



19 May 2021

Submissions
Electricity Authority

By email: wholesaleconsultation@ea.govt.nz

Internal transfer prices and segmented profitability reporting

Meridian appreciates the opportunity to provide feedback to the Electricity Authority (**Authority**) on the consultation paper *Internal transfer prices and segmented profitability reporting*.

The Authority considers that the Code should be amended to require large generator-retailers to disclose annually their internal transfer price (**ITP**), as well as supporting information to improve third party understanding of what it represents and how it was derived. The Authority is also considering mandatory segmented profitability reporting for electricity businesses but is yet to decide on the merits of this and to whom the regime would apply.

Consultation on these two proposals follows the Final Report of the Electricity Price Review, which stated that:

“The Electricity Authority should require vertically integrated companies to report separately on the financial performance of their retailing and generation/wholesale operations using a common (regulated) set of reporting rules.”

Meridian did not oppose this option during consultation on the Electricity Price Review and Meridian continues to be open to this as a relatively low cost transparency measure. Meridian’s annual reports already disclose the ITP and the financial performance of different

segments following International Financial Reporting Standards (*NZ IFRS 8 Operating Segments*). The public disclosure of Meridian's segment performance provides a clear view of the component parts of the company's consolidated annual results. The retail segment is reported independently of wholesale and Meridian's international businesses allowing a consistent view of segment performance over time.

Because of this starting point, Meridian does not oppose the Authority's ITP proposal as it may provide some benefit, is not likely to be overly onerous and has a low risk of harm. However, this submission includes some suggestions to improve the proposal and ease the compliance burden.

Mandatory reporting of internal transfer price

While compliance costs may be low, Meridian believes the benefits to consumers from the proposed mandatory reporting of ITP are likely to be limited. The proposal may be helpful in dispelling some of the myths promulgated by non-integrated retailers in this area and while an industry educational exercise may be useful, this needs to be weighed against the increased and ongoing regulatory costs.

Meridian considers ITPs to be essentially an accounting mechanism via which to benchmark retail performance over time. The level of the ITP makes no difference to a generator-retailer's overall performance. Meridian agrees with the Authority that "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."¹ Meridian also agrees with the Authority that "ITPs do not unduly impact generator-retailer decisions which have a direct bearing on competitive practices: importantly, ITPs are not used by integrated-retailers to price new retail customers or to drive retail strategy within a period."²

Given the above we query the Authority's problem definition and its identification of benefits to consumers of regulating disclosure of ITP and retail segment profitability. Appendix B of this submission contains a short paper from NERA Economic Consulting on the problems (or lack thereof) identified by the Authority.

A key concern Meridian has with the current drafting of the proposed amendment is that proposed clause 13.256(2)(b) implies that ITP should reflect the "fair...cost" of electricity for

¹ Consultation paper, para 2.18.

² Consultation paper, para 3.43.

a generator retailer. This risks perpetuating some of the myths referenced above and is inconsistent with acknowledgements by the Authority elsewhere that ITP is purely notional (see below) and is “little more than an internal means of accounting for the allocation of profits and risks between two internal groups”.³ Meridian suggests that proposed clause 13.256(2)(b) be reworded to require disclosure of “information on how the **generator retailer** has determined the **retail ITP** at a sufficient level of detail to enable a reasonable person to understand how the **retail ITP** was determined ~~determine whether or not the generator retailer’s retail ITP is a fair reflection of the cost of electricity to the generator retailer.~~”

Meridian also suggests that proposed clause 13.257 should require the generator retailer to send the Authority a copy of, or a link to, the publicly available information. The requirement to use a prescribed form adds unnecessarily to the compliance burden by creating a duplication of effort.

Finally, Meridian strongly agrees with the following statement from the Authority:⁴

“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:

³ Consultation paper, para 3.37.

⁴ Consultation paper, para 3.41.

- (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.”

Mandatory reporting of retail gross margin

According to the consultation paper, “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.”⁵

Given the structure and level of competition in the wholesale and retail electricity markets, it would be near to impossible for any one firm to act in a predatory manner towards others by lowering retail prices below profitable levels with the intention of then recouping losses once others are forced out the market. The main upshot would be that consumers would benefit from lower prices. The firm would not have the ability to make back its losses as competition and low barriers to entry would not allow higher prices in the long term. Mandatory disclosure of retail gross margins will therefore provide only limited insight into the sector’s competitiveness. In fact, by regulating disclosure the Authority risks elevating the perceived importance of this information and exacerbating the extent to which non-integrated retailers misinterpret and misrepresent ITP, segment profitability, and vertically integrated business models.

Mandatory reporting of retail gross margin as currently proposed by the Authority would also inappropriately discriminate between large firms and the small firms not required to provide such reports (firms below the 1% threshold) and firms whose reporting is anonymised (firms below the 5% threshold). These smaller firms will gain insight into their rivals’ costs and margins, while not facing the same transparency themselves. This would distort the retail market. Meridian does not consider distortions of this kind to be in the long term interests of consumers and does not consider the introduction of such distortions is generally

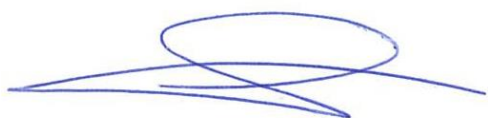
⁵ Consultation paper, para 3.85.

consistent with the Authority's objective to promote competition. While the proposed different treatment of very small firms below the 1% threshold is possibly justifiable under the *de minimis* principle, Meridian does not agree with the proposed anonymity for retailers with less than 5% of ICPs.

Meridian's responses to the consultation questions are included in Appendix A.

Please contact me if you have any queries regarding this submission.

Yours sincerely

A handwritten signature in blue ink, consisting of several overlapping loops and a long horizontal stroke extending to the left.

Sam Fleming
Manager Regulatory and Government Relations

Appendix A: Responses to consultation questions

	Question	Response
1.	Do you agree the issues identified by the Authority are worthy of attention?	Meridian considers the Authority's proposed amendments to the Code are likely to be of very limited benefit to consumers.
2.	Do you agree with the objectives of the proposed amendment? If not, why not?	The proposed amendments are intended to increase trust and confidence in the wholesale and retail markets. Trust and confidence are not measurable objectives and it is not clear whose trust and confidence the Authority seeks to increase. There is also no clear link to the long term benefit of consumers.
3.	Do you agree that disclosure of ITP by large generator-retailers is important for trust and confidence in electricity markets?	No. Non-integrated firms have misunderstood and misrepresented the role of ITP. It is not a useful measure by which to consider competition in electricity markets. It would be better if the misunderstandings and misrepresentations were addressed directly rather than by mandating disclosures and thereby adding to the regulatory costs faced by the sector.
4.	Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?	The benefits to consumers are likely to be limited.
5.	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?	No.
6.	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?	<p>Yes, if ITPs are to be mandatorily disclosed then these matters should be disclosed as part of that. However, the Code should not prescribe components and the words "if relevant" should be retained throughout proposed clause 13.256(3) so as not to force generator retailers into a specific method for determining ITP.</p> <p>Any benchmark will do for tracking the long term performance of a retail business. For example, there should be no issue in principle if a generator retailer chose to set its ITP at the level of very long run average wholesale electricity prices (say a 10 year rolling average).</p>

7.	Do you have any comments on the specifics of the information requirements with respect to the price, methodology, component parts, and terms and conditions?	See above.
8.	Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?	<p>While any threshold will be somewhat arbitrary, Meridian considers the proposed thresholds to be reasonable.</p> <p>However, the thresholds should not be implemented via the defined term generator retailer. That terms should refer to any firm that both sells electricity to the clearing manager and retails at ICPs. It is a business model that can be adopted irrespective of scale. If the Authority wants to apply <i>de-minimis</i> thresholds to the proposed reporting requirements it should do so outside of the definition of generator retailer.</p>
9.	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?	Yes.
10.	Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?	<p>While we are not convinced that ITP disclosures have significant value, to the extent there is an interest in them it would make sense for the Authority to report on the disclosures in one place. The Authority can easily source this information from annual reports.</p> <p>Meridian does not support the proposal to require separate reporting to the Authority of this information via a prescribed form. This creates duplication and an unnecessary added compliance burden. It should be sufficient for the firm to make the information readily available to the public and provide the Authority with a link to, or copy of, that information.</p>
11.	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	Yes, provided the Authority is clear that there are other valid hedging strategies and methods of determining ITP besides those reflected in the benchmarks. It is also important that the Authority is clear on the limited purpose of benchmarks. As the Authority notes "ITPs do not unduly impact generator-retailer decisions which

	any specific benchmark strategies you would like to see published?	have a direct bearing on competitive practices: importantly, ITPs are not used by integrated-retailers to price new retail customers or to drive retail strategy within a period.” ⁶
12.	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?	We agree that it would be reasonable for the ITP to reflect the costs and risks of being part of a vertically integrated entity. However, as noted above if the Authority publishes benchmarks, they should reflect a very wide range of feasible approaches and should also indicate that those approaches are not the only ones that might be valid or reasonable.
13.	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?	Yes.
14.	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.	No. It is not clear why any change in ITP methodology should be retrospectively applied to previous years when in reality a different ITP was used in those years and financial reporting in respect of those years has been completed. The Authority has not articulated what benefit would result from this retrospective reporting. The main (and potentially only) effect would likely be to disincentivise any changes to ITP methodologies. It’s not clear why this is a good policy goal.
15.	Do you support electricity retail segment profitability reporting?	No as it seems to us it would provide little benefit to consumers.

⁶ Consultation paper, para 3.43.

16.	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?	Meridian does not bundle other products with electricity so is not well placed to answer this question.
17.	<p>Do you support requiring gross margin electricity retail segment reporting?</p> <p>a. If so:</p> <ul style="list-style-type: none"> 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? <p>b. If not:</p> <ul style="list-style-type: none"> 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 anticompetitive practices? 	<p>No. Meridian's preference would be to not mandate the reporting of retail segment profitability. Voluntary disclosures already occur, and we do not consider mandatory reporting of this information to provide any useful insights into potential anti-competitive concerns or retail competition regulatory settings. Furthermore, the retail market is highly competitive, and the Commerce Act 1986 already prohibits practices that substantially lessen competition, cartels, and the taking advantage of market power.</p> <p>Independent retailers will almost certainly argue that differences in retail profitability are a cause for concern. Meridian considers it likely that the proposal will encourage misrepresentation of the market and further misunderstandings rather than increase trust and confidence.</p>
18.	<p>If retail segment gross margin reporting was introduced, do you agree:</p> <ul style="list-style-type: none"> 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? 	<p>If, despite this submission, retail segment gross margin reporting was introduced then Meridian agrees with a. to d and f. However, reporting to the Authority should be a simple case of providing the Authority with a copy of, or link to, the information made readily available to the public. Requiring use of an approved form will duplicate efforts and increase compliance costs for no reason.</p> <p>In respect of e. Meridian disagrees that firms with less than 5% market share of ICPs should be anonymised. Reporting should be standardised</p>

	<ul style="list-style-type: none"> 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? 	<p>to ensure a level playing field of available information about competitors and avoid market distortions. Meridian does not consider retail market distortions of this kind to be in the long term interests of consumers.</p>
19.	<p>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> <ul style="list-style-type: none"> 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? 	<p>If, despite this submission, retail segment gross margin reporting was introduced then yes – reporting at an aggregate country level is sufficient.</p>
20	<p>Do you support mandating gross margin reporting for the generation, and commercial and industrial segments? If so,</p> <ul style="list-style-type: none"> 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? 	<p>No. Meridian agrees with the Authority that mandating gross margin reporting for commercial and industrial businesses rather than mass market would be problematic. There would be a wide range of legitimate margin variability based on cost inputs as well as depending on such things as when supply contracts were signed, locational, and load differences.</p> <p>Gross margin reporting by segment would also increase the risk of distorting competition in the market. If gross margin reporting by segment (mass market, commercial, industrial) proceeds, it would be even more critical to remove the anonymity thresholds so that all competitors would have access to the same information and could compete on the same basis.</p>
21.	<p>Do you agree the benefits of the proposed amendment outweigh its costs?</p>	<p>The total annual compliance costs are expected to range from between \$370,000 and \$1,090,000,</p>

		<p>whereas the benefits are unclear and not able to be easily quantified.</p> <p>Meridian considers the benefits described in the consultation paper could be delivered if the Authority simply published a paper to dispel myths about ITP and explain to participants why differences between ITP and retail or hedge offerings are not grounds for competition concerns.</p>
22.	<p>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>Meridian is not opposed to mandatory ITP reporting. However, given 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" it is not clear that mandatory reporting of ITP would confer any significant benefit on market participants or consumers. There is a risk that any minor benefits identified would likely be outweighed by the added costs of compliance with mandatory reporting requirements. Therefore, Meridian strongly supports the Authority's expectation that a post implementation review of the policy would be conducted two years after implementation. This will be a useful check to see if the benefits of any amendments are still considered to outweigh their costs.</p>
23.	<p>Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?</p>	<p>This seems debatable.</p> <p>Section 32(1)(a) – the Code may contain provisions that promote competition in the electricity industry – this is different to promoting <i>confidence</i> in competition. Furthermore, retail gross margin reporting risks distorting competition to the extent that thresholds are applied so that some retailers will have increased access to information while others do not.</p> <p>Section 32(1)(b) – the Code may contain provisions that promote the reliable supply of electricity to consumers. It is not clear that increased confidence in retail competition will necessarily support investment in generation. The independent retailers that seem to lack confidence in competition do not invest in</p>

		<p>generation and choose to operate very low capital business models.</p> <p>Section 32(1)(c) – the Code may contain provisions that promote the efficient operation of the electricity industry. It is not clear how mandatory (as opposed to voluntary) ITP disclosures would promote the more efficient operation of the market.</p> <p>Meridian agrees that section 32(1)(e) and (d) are not relevant to the proposed amendment.</p>
24.	Do you have any comments on the drafting of the proposed amendment?	Meridian comments on the drafting in the cover letter of this submission as well as the responses to questions 6 and 8 above.

Appendix B: NERA Report

MEMO

TO: Jason Woolley and Sam Fleming, Meridian Energy
DATE: 18 May 2021
FROM: James Mellsop and Will Taylor
SUBJECT: **Problem definition underlying “Internal transfer prices and segmented profitability reporting” consultation paper**

1. Introduction and conclusion

1. On 8 April 2021, the Electricity Authority (“**the Authority**”) released a consultation paper entitled “Internal transfer prices and segmented profitability reporting” (“**the Consultation Paper**”). The Consultation Paper proposes to require disclosure of:
 - a. The internal transfer prices (“**ITPs**”)¹ set by vertically integrated generator/retailers (“**gentailers**”); and
 - b. Retail gross margins of electricity retailers.
2. We understand that Meridian Energy will be submitting its views on the proposals in the Consultation Paper. Meridian has asked us to focus more narrowly on the problem definition contained in the Consultation Paper, particularly to provide our views on the adequacy of the problem definition.
3. In our view, the Consultation Paper does not adequately define any problems that would justify increased disclosure of ITPs or retail margins. We explain why in this memo, which is structured as follows:
 - a. Section 2 sets out the Authority’s problem definition, which is essentially that gentailers will set the ITP and the retail price “too low”, precluding independent retailers;
 - b. Section 3 describes the conditions for predatory pricing to be rational, notes the Authority has not demonstrated these conditions are likely to hold as part of its problem definition and identifies evidence suggesting they are unlikely to hold;
 - c. Section 4 sets out the Authority’s acknowledgment that the ITP has little impact on commercial decision-making and points out that the Authority has not reconciled this acknowledgment with its proposal to require disclosure of the ITP;
 - d. Section 5 outlines why there are risks in attempting to “level the playing field” after investments have been made; and
 - e. Section 6 points out that the Authority’s aim of price being near short-run marginal cost (“**SRMC**”) should not be narrowly applied such that it is in conflict with generator cost recovery and prices tracking long-run marginal cost (“**LRMC**”).

¹ And methodology and non-price terms.

2. The Authority’s problem definition

4. The Consultation Paper ostensibly identifies two potential problems:
 - a. The gentailers may set ITPs that are “below fair market prices”² and accordingly favour their retail businesses over the “independent retailers”; and
 - b. The gentailers may set their retail prices below cost,³ predating the independent retailers.⁴
5. If these behaviours were occurring, the effect would appear to be:
 - a. Good for electricity consumers; and
 - b. Bad for the gentailers and the independent retailers.
6. This last point is very important. The irony of the Consultation Paper is that it is proposing to implement policies intended to discourage what the Authority considers to be prices that are too low. Policies that are intended to discourage low prices would of course suit the independent retailers, but may not be in the long-term interests of consumers.
7. We also note the Consultation Paper states ([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 [emphasis added].*
8. This statement appears to describe a theory of harm known as “raising rivals’ costs”. It is not clear how this is relevant to a discussion of the ITP, as by definition the ITP only relates to how the vertically integrated firm deals with itself, not third parties.
9. It is also not clear whether the Consultation Paper has in mind individual “strategic” behaviour by the gentailers or some sort of concerted behaviour. A necessary condition for anticompetitive strategic behaviour is that the party alleged to be behaving “strategically” has substantial market power. However, the Consultation Paper does not discuss whether each gentailer has substantial market power or any theory about whether there is somehow joint substantial market power.

² Consultation Paper, page i.

³ Consultation Paper, page ii.

⁴ Consultation Paper, page 4.

3. **Predatory pricing requires recoupment, and the Authority has not assessed the likelihood of this occurring**

10. If the Consultation Paper’s concern that gentailers may set retail prices below costs was correct, then by definition the gentailers would be sacrificing profits, at least in the short-run. The only way this gentailer retail pricing behaviour could be rational would be if it resulted in:⁵
- a. Independent retailers exiting the market, being forced to such a low market share as to be rendered competitively ineffective, or being deterred from entering the market;⁶
 - b. The gentailers then raising retail prices (whether independently or collectively) to recoup the losses they incurred during the predatory period; and
 - c. Independent retailers not re-entering the market, or expanding, when the gentailers attempt to raise price (or one or more gentailers not expanding).
11. The Consultation Paper does not explore the likelihood of these conditions. For example, the Consultation Paper does not explore whether there would be any barriers to independent retailers (re-)entering the market if the gentailers attempted to raise retail price. On its face, it seems unlikely there would be any material barriers, given that:
- a. There are currently 27 independent retailers operating in New Zealand.⁷ While many of these will be very small, five of them have between 10,000 and 100,000 ICPs;⁸ and
 - b. The market share of these independent retailers as a group has been increasing from around 4.3% in March 2011 to 16.2% in March 2021.⁹ Indeed, at [2.26] the Consultation Paper notes that “there has been growth in the market share of independent electricity retailers”.
12. Relatedly, a necessary condition for predatory pricing is that the alleged predator has substantial market power. Without substantial market power, the alleged predator would not be able to raise

⁵ See, for example, at Massimo Motta (2004), *Competition Policy: Theory and Practice*, Cambridge University Press, at p.412; Dennis W. Carlton and Jeffrey M. Perloff (2005), *Modern Industrial Organization*, Fourth Edition, Pearson Addison-Wesley, at pp.352-353; and Kenneth G. Elzinga and David E. Mills (2015), “Predatory Pricing”, chapter 2 in Roger D. Blair and D. Daniel Sokol (eds.), *The Oxford Handbook of International Antitrust Economics*, vol 2, Oxford University Press at p.42.

⁶ Much of the literature defines predatory pricing only in terms of the predator inducing the exit of rivals or deterring their entry. However, Milgrom and Roberts (1990, p.112) define predatory pricing as “the temporary charging of particularly low prices in order to improve long-run profitability by inducing exit, deterring entry, or ‘disciplining’ rivals into accepting relatively small market shares” (Paul Milgrom and John Roberts (1990), “New Theories of Predatory Pricing”, in Giacomo Bonanno and Dario Brandolini (eds.), *Industrial Structure in the New Industrial Economies*, Oxford University Press). Similarly, Motta (2004, p.443) refers to “the exit (or down-sizing) of the prey” (Massimo Motta (2004), *Competition Policy: Theory and Practice*, Cambridge University Press).

⁷ EA EMI, Market Share Snapshot, accessed 3/5/2021, https://www.emi.ea.govt.nz/Retail/Reports/R_MSS_C?MarketSegment=Res&seriesFilter=ALL&si=db|BZTDDC.dri|969.v|3

⁸ EA EMI, Market Share Snapshot, accessed 3/5/2021, https://www.emi.ea.govt.nz/Retail/Reports/R_MSS_C?MarketSegment=Res&seriesFilter=ALL&si=db|BZTDDC.dri|969.v|3#tabs-2

⁹ EA EMI, Market Share Trends, accessed 3/5/2021, https://www.emi.ea.govt.nz/Retail/Reports/R_MST_C?DateFrom=20110301&DateTo=20210331&Grouping=T5Grp&Percent=Y&si=db|BZTDDC.dri|971.v|3

prices after the predation episode.¹⁰ Once again, the Consultation Paper does not discuss whether each gentailer has substantial market power in the retail market.¹¹ Given there are five gentailers in addition to the independent retailers, this seems unlikely, at least at a national level.

13. In addition, while the five gentailers supply the majority of the generation in New Zealand,¹² because the wholesale market in New Zealand is essentially an open access “gross pool”,¹³ they are unable to use their generation positions to deny access to retailers seeking to re-enter.
14. For these reasons, we do not consider that the Consultation Paper has adequately identified or defined a retail predation problem.

4. Internal transfer prices do not impact commercial decisions

15. Regarding the setting of ITPs that are “too low”, the Consultation Paper acknowledges that an ITP is really just an accounting number that does not affect the economic decision-making. For example, the Consultation Paper states (at [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.

16. However, the Consultation Paper does not reconcile this acknowledgment with its theory of harm that ITPs may be “too low” and the proposal to require increased disclosure by gentailers of their ITPs. If the ITP does not affect commercial decision making, including pricing:
 - a. How can the ITP disadvantage independent retailers?
 - b. What is the point of requiring disclosure of the ITP?
 - c. How can disclosure of the ITP increase “market confidence”, an aim the Consultation Paper frequently refers to?¹⁴

¹⁰ For example, at Massimo Motta (2004), *Competition Policy: Theory and Practice*, Cambridge University Press, at p.443, states “A necessary element for predation is the ability to more than compensate after the exclusion of the competitor for the minor profits made during the predation episode. Clearly, this requires the existence of market power on the side of the firm, and the stronger its market power the more likely for it to gain in the long-run from the exit (or down-sizing) of the prey”.

¹¹ Or whether there is some joint market power theory.

¹² MBIE, Electricity Industry, <https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-generation-and-markets/electricity-market/electricity-industry/>.

¹³ In a “gross pool” all energy is traded through the spot market. Therefore any party can buy power on the demand side of the market irrespective of whether it is supplying power on the supply side.

¹⁴ For example, the executive summary of the Consultation Paper uses the word “confidence” seven times.

5. Levelling the playing field

17. The Consultation Paper’s aim “to ensure independent retailers can compete on a level playing field”¹⁵ appears on its face to be an uncontroversial objective. However, there is an economic difference between “levelling the playing field”:
- a. Before firms make their business model and investment decisions; and
 - b. After firms make their business model and investment decisions.
18. There is a risk that “levelling the playing field” after firms make their business model and investment decisions effectively amounts to “changing the rules of the game” in favour of one business model over another. In respect of electricity supply, risk management is fundamental to competing, and is a cost of doing business, incurred by both incumbents and entrants. Some firms choose to manage risk by vertically integrating (i.e., investing in generation) and others choose not to. Care is needed that any attempts to “level the playing” field do not:
- a. Undermine the efficiencies the vertically integrated firms anticipated when making their investments, as this would deter future investment; or
 - b. Give a “leg up” to firms that have opted not to make the investments, if that “giving a leg up” could result in social costs (e.g., deterred investment that would have been efficient).
19. Perhaps in the present case the dynamic efficiency costs of the proposed disclosure policies will not be significant (but as already noted in this memo, we question the rationale for, and the benefits of, these policies). However, the point remains that there are risks to using an *ex post* “levelling the playing field” justification for changes in policy. Such a justification could result in policies that skew electricity supply entry and expansion towards the relatively low investment independent model and away from the more investment intensive vertical integration model.¹⁶ This would lower “market confidence”, not raise it (unless the concern is more narrowly with independent retailer confidence).

6. SRMC versus LRMC

20. As a final comment, the Consultation Paper states ([2.1]):

The Authority aims to ensure ... 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.

21. It is not clear whether the Consultation Paper is referring here to wholesale or retail prices, or both. Regardless, care is needed in focussing narrowly on SRMC. For example, New Zealand has an energy-only wholesale market where generators receive the market clearing price, rather than the price they bid. Variable and fixed costs must therefore be recovered through a single per unit price. Like in most real-world, workably competitive markets, generators need to find opportunities to recover their fixed as well as their marginal costs. Price will need to exceed SRMC frequently enough, and by enough, to recover those fixed costs.

¹⁵ [2.1] of the Consultation Paper.

¹⁶ ITP disclosure is not the only regulation proposed or put in place by the Authority that risks disincentivising vertical integration to manage risk and giving a “leg up” to non-integrated firms (as opposed to levelling the playing field). Requiring the four largest vertically integrated firms to market-make without explicit compensation is another example.

22. Over time, electricity prices in a workably competitive wholesale market will average the LRMC of new entrant power stations, although will spend periods of time both above and below this level.¹⁷

¹⁷ Marginal cost is the cost producing the next unit of electricity. SRMC is marginal cost measured over the *short run* and therefore excludes fixed and capital costs. LRMC measures the costs of producing the next unit of electricity over the *long run* and therefore includes fixed and capital costs.