultation@ea.govt.nz) or 04 460 8860 if you do not receive electronic acknowledgement of your submission within two business days.



## 2 The Authority is seeking to ensure stakeholders have sufficient information to be confident in the competitive process

### **Problem definition**

- 2.1 Vertical integration of generation and retail electricity businesses has the potential for economies of scale where there are genuine fixed costs that can be spread over the consolidated business. Integration can also efficiently mitigate risk, with the potential to reduce costs for consumers. However, integrated generator-retailers' controlling the bulk of electricity generation can raise competition concerns. The Authority aims to ensure independent retailers can compete on a level playing field, and that generator-retailers' pricing of electricity is held in check by competitive pressures to encourage pricing near, if not necessarily at, short run marginal cost of production.
- 2.2 Integrated generator-retailers influence over the pricing and supply of electricity, without sufficient transparency and other assurances, could adversely affect market confidence and retail competition outcomes. For example, the EPR heard concerns that integrated generator-retailers may be stifling competition by advantaging their own retail arms via preferential pricing of electricity and/or cross subsidisation.
- 2.3 Confidence in the industry, and the regulation of the industry by the Authority, may be undermined by dominant vertically integrated generator-retailers behaving strategically to increase the costs of rivals, thereby limiting competition and increasing their own profitability. The Authority considers that it is largely the size of integrated retailers, rather than their vertical integration per se, that is the primary driver of any competition or confidence concerns (small integrated players do not raise competition concerns). Potential concerns with the pricing practices between the generation and retail arms of large integrated firms are the basis for any intervention by the Authority with respect to ITP.
- 2.4 Confidence in electricity markets could also be undermined by predatory pricing practices, including generator-retailers selling at prices below what is economic and sustainable, or with the express intention of forcing the exit of competitors. Investigating this possibility would require disclosures which incorporate retail revenues, and would form the basis for any intervention by the Authority in regard to segment reporting.

### **The existing arrangements**

#### *Existing disclosure of ITP and electricity retail segment profitability*

- 2.5 A generator-retailer's ITP set the prices at which its generator arm sells electricity to its retail arm. The ITP is a mechanism which allocates costs between the two businesses and is instrumental in measuring the performance of both business lines.
- 2.6 Currently ITP disclosures are voluntary. Of the five largest generator-retailers (Contact, Genesis, Mercury, Meridian and Trustpower), four voluntarily disclosed their average ITP for the financial year ending 2020. The fifth derives an ITP but elected not to disclose it publicly.

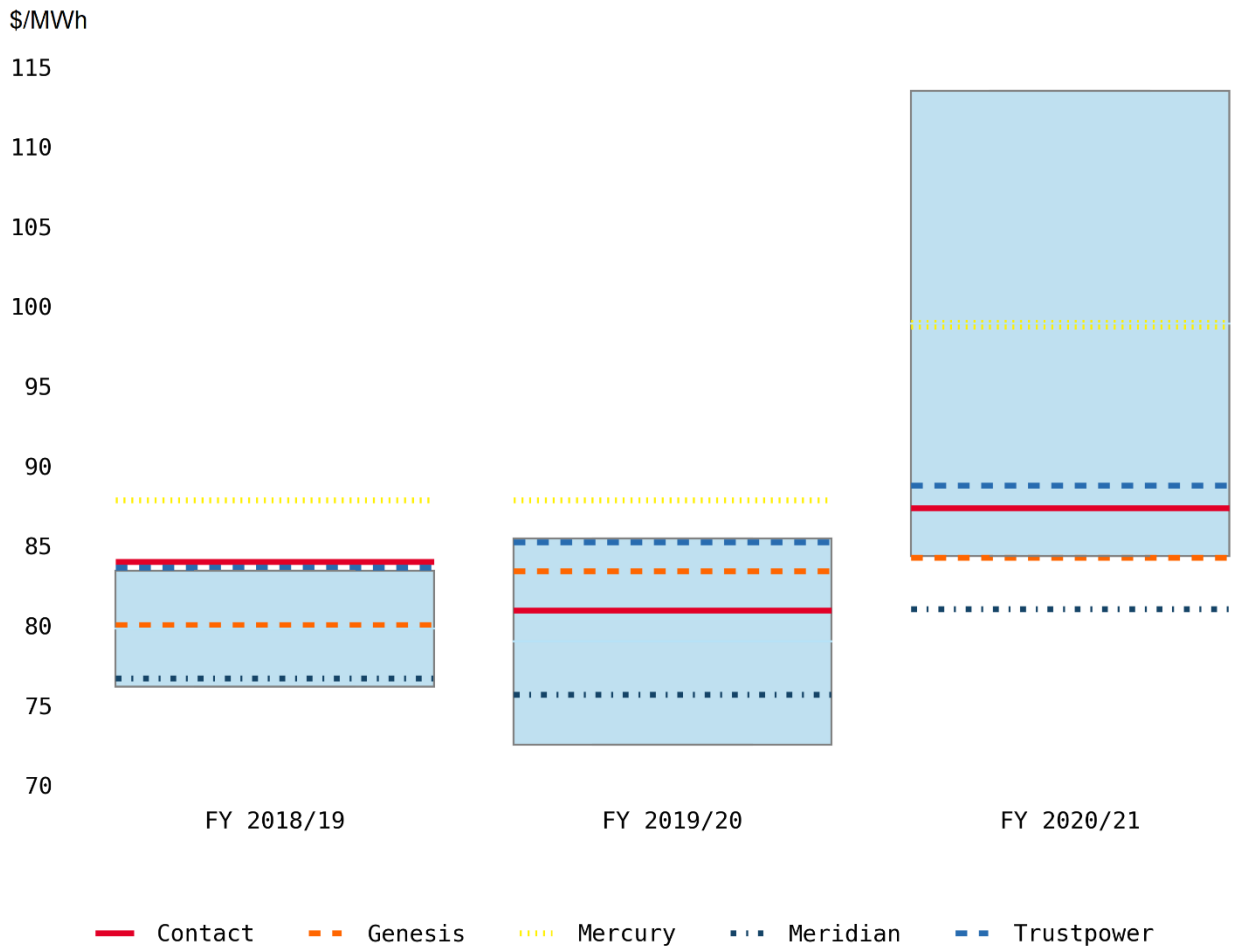
- 2.7 The disclosures typically occur as part of the annual financial report, with supplementary information sometimes included in investor briefings or similar market announcements. The ITP are described on a per MWh hour basis, accompanied by short statements about how the price was arrived at for the period. While these descriptions typically reference the use of market prices in the approach used, there are not sufficient technical details about the methodologies to enable third parties to formally link ITPs to historic futures prices for electricity.
- 2.8 The ITP disclosed by the five largest generator-retailers vary significantly even for the same disclosure period, due to a number of factors including both the underlying volatility in electricity prices, and firm-specific factors such as:
- (a) differences in retail load profiles across generator-retailers, eg location; and
  - (b) differences in the methodologies used to determine the transfer prices, eg hedging strategies, granularity of internal pricing by location and time of use.
- As a consequence, in recent years differences in the order of \$15 per MWh have been observed in prevailing ITP across the large generator-retailers.
- 2.9 The variation in ITPs across generator-retailers, the relative stability and low levels of ITPs compared to prevailing electricity futures in recent periods, and the absence of sufficient transparency on ITP methodologies have raised questions, about whether ITPs adequately reflect the market costs of electricity.
- 2.10 International financial reporting standards, ie NZ IFRS8, govern reporting on operating segments for all entities whose debt or equity securities are publicly traded. All five of the largest generator-retailers are public companies and therefore disclose retail segment reporting. However, this reporting is not exclusively for electricity – the retail segment often includes multi-products, such as gas, broadband and telephony. There is also some uncertainty as to whether the retail segment reporting is limited to mass market customers, or also incorporates commercial and industrial customers.

*Examination of existing ITP methodologies*

- 2.11 In mid-2020 the Authority initiated a project to respond to the EPR’s recommendation that the Authority “Make generator-retailers release information about the profitability of their retail activities”. To better understand the effectiveness of the existing arrangements and the implications for confidence in retail competition, the Authority obtained information from the five largest integrated generator-retailers on their ITP price histories and methodologies. Using that data, the Authority investigated whether generator-retailers’ historic ITP series are in line with the prices available to other market participants through financial markets, such as futures.
- 2.12 The ITPs provided to the Authority by the five large integrated retailers were compared to notional “benchmark” prices the Authority built for each financial period from market data and methodologies similar to those employed by the generator-retailers. The notional benchmarks were derived using historical time-series of external financial prices (notably ASX futures prices), as well as historical time series for load seasonality and locational price differences.

- 2.13 The analysis did not consider the underlying efficiency of the external price series used – these were taken as is. Rather, staff conducted a “relative” comparison between the prices that integrated generator-retailers charge their own retailing arms against the external prices that a non-integrated retailer, eg independent retailers, commercial and industrial businesses, and others, could obtain through financial markets.
- 2.14 Consistent with the EPR’s consumer-guided focus, the analysis focused on the ITPs for mass-market consumers (households, and small and medium businesses). Non-integrated retailers predominantly target mass-market consumers, and their apprehensions regarding reported transfer prices largely relate to the pricing of generation for mass-market customers.
- 2.15 The benchmark prices were developed using methodologies that could broadly be replicated by a financially credible independent retailer. Despite differences in the specific details of the methodology used by each integrated generator-retailer, the range of benchmark methodologies are consistent with the approaches used by the integrated generator-retailers in the great majority of cases. The prices were built up from four main components:
- (a) ASX futures prices, sampled with varying frequencies and timings over the three years preceding the date at which the ITP for a period might reasonably be calculated (typical 2-6 months prior to the financial period commencing)
  - (b) locational price differences – adjustments reflecting observed historical spot price differences across locations
  - (c) price profile adjustments for seasonality in prices
  - (d) weights derived from consumer load across time and location (load seasonality).
- 2.16 A fifth component, one that is not reflected in the notional benchmarks, relates to the transactional or operational costs that arise in relation to participation in these hedging markets. These costs largely arise because the seller and the buyer of the hedge are different parties, dynamic posting of margins mitigates credit risk due to market-to-market exposures eventuating over the life of the hedge contract. With respect to ITPs, vertical integration avoids these costs because the counterparties to the hedge are the same party. The Authority does not consider it unreasonable for large integrated electricity companies to generally ignore these costs in determining an applicable ITP. That said, at least one of the five generator-retailers reflects a provision of this nature, in the order of \$2/MWh.
- 2.17 The results from the Authority’s comparative analysis of independent benchmarks against the large vertically integrated generator-retailers’ transfer prices are:
- a) the ITP methodologies employed by integrated generator-retailers are plausible and result in prices that are broadly consistent with the range of benchmark prices the Authority derived. The picture below compares the ITP levels for the last three years against the ranges generated by the benchmarks. The ranges for the benchmarks are not equivalent to statistical confidence intervals, but rather serve to illustrate the variation in prices within and across years from a number of plausible benchmark strategies and load profiles.

**Figure 2: Internal transfer prices with ranges from external benchmarks**



*Note: Trustpower's financial year ends in March, whereas the other companies' financial years end in June. The benchmark range is determined for June financial years.*

- b) the ITPs for mass-market consumers predominantly reflect a hedging “book build” process that averages across multiple futures contracts, as if the generator-retailer had hedged a portion of its business through time (the last 3-years).<sup>1</sup> This book-build process provides the generator-retailer with a comparatively smooth path for its internal prices from year-to-year, however differences in methodologies and customer profiles between generator-retailers leads to significant variance in ITPs across generator-retailers within a period. A consequence of this smoothing is that internal prices charged to retailing arms reflect forward prices that prevailed on average in the order of 2 to 2.5 years ago – short term volatility or a systemic change in pricing levels can take a considerable period to manifest in ITPs.

<sup>1</sup> One of the large integrated-retailers utilised a different approach to assuming a hedge book is built up over a number of years prior. They assume that cover going out three years is bought a few months prior to the commencement of their new financial year. This approach has resulted in a higher ITP than the average across the five generator-retailers for the period studied, in large part because of the upward trend in wholesale futures over recent years.

- c) importantly, the Authority's investigation did not find evidence to support non-integrated retailers' concerns ITPs were too low and smooth given the volatility and upward trend in forward prices observed in recent years. As noted above this volatility is typically smoothed through sampling over a longish (3 year) period, and the upward trend in prices takes years to materially impact ITPs – all of which is appropriate given the nature of the hedging strategies underpinning ITPs. The Authority observed a general upward trend in ITPs over the three years studied, similar to what were observed in the independent benchmarks.
  - d) the benchmark analysis illustrated that futures prices are the dominant driver of ITPs. Because of the volatility in forward prices, small differences in the timing and averaging of futures prices assumed by the generator-retailers in their methodology can have quite large effects on the internal prices that are derived. Given this volatility in the underlying futures prices, a wide range of ITPs can be expected across the five large generator-retailers.
  - e) location, reflecting customer mix, has a moderate impact on ITP. An Auckland-centric customer strategy results in a benchmark transfer price about \$5 higher than a nationally diversified customer acquisition strategy. Customer load profiles that overweight lower South Island prices result in lower ITPs (because South Island electricity prices are generally a little lower than in the North Island).
  - f) annual transfer prices are relatively insensitive to changes in both price and load seasonality, with this effect ranging from \$1 to \$2/MWh across the benchmarks developed by the Authority.
- 2.18 The Authority also considered the role the ITP plays within a generator-retailer. Vertically integrated entities seek to maximise shareholder value at the group level – not the individual business unit level. In this context an ITP is primarily an accounting concept for allocating costs across two business units and has limited application in commercial decision making, such as pricing new business. The Authority were advised by a number of generator-retailers that the ITP's primary use is to support the measurement of the retail and generation groups' longer-term performance, to inform decisions about whether to grow or shrink these business lines, and explain continued investment to shareholders.
- 2.19 Given the strategic nature of these decisions, it is not uncommon to favour a performance metric which is both explicitly linked to historical electricity prices and hedging options, but is not unduly sensitive to short-term volatility. Moreover, a metric used for accounting and strategic resource allocation at the business unit level is unlikely to be as refined and precise as a measure used for pricing new business.
- 2.20 The Authority was advised by generator-retailers that they do not rely heavily on the ITP in a period to price new retail customers. Pricing is more dependent upon the opportunity cost of the electricity at the time a customer is signed up, eg current futures prices for the expected term of the contract, subject to some discretion reflecting perceptions of customer profitability, competitive conditions, and the entity's business strategy.

### *Segmented Profitability Reporting*

- 2.21 As the five largest generator-retailers are public companies, they are required to report on operating segment profitability. However, the Authority makes several observations:
- (a) retail/mass market segment reporting is not limited to electricity products. Therefore, to the extent segment profitability is a useful indicator of anti-competitive practices in the electricity sector, the reporting was compromised by the inclusion of other products, such as gas and broadband
  - (b) the reporting is in nominal dollars. The reporting would be more useful for comparative purposes across firms if the constituent line items were standardised to a per MWh base
  - (c) the reporting includes allocation of indirect costs, eg corporate overheads, which may introduce a level of arbitrariness into the segment reporting and makes comparing businesses of different sizes and levels of efficiency problematic
  - (d) businesses not covered by NZ IFRS8 would not be required to publish segment reports. Reporting on segment profitability for the purposes of identifying anti-competitive practices should not be limited to public companies
  - (e) it was not obvious in all cases whether the segment being reported on was solely retail/mass market or whether it included commercial and industrial clients as well.

### **Issues with the existing arrangements**

- 2.22 The Authority thinks it is worth consulting on whether a Code change is required to improve transparency with respect to ITP. Mandating disclosure would provide all parties with better information to assess whether large generator-retailers' ITPs adequately reflect the market cost of electricity.
- 2.23 There is no existing requirement to disclose electricity retail segment profitability. Current retail segment reporting by the large generator-retailers is a consequence of these entities all being public companies. The existing disclosures are not instructive with respect to electricity sector competition, because these businesses are often diversified across other product lines. Unbundling is required to be able to identify the specific performance of the electricity retail business. For this information to be useful to assessing the competitive nature of the sector, it will be necessary to get equivalent data from smaller electricity retailers, many of which may not be public companies, and use this to identify systemic differences between the two groups.
- 2.24 As a consequence of the proposed Code change, stakeholders would be in an improved position to assess what level of confidence they should have in the competitiveness of wholesale and retail electricity markets. Better information about risks is expected to increase confidence and consumer welfare. An absence of information can be expected to have a more detrimental effect on confidence than is perhaps warranted, because of a general risk aversion amongst current and prospective participants.
- 2.25 The proposed Code changes seek to better inform prospective and existing participants' perceptions of risk as to whether the large, established generator-retailers are compromising competition in the sector by:
- (a) providing their retail arms with electricity on favourable terms (ITP disclosure proposals)

- (b) employing anti-competitive retail pricing practices or providing subsidies to their retail business (retail segment profitability reporting proposals).

### **Why the Authority is addressing these issues now**

- 2.26 The Authority has prioritised disclosure of internal pricing of electricity by large generator-retailers and retail segment profitability for two reasons. First, the issues were identified in the recommendations of the Electricity Price Review. The Authority is addressing these issues in a timely manner. Second, there has been a growth in the market share of independent electricity retailers, which are potentially an important channel for competition, including stimulating innovation and improving cost outcomes for consumers. The volatility and levels of wholesale electricity in recent years has put a spotlight on how generator-retailers set their internal prices.
- 2.27 Improved disclosure may address possible concerns that generator-retailers are favouring their retail arms through internal pricing of electricity or subsidising returns in the retail sector. Ongoing disclosure will provide an evidence base to support an appropriate level of confidence in the competitive operation of NZ electricity markets, and inform future debates and decision making on settings.

**Q1. Do you agree the issues identified by the Authority are worthy of attention?**

### 3 Regulatory Statement for the proposed amendment

#### Objectives of the proposed amendments

- 3.1 The proposed amendments are intended to increase trust and confidence in the wholesale and retail markets. The proposed Code changes with respect to ITP would improve transparency on how large vertically integrated generator-retailers, which dominate electricity generation, price electricity for their own retail arms and how this pricing compares with public market prices for electricity. The Code changes considered by the Authority for retail segment profitability reporting are premised on the benefits of improving disclosure pertaining to electricity-specific retail revenues across firms, including addressing any suggestion of large generator-retailers pricing below cost or subsidising returns on investment.
- 3.2 The proposed Code amendment for ITP is intended to instil confidence that large generator-retailers are pricing internal electricity sales appropriately, using prices which could have been reasonably achieved by third parties through futures and spot markets. Moreover, when a generator-retailer changes their ITP methodology they would be required to disclose the impact this change has on both the current and three preceding years of ITPs.
- 3.3 Evidence that ITPs within generator-retailers are a reflection of electricity prices available to third parties may reduce perceptions of impediments to competition facing independent retailers. Greater competition in this context promises greater choices, more innovation, and sharper pricing for the benefit of consumers.
- 3.4 The proposed Code amendment about retail segment gross margin would provide greater transparency on retail revenues and gross margins amongst entities with market share of more than 1% of all ICPs. This information has the potential to provide further assurances to stakeholders and prospective new entrants about retail pricing practices and gross return performance.

**Q2. Do you agree with the objectives of the proposed amendment? If not, why not?**

#### The proposed amendment

- 3.5 The drafting of the proposed amendment is contained in Appendix A. The Authority currently considers that the Code should be amended to require large generator-retailers to disclose annually their ITP, as well as supporting information to improve third party understanding of what it represents and how it was derived.
- 3.6 The Authority has yet to decide on the merits of segment reporting for electricity businesses, and to whom the regime should apply. However, the Authority is taking this opportunity to consult on the merits of the option.  
*Mandate annual disclosure of ITPs and methodology details by large generator-retailers*
- 3.7 The Authority considers that transparent and defensible transfer pricing methodologies are an important means of increasing confidence in the wholesale and retail electricity markets. For this reason the Authority is proposing that the ITPs of generator-retailers, of a size that could raise competition concerns, should be disclosed annually in line with the entity's financial year reporting, accompanied by supporting information explaining the methodology used to derive the ITP on a \$/MWh basis.



- 3.8 Mandating disclosure through a Code change is expected to provide the following benefits. It would:
- (a) allow the Authority to define minimum reporting requirements consistent with advancing market confidence objectives
  - (b) ensure completeness regarding which firms are required to report this information, to maintain and advance confidence in the competitiveness of the market
  - (c) strengthen resilience and continuity of future ITP reporting. The Authority's experience in other areas is that voluntary disclosure (such as spill from hydro dams) are not always durably maintained.
  - (d) incentivise participation as the Code has legal force in contrast to informal agreements or requests by the Authority.
- 3.9 Requiring disclosure of ITP information is expected to impose minimal additional costs on generator-retailers subject to the provisions. All of the large generator-retailers calculate an ITP in the course of their business and (internal) financial reporting. An ITP is generally not considered commercially sensitive, as evidenced by the majority of the largest generator-retailers voluntarily disclosing this information.
- 3.10 The Authority is of the view that mandating the disclosure of ITP in isolation – without complementary disclosures about how the price was set, what the price represents and what it is used for – creates a potential for misunderstanding and even a decrease of confidence. There should be a positive obligation on large generator-retailers to disclose the material details of their approach, to demonstrate that their ITP are a fair reflection of the cost of electricity. These disclosures ought to enable a reconciliation, within an acceptable range, and would likely necessitate disclosure of important methodological details, the contribution of the major component elements to the ITP, and summary level information about the load profile by location. The proposed amendment is intended to build confidence further by requiring large generator-retailers to be explicit about what the ITP is used for within the business.
- 3.11 For the reasons identified above, the Authority proposes that generator-retailers must provide sufficient details in relation to their ITP to enable a reasonable person to be satisfied as to whether the ITP is a fair reflection of the cost of electricity to the generator-retailer. The Authority considers that the types of information required to enable this will include the following:
- (a) the ITP on a \$/MWh base – this is the average load weighted price per MWh sold to the internal retail arm for the period. The average load weighted price is equal to the total cost of electricity charged to the retail business by way of the ITP divided by the number of MWh supplied.
  - (b) disclosure of the major component parts constituting the ITP (expressed in per MWh) including, but not limited to:
    - (i) electricity futures prices – the component of the total ITP explained by the use of electricity hedge contracts linked to public market prices, such as the ASX
    - (ii) location – the component of the ITP explained by the distribution of the total load across locations, notably the average load weighted price adjustment because the electricity supplied to customers extends beyond the two ASX futures nodes

- (iii) management or other fees charged to the retail business, through the ITP, for example to reflect the overhead costs associated with managing the generator-retailers' retail risk position
  - (iv) executive discretion – the extent to which the generator-retailer's management or Board used their discretion to amend or modify the final ITP, such that it differs from what was calculated using the methodology which relies exclusively on public market prices, historical benchmarks, load profiles etc
  - (v) other – any other components the generator-retailer considers material for explaining the level of the ITP
  - (vi) residual – that part of the ITP not explained by the component elements identified above.
- (c) an explanation of the methodology used to derive the ITP, including where appropriate:
- (i) The assumed process for building the hedge book of electricity futures contracts, including:
    1. what proportion of the total futures cover is assumed to be purchased when
    2. the relative weighting on Benmore versus Otahuhu contracts
    3. the types of contracts, eg strips and maturities assumed to be purchased and the maturities purchased
    4. what basis the contracts are priced, eg bid, offer, mid.
  - (ii) the adjustment, if any, for differences in the within-day load and cost profile underlying ASX futures contracts and customers' actual load profile
  - (iii) the adjustment, if any, to price for the distribution of load across locations – including whether the approach assumes the utilisation of Financial Transmission Rights (FTRs), historical price differentials or some other method
  - (iv) the load profile used for determining the ITP, including:
    1. whether actual or assumed load profiles are relied upon
    2. degree of granularity of load with respect to location, seasonality and intra-day
    3. the percentage of load by regional geographical location.
  - (v) the basis and determination of any management or other fees charged to the retail business through the ITP
  - (vi) the rationale for allowing any executive discretion over an ITP generated by a formal methodology
  - (vii) any other methodical elements the generator-retailer considers material for understanding the approach
- (d) the terms and conditions of the internal supply and pricing arrangements, eg FPVV

- (e) the purposes for which the ITP is used by the generator-retailer, including whether it is used or affects retail pricing.

3.12 The Authority is seeking guidance on the appropriate balance between the disclosure necessary to improve confidence and the costs of disclosure, whilst also being mindful of commercial sensitivities.

**Q3. Do you agree that disclosure of ITP by large generator-retailers is important for trust and confidence in electricity markets?**

**Q4. Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?**

**Q5. Do you agree that the generator-retailers subject to these provisions should have an obligation to demonstrate their ITP are a fair reflection of the cost of electricity?**

**Q6. Do you agree that ITP disclosure requirements should encompass the price, pertinent details of the methodology used, the major component parts which the price comprises, and the terms and conditions?**

**Q7. Do you have any comments on the specifics of the information requirements with respect to the price, methodology, component parts, and terms and conditions?**

*Implementation issues*

*Entities subject to ITP disclosure requirements*

3.13 The Authority recognises the challenges in prescribing rules to define when and in what circumstances an entity might have market power sufficient to warrant it being subject to these provisions. A balance needs to be struck between being sufficiently wide to capture all firms that potentially raise market power concerns, but not so wide as to impose unnecessary costs on firms with a trivial amount of market power.

3.14 Further, the Authority considers that the disclosure obligations should be future-proofed to take account of possible changes in the composition of the largest generator-retailers. It would be inappropriate to simply list the existing parties to which the disclosure provisions apply. Growing retailers may not be prepared to adhere to disclosure standards that were agreed in their absence. The Authority currently considers that it is appropriate that all vertically integrated entities that meet criteria should be covered by the provisions.

3.15 It is proposed that the provisions apply to any trader, who is both a generator and a retailer and in the preceding 12 months:

- (a) has sold to the clearing manager an amount of electricity at least equivalent to 5% of the total amount of electricity sold in any of the preceding 12 months by all generators who are traders, as measured in MWh; and
- (b) was recorded in the registry in any of those preceding 12 months as being responsible for at least 5% of the total ICPs registered in the registry.

- 3.16 The Authority considers that on internal supply of electricity to retail businesses, market power comes from market share and not absolute size. As such, both criteria are defined as a percentage of the market. It is also recognised that total ICPs incorporates mass market and larger commercial and industrial clients. However, the vast majority of ICPs are mass market, so making the condition a function of the total number of ICPs will capture all retailers of sufficient scale to warrant investigation. This approach is simple and avoids potential boundary and definitional issues.
- 3.17 Based on 2020 ICP and MWh generation market share data, the thresholds proposed would result in five entities being subject to the ITP data – Contact, Genesis, Mercury, Meridian and Trustpower.
- 3.18 The Authority proposes that generator-retailers can report on a consolidated basis where they own more than one retail business, and these businesses are supplied electricity by way of ITP.

*Centralised reporting of information*

- 3.19 Mandated reporting provides an opportunity for the Authority to publish ITP disclosures in a single location on the EMI website, thereby reducing search costs and facilitating comparative analysis. The identity of the reporting parties would be disclosed along with their responses to the disclosure requirements. It is also proposed that alongside these disclosures the Authority will publish ITP benchmarks using several default hedging strategies employing futures prices as their base. The benchmark strategies would reflect a range of hedging strategies similar to those used by the generator-retailers. ITPs found to be consistently outside the bounds of these benchmarks, without a robust explanation, may raise questions about the integrity of the entity's ITP process.

**Q8. Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?**

**Q9. Do you agree that generator-retailers which own more than one retail business, and supply electricity to each by way of an ITP, should be permitted to report on a consolidated basis?**

**Q10. Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?**

**Q11. Do you agree it would be helpful if the Authority published prices for a series of benchmark hedging strategies, for the purposes of evaluating whether generator-retailers' internal pricing reflects the cost of electricity? Are there any specific benchmark strategies you would like to see published?**

*Independent retailers' equivalence - differences in operational costs, and ITP terms and conditions*

- 3.20 The Authority's benchmarking exercise explored whether the ITPs being used by integrated generator-retailers are linked to market prices. Another related dimension is whether independent retailers', who are competitors of the generator-retailers, can secure electricity at prices and on terms without discrimination.

- 3.21 The Authority's methodology does not attempt to mirror the commercial realities facing independent retailers seeking to "replicate" these costs and arrangements for themselves:
- (a) independent operators face costs operationalising and supporting a hedge strategy,
  - (b) the terms and conditions of ITP arrangements are often more favourable than what can be secured through public hedge markets, eg FPVV versus fixed price fixed volume,
  - (c) an independent retailer might typically find that seeking hedges with equivalent terms through over the counter (OTC) markets may prove very expensive relative to ASX forward prices or may not be available at all.

The question is whether these differences are enough reason to suggest discriminatory practices by generator-retailers towards independent retailers.<sup>2</sup>

#### *Operational costs*

- 3.22 There are financial costs associated with satisfying the prudential and margin requirements supporting a hedge book when transacting with an independent third party. These costs arise largely to address credit counterparty concerns which exist in arm's-length arrangements. These credit concerns are effectively mitigated through vertical integration.
- 3.23 The Authority considers it is appropriate for their benchmark modelling of generator-retailers' costs of supplying electricity internally to ignore these costs, as no credit risk arises in this case.

<p><b>Q12. Do you agree that to be a fair reflection of the cost of electricity, large integrated generator-retailers' ITPs should reflect the costs and risks of being part of a vertically integrated entity? Or should their ITPs include the additional costs and risks their retail arms would face if they were not part of an integrated business?</b></p>
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#### *Terms and conditions*

- 3.24 The terms and conditions of most ITP arrangements have attractive features that cannot be replicated through trading markets, such as ASX futures and FTRs. Notably, integrated generator-retailers typically:
- (a) provide electricity to their retail arms on a "FPVV basis, whereas ASX contracts are "fixed price, fixed volume". FPVV typically provide a schedule of unit energy prices (\$/kWh) which depends on the time day, day of the week and month.
  - (b) their ITP strategies do have the benefit of a "look-back option".

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<sup>2</sup> The Authority's project investigated whether ITPs used by generator-retailers reflect what the cost of electricity should be, given the retail arm is part of a vertically integrated entity. This is not the same question as what the cost of electricity and terms of supply should be if the retail arm is independent.

- 3.25 Differences in costs and contractual terms are not sufficient conditions to demonstrate discriminatory practices. The cost and flexibility of the arrangements to produce a product are expected to vary within a firm versus across a market<sup>3</sup>. Organisation within a firm, ie integration, is expected where the production can occur at lower cost than it can across markets, and vice-a-versa. Therefore, differences in the availability and pricing of products a generator-retailer offers internally versus externally may not be due to discrimination, as much as to differences in the underlying risk and cost profiles.
- 3.26 The costs of writing, monitoring and enforcing “complete” contracts are some of the reasons why production within a firm may be more efficient. Commercial pricing and structuring of electricity hedge contracts should take account of the severity of adverse selection<sup>4</sup> and moral hazard<sup>5</sup> problems. The extent of both moral hazard and adverse selection issues depends on the degree of information asymmetry (which could lead to mispricing) and the potential for differences in the interests of the two parties (the buyer of insurance has the incentive to take on additional risk once the contract is in place). The severity of these problems may vary between internal and external relationships.

*Fixed Price Variable Volume*

- 3.27 FPVV contracts mitigate both the price risk and the potential for being either under or over hedged with respect to volume requirements.
- 3.28 The Authority recognises why FPVV hedges could help growing independent retailers to hedge the volume risk associated with uncertain customer growth, as well as managing the within-day, day-of-the-week and seasonal load profile characteristics of a mass-market portfolio. An FPVV contract would also reduce independent retailers’ need to incur the costs of managing their hedge portfolio.
- 3.29 However, unlike a FPFV contract, the value and perceived risk to the supplier of a FPVV contract is (materially) dependent upon the specific purchaser’s unique load characteristics (a potential information asymmetry), and the purchaser’s capacity and incentive to influence volume subject to price (moral hazard). These issues are significant when the buyer of the electricity is a growing retailer wanting a contract sufficiently flexible to encompass the marginal load increase from (unknown) customer growth over a period.
- 3.30 These complexities need to be priced and managed by way of contract that:
- (a) prudent generator-retailers are understandably reluctant to provide third parties with the option to buy variable amounts of electricity at a fixed price where the purchaser has better information about the potential load profiles, and may also have opportunities to influence the volume requirement for a period, depending on whether prevailing prices are above or below the price in the FPVV hedge. These risks can make FPVV contracts appear unaffordable, unless they are governed by relatively tight restrictions on the volume range covered, eg a volume range is fixed, or the contract relates to defined ICPs.

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3 Coase, R. H. (1937), The Nature of the Firm, *Economica*, 4(160), 386-405.

4 Adverse selection - an information asymmetry between buyers and sellers, so that a party selectively enters into trades which advantage them at the expense of the other party.

5 Moral hazard - a party makes decision about the volume of risk to take, while another party bears the cost.

- (b) variable volume contracts are feasible for integrated retailers because the information asymmetries are alleviated between the generation and retailing arms. Furthermore, as part of an integrated business, a retailing arm does not face the same incentive to game volume, because to do so would simultaneously impose economic cost on the generation arm of the business, and would ultimately destroy value for shareholders.
- 3.31 FPVV contracts are common for commercial and industrial customers. FPVV contracts are far less common for independent retailers, and anecdotally the Authority understands the premium over FPFV contracts are greater than is typically the case for commercial and industrial customers.<sup>6</sup> Again, these differences may be attributable to differences in information and perceived risks across the two groups:
- (a) the scope of FPVV supply contracts with commercial and industrial customers can be limited to specific ICPs, the historical load characteristics may be well known, and the customer's demand for electricity will be only one input into wider commercial considerations as to how much to produce in a period, and may not be highly sensitive to electricity prices.
  - (b) a growing independent retail customer ideally wants a FPVV contract that affords them cover from being under or over hedged in future years, but the firm's growth is uncertain and subject to the effectiveness of their strategy. The ICPs of the future customer base are also not known. Where the future price of electricity increases above the price specified in the FPVV contract, the FPVV contract can become a comparative advantage, and the independent retailer could use the price differential to attract customers at prices below the prevailing opportunity cost of electricity.
- 3.32 One response to the challenges and costs of providing these contracts to an independent retailer is to narrow the scope of the FPVV contract, say through explicitly identifying the ICPs within scope, and/or specifying a minimum and maximum range in MWhs.<sup>7</sup> However, the resulting contracts, though more affordable, might only be marginally more flexible than fixed volume contracts, like those on the ASX. The FPVV may provide some improved hedging, eg peak versus off-peak, but only partially address the uncertainty around the growth in customers for the period.

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<sup>6</sup> The Authority undertook a review of fixed price variable offers made by generator-retailers to commercial parties, and found the offer prices were on average higher than prevailing ASX bid prices by approximately \$6/MWh.

<sup>7</sup> The Authority is aware of at least one financial intermediary exploring the development of a commercial FPVV hedging product specifically targeting growing independent retailers, and the Authority understands this product would likely have restrictions on minimum and maximum volumes for a period, as well as requirements to explicitly identify the ICPs covered.

3.33 The Authority has previously (2017) reviewed the pricing of FPVV contracts in the commercial/industrial segment.<sup>8</sup> The Authority initiated this review following claims that there are inefficient barriers to entry in the commercial segment of the retail electricity market because large retailers systematically discount FPVV contracts below the bid price of ASX NZ energy futures contracts. The review tested whether this systematic discounting is occurring. The review did not find evidence to substantiate the claim that there is systemic discounting in the FPVV market relative to the ASX. The Authority intends to repeat the review with an expanded scope this year, and is considering the merits of continuous disclosure/analysis of this market segment.

*Look-back Option*

3.34 A generator-retailer can change their ITP strategy at any time without any direct financial consequences. The new strategy and the resulting ITP can be instituted with immediate effect.

3.35 In contrast, independents do not have the benefit of a “look-back” option – they are not able to retrospectively contract at historical prices. Independent retailers enter into financial contracts with third parties to execute their hedging strategies. Changing a hedging strategy involves unwinding existing hedge contracts and commencing a new book-build through time and at prevailing rates. It can take years to implement a strategy fully, resulting in an interim period of incomplete or partial hedges.

3.36 It can be argued that generator-retailers that change their ITP policies without regard for the cost of transition may be providing their retail arm with a competitive advantage relative to independent retail competitors.

3.37 On the other hand, the ITP for a vertically integrated entity is little more than an internal means of accounting for the allocation of profits and risks between two internal groups. As a consequence, changing an ITP methodology in a vertically integrated retailer does not create financial risks or value for the aggregate business. Nor would it be expected to lead to significant changes in decision making about the terms offered to new customers.<sup>9</sup>

3.38 The Authority considered whether it was reasonable for independent competitors to expect a look back option – granting them the right but not the obligation to purchase electricity at historical prices from generator-retailers. Contrary to the situation within a vertically integrated business, providing independents with a look back option is not costless to the generator-retailer. The Authority believes providing independent retailers (and others) with this option would either necessitate these options being provided at a subsidy (implying a significant and arbitrary wealth transfer) or they are likely to be unaffordable. If provided at a subsidy, then independent competitors would have reduced incentives to proactively manage risk and participate in hedge markets.

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<sup>8</sup> Available at: <https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2017/review-of-fixed-price-variable-volume-commercial-offers/>.

<sup>9</sup> Hypothetically, if a generator-retailer chose to set its ITP at zero it would not result in the group pricing retail customers on the assumption that electricity had no cost. The entity would still look to maximise group profits, which would not be achieved by the retail group acting as if electricity had no cost.



- 3.39 Another question is whether there should be limits or consequences on generator-retailers for changing the strategy underlying their ITP. As noted above, the Authority do not consider ITP policy is a particularly effective means for a generator-retailer to advantage their retail operations. Also, the Authority do not support limiting generator-retailer's capacity to innovate their methodologies, because there are often legitimate business reasons for making changes that are not anti-competitive in nature or intent. From what the Authority has observed, generator-retailers modify their strategies in response to technological innovation, eg more granular and frequent load data can enable sharper pricing between wholesale and retail groups, or lessons learned from evolving market conditions (sampling of prices through time has increased in recent years to mitigate increased volatility in forward prices).
- 3.40 It is proposed that any residual concern with generator-retailers changing their ITP policy be addressed by requiring generator-retailers to retrospectively apply methodological changes to past reported ITP data where it has an impact of more than 5% on the current years ITP. In these cases the generator-retailer would be required to disclose the impact of the change on the ITP and segment profitability for the current and the preceding three financial years. The Authority seeks guidance on what (if any) changes in methodology should be excluded from the requirement to retrospectively apply that changed methodology.
- 3.41 It has been suggested that independent retailers should be able to buy electricity from generator-retailers at their prevailing ITPs within the period. The Authority does not support this proposal as:
- (a) the Authority's analysis of generator-retailers' ITPs suggests that third parties, including adequately capitalised independent retailers, can buy electricity in the range of ITP levels if they adopt similar hedging strategies to those used notionally by generator-retailers for setting their ITP. The four largest generator-retailers each provide futures market making services on an unpaid basis which facilitate hedging by independents.
  - (b) ITPs are the outcome of a notional hedging strategy, and thus reflect historical prices. These prices are not relevant to current pricing of new business and nor should a party be compelled to sell at historical prices.
  - (c) as stated above, the fact that internal supply agreements have a FPVV structure, is not an argument for providing equivalent terms to independent third parties. The willingness to supply variable volume internally on an agreed accounting basis is not equivalent to selling electricity to a third party on those terms.
  - (d) such an arrangement would be in the form of either an obligation or an option for the independent retailer to buy from a generator-retailer. An obligation would be unduly restrictive and as noted in (a) above is available anyway to those parties that would choose it. Requiring generator-retailers to provide third parties with an option to buy at their ITP would:
    - (i) be costly if priced commercially or would involve a subsidy if it wasn't;

- (ii) provide independent retailers a competitive advantage over generator-retailers if the option was free or subsidised – independents could freely switch between the ITP price and market prices depending on which was cheaper. There is significant volatility across prevailing ITPs, even small differences would result in the generator-retailer with the lowest ITP facing significant demand and costs. This could result in changes to ITP practices within generator-retailers to avoid these costs, which may undermine the legitimate role an ITP plays within a generator-retailer.

3.42 The Authority intends to monitor ITP disclosures and will consider any implications this raises for the competitive operation of the sector. If this monitoring were to identify a misuse of a market power by large generator-retailers when pricing and supplying electricity to internal or independent parties, the Authority would consider appropriate penalties and policy responses.

**Q13. Do you agree that differences in risk largely explain the variation in the appetite and pricing generators are willing to offer fixed price variable volume contracts to internal parties, commercial and industrial clients, and independent retailers?**

**Q14. Do you agree that where a generator-retailer changes their ITP methodology and it has an impact of more than 5% on the current years ITP, that they be required to disclose the impact the new policy would have on the preceding three financial years and the current years ITP and retail segment profitability disclosures? Please note any methodology changes that should be excluded from this requirement.**

#### *Segmented Profitability Reporting*

- 3.43 Confidence in electricity markets is strengthened by large generator-retailers' demonstrating that their ITPs are a fair reflection of the cost of electricity. However, a robust ITP disclosure regime cannot fully ensure that the retail market is competitive. Despite some quarters having a different perception, ITPs do not unduly impact generator-retailer decisions which have a direct bearing on competitive practices:
- (a) importantly, ITPs are not used by integrated-retailers to price new retail customers or to drive retail strategy within a period.
  - (b) rather, the major generator-retailers primarily use their ITPs as an input to enable the assessment of the longer-term performance of their retail businesses by the investor community.

The concern that generator-retailers might be compromising competition in retail markets by selling at prices below what is economic and sustainable might be better addressed through disclosures that incorporate retail revenues, and therefore pricing of new and existing customers.

- 3.44 The Authority is considering whether mandating segmented retail profitability reporting specific to electricity would strengthen confidence in electricity markets. More specifically the Authority is considering the merits of mandating the disclosure of gross margin for the mass market / retail segment.
- 3.45 Currently the five largest generator-retailers disclose the performance of their retail businesses. Segment reporting is required through IFRS 8 for publicly listed companies – which all five of these businesses are. However, this reporting is for the entire retail segment which can include other products and services beyond electricity.

*Definition of Retail gross margin*

3.46 Retail gross margin would be computed with the following standardised line items:

- (a) retail Revenue
- (b) cost of Electricity:
  - (i) cost of electricity supplied internally (ITP)
  - (ii) cost of other sources of electricity
- (c) transmission and distribution costs
- (d) metering costs and levies.

*Other elements of Retail gross margin disclosure regime*

3.47 It is proposed that if the Authority were to proceed with this Code amendment, to improve comparative analysis:

- (a) gross margin and each of the constituent line items would be required to be reported in both nominal dollars and on a per MWh basis
- (b) reporting would be centralised on the Authority's EMI website, for both ITP and mandated segmented reporting.

*Entities subject to Segmented Profitability Reporting*

3.48 Most insights on anti-competitive practices from segment reporting occurs through a comparative analysis of (larger) entities with potential market power against those that don't. Gross margin reporting has a further benefit that it informs an assessment of the viability of retail businesses through time, specifically whether margins are sufficient to cover the variable costs of supply. The Authority is therefore of the view that segment reporting is most useful if it is mandated to apply to a relatively wide cross-section of retailers.<sup>10</sup>

3.49 That said, having the regime apply to micro and early stage firms/traders with retail operations is not recommended, because of the costs of compliance this would impose on small operations, and because early stage firms' financials may not be representative of actual competitive conditions. The Authority is proposing that any retail segment reporting should apply to all firms with more than 1% of all ICPs. This cut-off would have meant that as for 2020, 10 firms would have been subject to this reporting regime.

3.50 Moreover, for the purposes of reporting on EMI, The Authority is proposing that only those firms with a market share of more than 5% of all ICPs will be named. Retailers with more than 1% but less than 5% will be anonymised, because while they serve an important function as a counterfactual their individual identities are not critical as they are not judged to have sufficient market power. To further ensure anonymisation of these entities, they will only be required to disclose their gross margin report on a per MWh basis.

3.51 The Authority proposes that entities can report on a consolidated basis where they fully own more than one retail business.

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<sup>10</sup> In contrast the ITP regime is only to be applied to relatively large generator-retailers. There is no inconsistency between the two regimes. The primary concern the ITP regime addresses is whether the internal pricing of electricity to the retail business is reflective of public market prices for electricity. Segment reporting is concerned with whether there are systemic differences between individual or groups of firms which aren't explained by size, competency etc.

*Pros and cons of Segmented Retail gross margin Disclosure*

- 3.52 As noted above, the Authority is considering requiring segmented profitability, and sees both benefits and costs. The Authority is reluctant to mandate disclosure of gross margins if differences between retail entities, that arise due to legitimate commercial decisions, could be misconstrued as evidence of anti-competitive behaviour. This “noise” could have the unintended consequence of undermining confidence, when it is not warranted. This section outlines the pros and cons as the Authority currently views them.
- 3.53 A possible advantage of mandating disclosure of gross margin for retail segments is that this measure incorporates retail revenues. Retail pricing practices, which over the medium to longer term ought to recover the true costs of servicing and supplying electricity to a client, could be a useful lens on possible competitive practices across firms and through time.
- 3.54 Moreover, revenues less the costs of servicing clients (distribution and transmission, metering and levies) is the residual the retailer has available for the cost of electricity (hedges), overhead costs and profit margins. This metric may be interesting for evaluating whether independent businesses have the operating capacity to pay for forward hedges given prevailing prices on the ASX (in the event they are not fully hedged). The Authority understands that variants of this metric, eg Netbacks, are often used by equity analysts to inform their evaluation and valuation of electricity retail businesses. These metrics mitigate potential ambiguity introduced by ITP (in the case of vertically integrated entities) or actual hedge strategies (in the case of independent retailers) and allows a direct comparison to spot and future prices
- 3.55 However, comparing retail revenue and gross margins across firms in the expectation of understanding competitive practices is not straight forward. Retail revenues on a per MWh basis can be expected to vary (significantly) between retail businesses for reasons other than anti-competitive practices, including differences across firms with respect to:
- (a) locational mix of customers – Internal modelling suggested that a locational price adjustments in the order of \$5-12 MWh is not unexpected. An Auckland-centric customer base versus a customer base spread across NZ, might result in a difference of ~\$5/MWh
  - (b) the age of customer contracts and renewal profiles – Systemic differences in the time at which customers are acquired or contracts renewed across customer portfolios could lead to significant differences in revenues per MWh
  - (c) client acquisition strategies – variations in appetite to acquire or divest customers can lead to pricing strategies (such as “loss leader”) which diverge in the shorter term from long-term sustainable pricing practises
  - (d) demand management incentives in customer contracts – contracts incentivising off peak usage would, for example, be expected to result in lower revenue per MWh
  - (e) the ability to identify and attract high value customers – firms should not be punished for being better at understanding customer profitability.

- 3.56 There is also the potential for differences to arise in the “cost of electricity” line item between firms in a period. For example, ITPs within generator-retailers might depart from the costs of supply facing some independent retailers, largely due to differences in hedging strategies, or absence thereof. In a market where electricity prices are trending up-ward, as has been the case in recent years, this difference might be construed as evidence of anti-competitive practises, whereas it more likely a consequence of divergent hedging strategies.
- 3.57 A further complexity when contemplating the merits of gross margin electricity retail segment reporting arises because firms are increasingly diversifying their retail offerings, eg electricity, broadband, gas etc, which complicates segmented reporting of profitability specific to electricity retailing. Meaningful segmented reporting of electricity for multi-product firms will require unbundling of costs and revenues, which may introduce a degree of arbitrariness into the calculation.
- 3.58 Prior to deciding whether to mandate retail segment gross margin reporting the Authority would like to hear from all parties as to its merits for building confidence, including how precisely such a measure would support improved understanding of the competitive practices and the robustness of the electricity sector, given the issues raised above.

**Q15. Do you support electricity retail segment profitability reporting?**

**Q16. Do you believe that for multiple product line retail businesses, the costs and revenues specific to electricity can be unbundled from other product lines, with sufficient rigour to advance confidence in the electricity industry?**

**Q17. Do you support requiring gross margin electricity retail segment reporting?**

**a. If so:**

- i. How precisely would this information be used to identify potential anti-competition concerns and improve decision making on retail competition settings? Please provide illustrations.**
- ii. What assurances are there that reported differences arising due to legitimate commercial reasons won't be misconstrued as evidence of anti-competitive practices?**

**b. If not:**

- i. Do you have a preferred alternative retail segment profitability metric which is feasible and low cost to implement, and would improve information on potential anti-competitive practices?**

- Q18. If retail segment gross margin reporting was introduced, do you agree:**
- a. With the proposed definition and line items constituting gross margin?**
  - b. That gross margin and the constituent parts should be reported on nominal dollars and a per MWh basis?**
  - c. That firms with more than 1% market share of all ICPs should be subject to these provisions?**
  - d. That reporting should be centralised on the Authority’s EMI website?**
  - e. That firms with less than 5% market share of ICPs should be reported on an anonymised basis on the EMI, and only report on a per MWh basis?**
  - f. That entities with more than one retail business can report on a consolidated basis?**

*Granularity of gross margin reporting*

- 3.59 The Authority is also interested in stakeholders’ views on whether electricity retail gross margin reporting at the national level is adequate, or whether further granularity would be desirable to improve confidence in the wholesale market. For example, geographical reporting could improve the understanding of competitive behaviours in regional markets. Customer categories could also be reported on, such as residential and SME customers. However, the more granular the reporting requirement, the greater the compliance costs and concerns with disclosing commercially sensitive information without a sufficient public benefit. There is also a question whether any greater granularity should be required for all line items or say just for revenues. If it were required for all line items then the “cost of electricity” line, which includes the ITP for generator-retailers, would also need to be reported on separately for each category.

- Q19. Do you agree that gross margin segmented retail reporting at an aggregate country level is sufficient to support confidence in the wholesale market? If not:**
- a. What categorisations would you propose?**
  - b. How would further granularity advance trust and confidence?**
  - c. What would the marginal cost of reporting at increased granularity be compared to the proposal in the paper?**

*Mandating segmented profitability reporting beyond retail, to include generation and/or commercial & industrial*

- 3.60 Finally, it is currently proposed that any segmented profitability regime should only apply to mass market retail. The Authority is interested in hearing views on whether segmented profitability reporting is feasible and required for the commercial and industrial, and the generation segments.

3.61 The Authority is seeking stakeholders views on the merits of segment reporting for these business lines and how it could be measured. Again, the Authority seeks to better understand how mandating specific segment reporting could be utilised cost effectively to improve confidence and monitor business practices to address any potential concerns with anti-competitive practises, such as predatory pricing. For example, comparative analysis of gross margins across generators might be problematic when some electricity generators have low marginal costs coupled with high capital costs, eg hydro, and others have lower capital costs and higher marginal cost generators, eg peakers. Similarly differences in revenues per MWh for commercial and industrial segments across entities can arise even when all firms are using the same or similar approaches to pricing new business - revenues per MWh will vary depending on such things as when supply contracts were signed, locational and load differences etc.

**Q20. Do you support mandating gross margin reporting for the generation, and commercial and industrial segments? If so,**

- a. **What line items would you propose for each segment?**
- b. **How precisely would this information be used to identify potential anti-competition concerns? Please provide illustrations.**
- c. **What assurances are there that reported differences arising due to legitimate commercial reasons won't be misconstrued as evidence of anti-competitive practices?**

*Post implementation review*

If the Authority proceeds with either of the proposed Code amendments, it would expect to conduct a post implementation review of the policy two years after implementation.

**The proposed amendment's benefits are expected to outweigh the costs**

3.62 The Authority's assessment is that the proposal would be of net benefit to consumers. In particular, the costs of the proposed changes to disclosure are comparatively minor, as much of the information is already being produced and disclosed. The benefits include greater confidence to invest in new retail and generation activities, resulting in more choices and innovation, and potentially lower prices for consumers. Moreover, the greater transparency will improve the quality of future policy debate on ITP and practices (and potentially segment profitability).

**Benefits**

3.63 The proposed code amendment is expected to:

- (a) increase retail competition, by reducing barriers to entry and expansion
- (b) increase innovation
- (c) reduce search and analysis costs.

3.64 The nature of these benefits is such that they are hard to quantify, but the Authority has included indicative and conservative dollar values where possible to illustrate their magnitude. The Authority is of the view that these benefits exceed the costs identified below.

- 3.65 As signalled above, the Authority is using this consultation process to assess the merits of mandating a gross margin reporting regime for retail electricity businesses. In particular, the Authority would like feedback to augment the evidence that the proposed amendment would improve understanding of pricing practices and other competition insights, such as whether returns are sustainable.

### **Increase retail competition, by reducing barriers to entry and expansion**

- 3.66 The improved disclosure regimes would increase competition in electricity markets, which through time can be expected to generate significant benefits for consumers. The greater transparency would make it easier for investors, and small and prospective retailers to assess risks of both market entry and expansion strategies.
- 3.67 The proposed amendments address, and indeed go beyond, many of the proposals raised by small and medium-sized retailers with respect to the disclosure of ITP and segment profitability. The Authority's analysis of the five largest retailers' ITPs refutes the suggestion that these prices were too low and stable, given recent volatility. This divergence between what some parties understood and what the Authority found to be the case, arose in part because of an information asymmetry between generator-retailers and independent retailers. Improved transparency, at least in the case of ITPs, can be expected to reduce existing perceptions of anti-competitive practices that are not supported by evidence, thereby reducing risk-premiums and encouraging greater investment.

### **Increase Innovation**

- 3.68 The prospect of greater competition from new entrants and growing small retailers will encourage innovation across the sector, including amongst the large generator-retailers. New entrants are an important source of innovation, often because they can see opportunities from fresh perspectives and are absent legacy investments, which can hinder adaptation by incumbents. The improved transparency occurring from the Code change will not directly generate innovation, but rather will strengthen the prospect for innovation through reduced perceptions of risk in turn encouraging new entrants and investment.
- 3.69 There are over 1.7 million residential ICPs. Retail costs to serve consumers have been estimated to be in the order of \$200 per ICP per year. Every 0.1% improvement in operational efficiencies, unlocked in part through the proposed changes strengthening confidence to invest, would translate into \$340,000 per annum savings for consumers.

### **Reduce search and analysis costs**

- 3.70 Each party covered by the disclosure requirements will be required to submit their information to the Authority within 90 days from the end of their financial year. The Authority intends to publish this information on the EMI website. Centralised reporting will reduce search costs compared with the current situation, because this information is often disbursed throughout financial reports and investor briefings.
- 3.71 The amendments will also improve the quality and cost effectiveness of comparative analysis across firms and time periods, by standardising reporting and mandating ongoing disclosure by all parties which are subject to the regimes. Having this information centralised on the EMI will increase this value proposition.



- 3.72 The Authority also plans to generate a range of ITP benchmarks for each period, reflecting a mix of defensible hedging strategies using historic and prevailing futures and other market prices and benchmarks. These benchmarks, and the range of prices they produce, can be used by interested parties to evaluate the reasonableness of a generator-retailer's ITP. It is more cost effective for the Authority to do this once, than have each interested party have to calculate their own set of benchmarks.
- 3.73 The Authority has seen analysis from independent retailers similar to what will be produced through the EMI. An indicative order of magnitude estimate, of reduced effort across the sector to produce this information would be between \$100,000 (10 parties, spending \$10,000 each) and \$400,000 (20 parties, spending \$20,000 each).

## **Costs**

- 3.74 The main costs of the proposal are:
- (a) compliance costs for entities subject to the disclosure requirements
  - (b) potential for disclosure of commercially sensitive information
  - (c) misuse of the disclosed information.

## **Compliance costs for entities subject to the disclosure requirements**

- 3.75 All five of the generator-retailers which would be subject to the ITP proposals in the first instance have existing policies and four disclose the price information already. The additional requirements pertain to more granular disclosure of the ITP into component parts, and greater transparency around the methodologies employed – both of which are considered important to enabling greater understanding and therefore confidence in generator-retailer practices.
- 3.76 These additional elements are not expected to be onerous in a technical sense, but it is recognised that there are costs associated with releasing information externally, especially with respect to public companies. An indicative order of magnitude estimate, for generating and releasing this information, would be between \$100,000 (5 generator-retailers, spending \$20,000 each) to \$300,000 (6 generator-retailers, spending \$50,000 each).
- 3.77 With respect to the gross margin reporting, the Authority would expect all businesses to have (internal) financial reports for the performance of their electricity retail operations. The Code amendment allows entities subject to the provisions to use their specific definition of mass market, thus reducing the cost of compliance if a prescribed definition was used. However, there may be additional costs associated with converting this information into a form which is acceptable and has the necessary assurances expected of a public release. The costs can be expected to be higher for larger firms. An indicative order of magnitude estimate, for generating and releasing this information, would be between \$220,000 (7 smaller independent retailers, spending \$10,000 each, and 5 large generator-retailers spending a further 30,000 each - over and above the ITP costs) and \$690,000 (8 smaller independent retailers, spending 30,000 each, and 6 large generator-retailers, spending an additional \$75,000).
- 3.78 Estimated compliance costs for the Authority are estimated at between \$50,000 and \$100,000.

3.79 The total annual compliance costs are expected to range from between \$370,000 and \$1,090,000.

### **Potential for disclosure of commercially sensitive information**

3.80 Requiring the disclosure of information which is commercially sensitive could undermine confidence and result in reduced investment and competition, thereby forgoing the attendant consumer benefits that implies.

3.81 The Authority is confident that nothing which is being requested with respect to ITP disclosures is confidential as:

- (a) much of the information is disclosed voluntarily already
- (b) generator-retailers have stated that their ITPs are not core to their comparative advantage
- (c) the methodologies draw on public prices, historic data, and load characteristics.

3.82 In summary, while requiring the disclosure of commercial information where it does not have net consumer benefits could occur, the Authority is confident that the process being followed effectively mitigates this risk.

### **Misinterpretation of the disclosed information**

3.83 Differences in ITPs and segment profitability between firms and types of firms can be caused by a number of factors, most of which can be attributable to legitimate commercial realities, eg hedging strategy, load profiles, business strategies, business acumen) and not anti-competitive practices.

3.84 The Code amendment is intended to cost effectively improve the understanding, discourse and performance of the sector, including levels of competition. The Authority considers mandating ongoing disclosure of ITP, coupled with methodology details and component analysis will support this end.

3.85 The Authority is seeking guidance from stakeholders through this consultation process as to whether segment profitability will also support these ends. The Authority will only implement a Code change with respect to segment profitability reporting if it is satisfied that the proposed changes will provide new insights on the sector's competitiveness, and won't inappropriately undermine confidence by introducing ambiguous signals.

3.86 The Authority is confident that this consultation process will mitigate the risk of inadvertently mandating disclosures which run an unreasonable risk of being misinterpreted.

**Q21. Do you agree the benefits of the proposed amendment outweigh its costs?**

### **The Authority has identified other means for addressing the objectives**

3.87 The Authority has identified other means for improving confidence and trust in electricity markets through greater transparency as to whether generator-retailers are compromising competition outcomes by:

- (a) advantaging their own retail arms through preferential pricing of electricity, addressed through the ITP disclosure proposals

- (b) selling electricity at prices below what is economic and sustainable, addressed through the segment profitability reporting.
- 3.88 The Authority has comprehensive priority projects underway to improve wholesale and retail competition. For example, proposed enhancements to hedge markets and wider wholesale market disclosure, coupled with the Code changes relating to ITP and retail segment profitability reporting will together strengthen confidence in electricity market competition.
- 3.89 The Authority identified two other means for addressing the objective with respect to ITP:
- a) status quo – this would mean continued reliance on voluntary disclosure of ITP information by some, but not all, large generator-retailers, often absent summary methodological specifics to give confidence the ITP numbers are explicitly linked to market prices and other data; and there is no surety that ITP information will continue to be disclosed or that new emerging large generator-retailers would voluntarily disclose this information.
  - b) mandate an ITP methodology to be used by all large generator-retailers - This was deemed inappropriate because of the divergence in commercial situations facing large generator-retailers- some are broadly balanced in terms of their generation assets' capacity to supply their customers, whereas others are short electricity. Moreover, while the approaches are somewhat consistent in principle they diverge significantly in terms of operationalising and the Authority does not consider it is best placed to decide what approach is best for individual firms, nor for the industry as a whole.
- 3.90 The Authority identified two other means of addressing the objective with respect of segment profitability reporting:
- a) status quo – Segment profitability would only be required for public companies as a consequence of being subject to generally accepted accounting practice. These reporting requirements are not specific to electricity trading, so retail segment reporting is for the combined multi-product (gas, broadband, electricity) business.
  - b) mandating a full cost profitability measure, such as net profitability. The Authority does not currently recommend this approach because of the increased cost and complexity, the somewhat arbitrary nature of indirect cost allocation, and because, unlike gross measure, a net measure is likely to be sensitive to scale differences between firms. Gross margin reporting is favoured over more complicated segmented “net” profitability reporting, which introduces the challenges of full cost allocation of indirect costs, eg overheads. A full cost allocation approach adds a further layer of arbitrary rules and would be more costly and complex. As importantly, gross margins are less sensitive to scale differences between market participants than methodologies allocating overheads and fixed costs, thereby facilitating comparative analysis between large and smaller, growing enterprises.

### **The proposed amendment is preferred to other options**

- 3.91 The Authority has evaluated the other means for addressing the objectives and prefers the proposal.
- 3.92 The Authority considers the preferred proposal relative to the alternatives outlined above.

- 3.93 Continued reliance on voluntary disclosure would risk not all large generator-retailers disclosing internal transfer information on an ongoing basis, and that the details of the disclosure are insufficient to advance the confidence objective.
- 3.94 The Authority currently considers that flexibility is appropriate to allow methodologies to reflect differences across generator-retailers' business contexts and goals. Consequently, the Authority currently considers that it would be undesirable to mandate a specific ITP price or methodology.
- 3.95 There is currently no obligation for electricity specific retail segment profitability reporting.
- 3.96 Gross margin reporting is lower cost to comply with and is less sensitive to scale differences across firms than full cost profitability measures.

**Q22. Do you agree the proposed amendment is preferable to the other options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.**

**The proposed amendment complies with section 32(1) of the Act**

- 3.97 The Authority's objective under section 15 of the Act is to promote competition in, reliable supply by, and efficient operation of, the electricity industry for the long-term benefit of consumers.
- 3.98 Section 32(1) of the Act says that the Code may contain any provisions that are consistent with the Authority's objective and is necessary or desirable to promote one or all of the following:

**Table 1: How proposal complies with section 32(1) of the Act**

(a) competition in the electricity industry;	The proposed amendment with respect to ITPs (and potentially segment profitability) is expected to strengthen confidence in retail competition.
(b) the reliable supply of electricity to consumers;	Increased confidence in the competitive nature of electricity markets is expected to support investment in generation and retail.
(c) the efficient operation of the electricity industry;	The Authority currently considers that improved information disclosure could inform more efficient operational decisions within the industry.
(d) the performance by the Authority of its functions;	The Authority currently considers that the proposed amendment would not materially affect the performance of the Authority.

(e) any other matter specifically referred to in this Act as a matter for inclusion in the Code.	The Authority is currently of the view that the proposed amendment would not materially affect any other matter specifically referred to in the Act for inclusion in the Code.
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**Q23. Do you agree the Authority’s proposed amendment complies with section 32(1) of the Act?**

### **The Authority has given regard to the Code amendment principles**

3.99 When considering amendments to the Code, the Authority is required by its Consultation Charter<sup>11</sup> to have regard to the following Code amendment principles, to the extent that the Authority considers that they are applicable. Table 2 (below) describes the Authority’s regard for the Code amendment principles in the preparation of the proposal.

**Table 2: Regard for Code amendment principles**

Principle	Comment
1. Lawful	The proposal is lawful, and is consistent with the statutory objective (see sections 3.63 – 3.87) and with the empowering provisions of the Act.
2. Provides clearly identified efficiency gains or addresses market or regulatory failure	The efficiency gains are set out in the evaluation of the costs and benefits (see sections 3.63 – 3.87).
3. Net benefits are quantified	The extent to which the Authority has been able to estimate the efficiency gains is set out in the evaluation of the costs and benefits (see sections 3.63 – 3.87). The Authority is currently of the view that the benefits of the baseline proposal exceed the costs.
	Principles 4 to 9 apply only if it is unclear which option is best (refer clause 2.5 of the Consultation Charter). The Authority considers the baseline proposal to be clearly superior to the alternatives and has not applied principles 4 – 9.

<sup>11</sup> The consultation charter is one of the Authority’s foundation document and is available at: <http://www.ea.govt.nz/about-us/documents-publications/foundation-documents/>

## Appendix A Proposed amendment

### New definitions to add to Part 1 of the Code:

**financial year** means, except in Schedule 12.4, the financial year adopted by a **participant** from time to time, being a 12 month period as a **participant** determines

**generator retailer** means a **trader** who is both a **generator** and a **retailer** and in any month of the **financial year** of the **generator retailer**:

- (a) has sold to the **clearing manager** an amount of **electricity** at least equivalent to 5% of the total amount of **electricity** sold in any of those months by all **generators** who are **traders** to the **clearing manager**, as measured in **MWh**; and
- (b) was recorded in the **registry** in any of those months as being responsible for at least 5% of the total number of **ICPs** registered in the **registry**

and, for the purposes of this definition, the terms “**trader**”, “**generator**” and “**retailer**” include any related company, as defined in section 2 of the Companies Act 1993, of a **participant** provided that the related company is a **participant**

**retail gross margin report** means a report provided by a **retailer** under clause 13.260

**ITP information** means information on internal transfer pricing as described in clause 13.256

**mass market customers** means all those **customers** of a **retailer** who the **retailer** classifies as mass market or who are commonly understood to be mass market **customers** in accordance with standard industry practice

**retail ITP** means the notional price or prices per **MWh** for **electricity** in relation to a **generator retailer’s** sale of **electricity** to **mass market customers** set between either the generating arm or the trading arm of a **generator retailer**, on the one hand, and the retailing arm of the **generator retailer**, on the other hand, for internal accounting, management, or other purposes

### New clauses 13.256 to 13.261 to add to Part 13 of the Code:

#### *Disclosure of internal transfer pricing information by generator retailers*

#### **13.256 Generator retailers must make retail ITP information available**

- (1) Each **generator retailer** must make **ITP information** in relation to the **generator retailer** readily available to the public, free of charge, no later than 90 days after the end of the **financial year** of the **generator retailer**.
- (2) The **ITP information** must consist of the following information in relation to the **generator retailer’s financial year**:
  - (a) the average load weighted **retail ITP**, calculated by dividing the total notional cost of **electricity** under the **retail ITP** arrangements of the **generator retailer** divided by the total amount of **electricity** in **MWh** sold by the **generator retailer** to **mass market customers**;
  - (b) information on how the **generator retailer** has determined the **retail ITP** at a sufficient level of detail to enable a reasonable person to determine whether or not the **generator retailer’s retail ITP** is a fair reflection of the cost of **electricity** to the **generator retailer**.

- (3) The information provided by a **generator retailer** under subclause (2)(b) must include the following:
- (a) a breakdown of the key components or factors which make up the **retail ITP** expressed as an amount in dollars and cents per **MWh** that each key component or factor comprises of the average load weighted **retail ITP** required by subclause (2)(a), and which must include (if relevant) the following components or factors:
    - (i) prices in **ASX NZ electricity futures**:
    - (ii) the distribution of the total electrical load across locations, including the adjustment, calculated on an average load weighted basis in **MWh**, that the **retailer generator** used to determine the **retail ITP** for the **electricity** supplied to **mass market customers** beyond a **node** specified in an **ASX NZ electricity future**:
    - (iii) administrative fees, including management fees, notionally charged by the **generator retailer** to the **generator retailer's** retail arm:
    - (iv) the level of discretion the **generator retailer** exercised to amend or otherwise modify the draft **retail ITP** before it was finalised:
    - (v) all other key components or factors the **generator retailer** relied on to determine the **retail ITP**, and any other material information used by the **generator retailer** to determine the **retail ITP** that is not publicly available:
  - (b) any residual components or factors that make up the **retail ITP**, but which are not components or factors required by paragraph (a), expressed as one combined amount in dollars and cents per **MWh**:
  - (c) an explanation of the methodology the **generator retailer** used to determine or to assist in determining the **retail ITP**, and which must include (if relevant) the following:
    - (i) the assumed process used by the **generator retailer** to build the hedge book of **ASX NZ electricity futures**, including the following:
      - (A) the proportion of **ASX NZ electricity futures** the **generator retailer** assumed would be purchased and the assumed timing of those assumed purchases:
      - (B) the relative weighting of **ASX NZ electricity futures** relating to Benmore as compared to those relating to Otahuhu:
      - (C) the types of **ASX NZ electricity futures** the **generator retailer** assumed to be purchased and the maturities purchased:
      - (D) the basis on which the **ASX NZ electricity futures** are priced:
    - (ii) the approach the **generator retailer** took to adjust for:
      - (A) differences in the within day electrical load and cost profile underlying the **ASX NZ electricity futures** and the **retailer generator's mass market customers** load profile:
      - (B) distribution of electrical load across locations, including the relative use of **FTRs** or historical price differences to price for load by location:

- (iii) the approach or methodology used to determine the electrical load profile, including the following:
    - (A) whether actual or assumed load profiles are relied upon:
    - (B) the degree of granularity of load with respect to location, seasonality and intra-day:
    - (C) the percentage of load by regional geographical location:
  - (iv) the basis for and determination of fees, including management or associated fees, the **generator retailer** notionally charged its retail arm:
  - (v) the basis for and rationale behind any discretion the **generator retailer** exercised:
  - (vi) any other details the **generator retailer** considers material to explain the methodology the **generator retailer** used to determine or assist in determining the **retail ITP**:
- (d) the key non-price parameters the **generator retailer** used to determine the **retail ITP** including whether or not the **retail ITP** is:
- (i) for fixed or variable volume of **electricity**; or
  - (ii) for a fixed or variable price of **electricity**:
- (e) the purposes for which the **retail ITP** is used by the **generator retailer** or the matters relating to the **generator retailer** which the **retail ITP** directly or indirectly affects, including whether the **retail ITP** is used as part of setting, or directly or indirectly affects, the price of **electricity** sold to **mass market customers** by the **generator retailer**.
- (3) Where a **participant** and one or more other **participants** are related companies, as defined in section 2 of the Companies Act 1993, and are required by subclause (1) to make **ITP information** readily available to the public, the obligation in subclause (1) is met by one of those **participants** making the **ITP information** relating to all the **participants** readily available to the public.

### 13.257 Submission of ITP information to the Authority

- (1) Each **generator retailer** must:
- (a) submit the **ITP information** made readily available to the public in accordance with clause 13.256(1) to the **Authority** in the form and by the means specified by the **Authority**;
  - (b) advise the **Authority** of the means by which it made the **ITP information** readily available to the public; and
  - (c) provide sufficient information to the **Authority** under paragraph (b) to enable the **Authority** to find the **ITP information** made readily available to the public, including any website addresses.



- (2) The **generator retailer** must submit the **ITP information** required by subclause (1) to the **Authority** by the earlier of:
  - (a) the date that is no later than 7 days after making the **ITP information** readily available to the public in accordance with clause 13.256(1); or
  - (b) 90 days after the end of the **financial year** of the **generator retailer**.
- (3) Where a **participant** and one or more other **participants** are related companies, as defined in section 2 of the Companies Act 1993, and are required by subclause (1) to submit **ITP information**, the obligation in subclause (1) is met by one of those **participants** submitting the **ITP information** relating to all the **participants** to the **Authority**.

### 13.258 Disclosure of change of methodology

- (1) This clause applies if:
  - (a) a **generator retailer** changes the methodology used to determine the **retail ITP** for a **financial year** (“the current **financial year**”) from the methodology used in a previous **financial year** for which the **generator retailer** disclosed **ITP information** under clause 13.256 and 13.257, other than where that change relates solely to the distribution of the customer load base or the input prices (**ASX NZ electricity futures** prices and locational prices as provided for in clause 13.256 (3)(a) (i) and (ii)); and
  - (b) that change in methodology has the effect of modifying the **retail ITP** by an amount in excess of 5% from the **retail ITP** contained in the most recent **ITP information** the **generator retailer** made readily available to the public.
- (2) Where this clause applies, the **generator retailer** must also make the following information readily available to the public, free of charge:
  - (a) details of the impact on the average load weighted **retail ITP** disclosed under clause 13.256 and 13.257 for any of the previous three **financial years** if the new methodology had been used to determine the **generator retailer’s retail ITP** for those previous **financial years**;
  - (b) details of the impact on the average load weighted **retail ITP** for the current **financial year** if the methodology used in any of those previous **financial years** was used to determine the **generator retailer’s retail ITP** for the current **financial year**.
- (3) Where subclause (2) applies, the **generator retailer** must make the information required by subclause (2) readily available to the public at the same time as making the **ITP information** readily available to the public for the current **financial year**.
- (4) Where this clause applies, the **generator retailer** must, at the same time as making **ITP information** for the current **financial year** readily available to the public in accordance with clause 13.256(1):
  - (a) submit the information made readily available to the public in accordance with subclause (2) to the **Authority** in the form and by the means specified by the **Authority**;

- (b) advise the **Authority** of the means by which it made the information required by subclause (2) readily available to the public; and
  - (c) provide sufficient information to the **Authority** under paragraph (b) to enable the **Authority** to find the information made readily available to the public in accordance with subclause (2), including any website addresses.
- (5) Where a **participant** and one or more other **participants** are related companies, as defined in section 2 of the Companies Act 1993, and are required by subclauses (2) and (4) to make information readily available to the public and to submit information to the **Authority**, the obligations in subclauses (2) and (4) are met by one of those **participants** making the **information** readily available to the public and submitting the information relating to all the **participants** to the **Authority**.

### 13.259 Publication of ITP information by the Authority

- (1) The **Authority** may **publish** any **ITP information** or information submitted to it under clause 13.258, as the **Authority** sees fit.

#### *Submission of retail gross margin reports by retailers*

### 13.260 Submission of retail gross margin report by retailers

- (1) Each **retailer** must submit a **retail gross margin report** to the **Authority** no later than 90 days after the end of the **retailer's financial year**.
- (2) Subclause (1) does not apply to any **retailer** who was recorded in the **registry** in any of the preceding 12 months as being responsible for less than 1% of the total number of **ICPs** registered in the **registry**.
- (3) The **retail gross margin report** must consist of the following information relating to the sale of **electricity** to **mass market customers** for the **financial year** by the **retailer**:
  - (a) the total amount of electricity sold by the retailer to mass market customers expressed as **MWh**;
  - (b) revenue derived from the sale of **electricity** to **mass market customers** expressed as an amount per **MWh**;
  - (c) cost of **electricity** sold by the **retailer** to **mass market customers**, including the cost of **electricity** derived from **retail ITP**, expressed as an amount per **MWh**;
  - (d) cost of **metering** services associated with the sale of **electricity** to **mass market customers** expressed as an amount per **MWh**;
  - (e) cost of **distribution** services associated with the sale of **electricity** to **mass market customers** expressed as an amount per **MWh**;
  - (f) cost of transmission services, being those services provided by **Transpower** under a **transmission agreement**, paid by the **retailer** associated with the supply of **electricity** to **mass market customers** by the **retailer** expressed as an amount per **MWh**; and

- (g) cost of levies associated with the supply of **electricity** to **mass market customers** by the **retailer** expressed as an amount per **MWh**.
- (4) A **retail gross margin report** must be prepared in accordance with generally accepted accounting practices and in the form specified by the **Authority**.
- (5) Where a **participant** and one or more other **participants** are related companies, as defined in section 2 of the Companies Act 1993, and are required by subclause (1) to submit **retail gross margin** reports to the Authority, the obligation in subclause (1) is met by one of those **participants** making the **ITP information** relating to all the **participants** readily available to the public.

### **13.261 Publication of information contained in retail gross margin reports by the Authority**

- (1) The **Authority** may **publish** the information received in a **retail gross margin report**, except that information contained in a **retail gross margin report** submitted by a **retailer** with less than 5% of total market share by **ISP** will be anonymised so as not to identify that **retailer**.

*Authority may require review of ITP information and retail gross margin reports*

### **13.262 Authority may require review of ITP information and retail gross margin reports by independent person**

- (1) The **Authority** may, in its discretion, require a review by an independent person of whether—
  - (a) a **generator retailer** may not have complied with any or all of clauses 13.256 to 13.258; and
  - (b) a **retailer** may not have complied with clause 13.260.

### **13.263 Nomination of independent person to undertake review**

- (1) If the **Authority** requires a review under clause 13.262—
  - (a) the **Authority** must require the **generator retailer** or **retailer** to nominate an appropriate independent person to undertake the review; and
  - (b) the **generator retailer** or **retailer** must provide that nomination within a reasonable timeframe.
- (2) The **Authority** may direct the **generator retailer** or **retailer** to appoint the person nominated under subclause (1) or to nominate another person for approval.
- (3) If the **generator retailer** or **retailer** fails to nominate an appropriate person under subclause (1) within 5 **business days**, the **Authority** may direct the **generator retailer** or **retailer** to appoint a person of the **Authority's** choice.
- (4) The **generator retailer** or **retailer** must appoint a person to undertake the review in accordance with a direction made under subclause (2) or subclause (3).

### 13.264 Factors relevant to a direction under clause 13.263

- (1) In making the direction required by clause 13.263(2) or clause 13.263(3), the **Authority** may have regard to any factors it considers relevant in the circumstances, including the following:
  - (a) the degree of independence between the **generator retailer** or **retailer** and the person nominated under clause 13.263(1);
  - (b) the expected quality of the review; and
  - (c) the expected costs of the review.
- (2) For the purposes of subclause (1)(a), the **Authority** may have regard to the special definition of independent under clause 1.4 but is not bound by that definition.

### 13.265 Carrying out of review by independent person

- (1) A **generator retailer** or **retailer** subject to a review under clause 13.262 must, on request from the person undertaking the review, provide that person with such information as the person reasonably requires in order to carry out the review.
- (2) The **generator retailer** or **retailer** must provide the information no later than 10 **business days** after receiving a request from the person for the information.
- (3) The **generator retailer** or **retailer** must ensure that the person undertaking the review—
  - (a) produces a report on whether, in the opinion of that person, the **generator retailer** or **retailer** may not have complied with clauses 13.256 to 13.258 or 13.260 (as specified by the **Authority**) under clause 13.262; and
  - (b) submits the report to the **Authority** within the timeframe specified by the **Authority**.
- (4) The report produced under subclause (3)(a) must include any other information that the **Authority** may reasonably require.
- (5) Before the report is submitted to the **Authority**, any identified failure of the **generator retailer** or **retailer** to comply with clauses 13.256 to 13.258 or 13.260 must be referred back to the **generator retailer** or **retailer** for comment.
- (6) The comments of the **generator retailer** or **retailer** must be included in the report.

### 13.266 Payment of review costs

- (1) If a report received under clause 13.265(3)(a) establishes, to the **Authority's** reasonable satisfaction, that the **generator retailer** or **retailer** may not have complied with clauses 13.256 to 13.258 or 13.260 (whether or not the **Authority** appoints an investigator to investigate the alleged breach), the **generator retailer** or **retailer** must pay the costs of the person who undertook the review.
- (2) Despite subclause (1), if a report establishes, to the **Authority's** reasonable satisfaction that any non-compliance of the **generator retailer** or **retailer** is minor or there is any other reason in the **Authority's** view that means the **generator retailer** or **retailer** should not pay the costs of the person who undertook the review, the **Authority** may, in its discretion, determine the proportion of the person's costs that the **generator retailer** or **retailer** must pay, and the **generator retailer** or **retailer** must pay those costs.

- (3) If a report establishes to the **Authority's** reasonable satisfaction that the **generator retailer** or **retailer** has complied with clauses 13.256 to 13.258 or 13.260, the **Authority** must pay the person's costs.

### **13.267 Requirement to provide complete and accurate information**

- (1) In addition to the requirements of clause 13.2, the **generator retailer** or **retailer** must take all practicable steps to ensure that the information that the **generator retailer** or **retailer** is required to provide to any person under clauses 13.256 to 13.258 or 13.260 is complete and correct.
- (2) If a **generator retailer** or **retailer** becomes aware that any information the **generator retailer** or **retailer** provided under clauses 13.256 to 13.258 or 13.260 does not comply with subclause (1) or clause 13.2, even if the **generator retailer** or **retailer** has taken all practicable steps to ensure that the information complies, the **generator retailer** or **retailer** must, as soon as practicable, provide such further information as is necessary to ensure that the information provided complies with clauses 13.256 to 13.258, 13.260 or clause 13.2.

**Q.24 Do you have any comments on the drafting of the proposed amendment?**

## Appendix B Format for submissions

Submitter	
Question	Comment
Q1. Do you agree the issues identified by the Authority are worthy of attention?	
Q2. Do you agree with the objectives of the proposed amendment? If not, why not?	
Q3. Do you agree that disclosure of ITP by large generator-retailers is important for trust and confidence in electricity markets?	
Q4. Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?	
Q5. Do you agree that the generator-retailers subject to these provisions should have an obligation to demonstrate their ITP are a fair reflection of the cost of electricity?	
Q6. Do you agree that ITP disclosure requirements should encompass the price, pertinent details of the methodology used, the major component parts which the price comprises, and the terms and conditions?	
Q7. Do you have any comments on the specifics of the information requirements with respect to the price, methodology, component parts, and terms and conditions?	
Q8. Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?	
Q9. Do you agree that generator-retailers which own more than one retail business, and supply electricity to each by way of an ITP, should be permitted to report on a consolidated basis?	
Q10. Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?	
Q11. Do you agree it would be helpful if the Authority published prices for a series of benchmark hedging strategies, for the purposes of evaluating whether generator-retailers' internal pricing reflects the cost of electricity? Are there any specific benchmark strategies you would like to see published?	
Q12. Do you agree that to be a fair reflection of the cost of electricity, large integrated generator-retailers' ITPs should reflect the costs and risks of being part of a vertically integrated entity? Or should their ITPs include the additional costs and risks their retail arms would face if they were not part of an integrated business?	

<p>Q13. Do you agree that differences in risk largely explain the variation in the appetite and pricing generators are willing to offer fixed price variable volume contracts to internal parties, commercial and industrial clients, and independent retailers?</p> <p>Q14. Do you agree that where a generator-retailer changes their ITP methodology and it has an impact of more than 5% on the current years ITP, that they be required to disclose the impact the new policy would have on the preceding three financial years and the current years ITP and retail segment profitability disclosures?</p> <p>Q15. Do you support electricity retail segment profitability reporting?</p> <p>Q16. Do you believe that for multiple product line retail businesses, the costs and revenues specific to electricity can be unbundled from other product lines, with sufficient rigour to advance confidence in the electricity industry?</p> <p>Q17. Do you support requiring gross margin electricity retail segment reporting?</p> <p>a. If so:</p> <p>i. How precisely would this information be used to identify potential anti-competition concerns and improve decision making on retail competition settings? Please provide illustrations.</p> <p>ii. What assurances are there that reported differences arising due to legitimate commercial reasons won't be misconstrued as evidence of anti-competitive practices?</p> <p>b. If not:</p> <p>i. Do you have a preferred alternative retail segment profitability metric which is feasible and low cost to implement, and would improve information on potential anti-competitive practices?</p> <p>Q18. If retail segment gross margin reporting was introduced, do you agree:</p> <p>a. With the proposed definition and line items constituting gross margin?</p> <p>b. That gross margin and the constituent parts should be reported on nominal dollars and a per MWh basis?</p> <p>c. That firms with more than 1% market share of all ICPs should be subject to these provisions?</p> <p>d. That reporting should be centralised on the Authority's EMI website?</p> <p>e. That firms with less than 5% market share of ICPs would be reported on an anonymised basis on the EMI, and only report on a per MWh basis?</p> <p>f. That entities with more than one retail business can report on a consolidated basis?</p>	
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<p>Q19. Do you agree that gross margin segmented retail reporting at an aggregate country level is sufficient to support confidence in the wholesale market? If not:</p> <p>a. What categorisations would you propose?</p> <p>b. How would further granularity advance trust and confidence?</p> <p>c. What would the marginal cost of reporting at increased granularity be compared to the proposal in the paper?</p> <p>Q20. Do you support mandating gross margin reporting for the generation, and commercial and industrial segments? If so,</p> <p>a. What line items would you propose for each segment?</p> <p>b. How precisely would this information be used to identify potential anti-competition concerns? Please provide illustrations.</p> <p>c. What assurances are there that reported differences arising due to legitimate commercial reasons won't be misconstrued as evidence of anti-competitive practices?</p> <p>Q21. Do you agree the benefits of the proposed amendment outweigh its costs?</p> <p>Q22. Do you agree the proposed amendment is preferable to the other options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.</p> <p>Q23. Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?</p> <p>Q24. Do you have any comments on the drafting of the proposed amendment?</p>	
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## Glossary of abbreviations and terms

<b>Authority</b>	Electricity Authority
<b>Act</b>	Electricity Industry Act 2010
<b>Code</b>	Electricity Industry Participation Code 2010
<b>Regulations</b>	Electricity Industry (Enforcement) Regulations 2010