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nova energy

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Submissions
Electricity Authority
PO Box 10041
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By email: wholesaleconsultation@ea.govt.nz

Re: Consultation Paper – Internal transfer prices and segmented profitability reporting

Nova Energy understands this discussion paper has been prepared in response to allegations that the generator-retailers are not trading on an equitable basis in competition to the independent retailers. The results of the analysis in the paper suggests there is little evidence of that occurring but concludes there is a net benefit in increasing the disclosure requirements anyway, despite increased compliance requirements.

While the increased transparency will help allay the concerns of some parties, Nova is still not convinced that the benefits outweigh the potential unintended consequences. If the Authority chooses to produce its own benchmark internal transfer price (ITPs), albeit based on market futures prices, there is a risk that retailers will opt to move to that level, irrespective of their own internal costs. Such convergence will not necessarily lead to a more competitive retail market but may result in more volatile residential prices over time.

In Nova's view the threshold for full disclosure in relation to the ITP proposal should be set at a level that captures only those with significant market share, i.e. of a size that could raise competition concerns. A 5% threshold is too low. It captures parties too small to influence the retail market from a competition perspective, while imposing additional regulatory burdens and costs. As such the cut-off of 5% share of ICP's should be increased (Nova suggests 10%), or the definition used to set the public disclosure level be redefined.

Likewise, in relation to the mass market gross margin reporting, Nova suggests that only those firms with a market share of more than 10% of all ICPs should be named. Otherwise the proposal risks capturing retailers which do not have sufficient market share to exercise market power.

Nova's detailed response is appended to this letter. Please feel free to contact me if you wish to discuss our views further.

Yours sincerely

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Nova submission

Consultation Paper – Internal transfer prices and segmented profitability reporting

Q No.	Question	Response
Q1.	Do you agree the issues identified by the Authority are worthy of attention?	The Authority states: *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*. The Authority has also undertaken some work to determine the internal transfer prices (ITPs) of the major retailers for 2018 – 2021. These prices appear to be within the scope of what might be expected. Given the volatility of the data used to determine the ITPs, and the nebulous benefits of what is expected to be achieved, the topic does not seem to warrant the level of attention it has been given, particularly given the additional compliance requirements expected.
Q2.	Do you agree with the objectives of the proposed amendment? If not, why not?	The benefits of disclosing an internal transfer price for electricity traders is largely intangible. To the extent that it helps address the concerns of detractors of the electricity market then it may be worthwhile. Nova's view is that requiring generator-retailers with a 5% share of generation revenues and ICPs to make ITP disclosures is too low a threshold: this would capture generator-retailers with no market power. Nova suggests that the disclosure requirements should be set at a higher threshold (e.g. 10%)
Q3.	Do you agree that disclosure of ITP by large generator-retailers is important for trust and confidence in electricity markets?	Not particularly. ITPs are determined as a function of investment horizons and market churn expectations as much as an averaging of hedge prices over a specific time period. ITPs can also be set at a level intended to grow market share, or the converse. It is very difficult therefore to determine the impact that disclosure may have on trust and confidence in electricity markets.

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Q4.	Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?	Mandating disclosure does make it consistent across the major players, whereas under voluntary disclosure there is potential that a party may withhold the information in an endeavour to gain a competitive advantage, although this is always subject to the threat of regulation.
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?	Yes, there is very little benefit in disclosures unless there is a clear definition of how they are constructed. Of course the concept of 'cost of electricity' is complex as it relies on different parties' provisions for the cost of capital, fuel prices, ETS costs, valuations of resource consents, etc.
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?	To be of value, these elements must be transparent to the regulator, but only the ITP and the parts of the market to which it applies should be required to be disclosed. The detail behind the calculations should not be made publicly available as they are likely to include commercially sensitive data.
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?	While the current cost of electricity may be reflected in prices of 1 -3 year CfD's, such contracts are not adequate from a risk perspective to underwrite major investments in generation or long term fuel contracts, i.e. growing the retail load is often a more effective hedge against new capital investments than selling comparatively short term CfD's into a volatile wholesale market. As such the generator-retailers also need to consider the long-run costs of their next best generation option when setting ITPs. We note that independent retailers also have the option of investing in their own generation capacity and that is more likely to improve long term market competitive outcomes for consumers. Alternatively independent retailers could align with independent generators through long term PPA arrangements.

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		There is an emergence of longer term PPA's which do serve to provide some perspective on the underlying costs associated with ITPs. Parties should not be required to publicly disclose these prices as part of the ITP disclosure regime given commercial sensitivities.
Q8.	Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?	The test captures those companies that are currently publicly traded and subject to NZX disclosure rules, which provides one benchmark for consideration. An NZX listing has compliance costs, and the benefit of access to the capital markets. As such, disclosure is an important aspect of ensuring equitable trading in the company's securities. Privately owned companies do not have that same advantage, and therefore should not be required to disclose similar amounts of information to the market unless there are strong reasons for doing so. As such, the criteria should allow smaller private companies to make their disclosures on anonymous basis. A threshold of 10% market share of ICPs would be more consistent with focussing attention on those parties which are able to exercise market power.
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?	Yes, as the underlying contracts and methodology used to set the ITP likely rely on the same wholesale book. Under the alternative, the generator-retailer may be inclined to manage its affairs in a way that achieves a certain result i.e. different ITP between the different retail brands, which would be unproductive.
Q10.	Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?	That would seem to be the most appropriate location for the disclosures.
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	No, because the Authority is not necessarily best placed to determine "the cost of electricity". The essence of markets is that the participants put their money at risk by making decisions based on their view of future market prices over

Q No.	Question	Response
	of electricity? Are there any specific benchmark strategies you would like to see published?	the long term, i.e. 10+ years. Having the Authority giving weight to 2-3 year electricity hedge contact as being “the cost of electricity” is likely to distort market perceptions and lead to misallocation of resources. Many small retailers entered the market when it seemed that that wholesale prices would stay low with occasional price spikes, and there were significant profits to be made from electricity retailing based on 1-2 year hedges. That position has now reversed for a period, and it is difficult to support a retail business with futures trading at their current prices. Perhaps if the Authority provide benchmark strategies based on a retail book with a 10+ year risk management timeframe, that might be useful. That then becomes more subjective, however, as it requires equating long term wholesale prices to long run LRMC economics of new investments. The issue is then that the LRMC of intermittent renewables won’t be the only driver of long run market costs as dispatchable generation will also be required.
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?	The issues raised are valid, but there also additional factors that impact the relative margins between incumbent and challenger retailers, such as: • the level of regulatory scrutiny/oversight, • economies of scale vs flexibility and ability to change quickly, • benefits of having a credit rating or parent company that can provide a guarantee, • lower capital requirements for retail businesses relative to vertically integrated generator-retailers, • the disadvantages of older legacy systems, • incumbency of low income customers that emerging retailers may avoid through targeted marketing, • incumbents requiring manual meter reads, • ability to offer dual fuel benefits, etc.

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		In effect, there are many differences impacting on the comparative costs of the integrated generator-retailers and challenger brands, and there are no easy ways to quantify those.
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?	Risk comes in many forms, but primarily in the electricity sector: counter-party credit, price, and volume risks. Exposure to price risk comes from the mismatch of volumes, which in turn can be the result of generation uncertainties, variable volume contracts, and contract renewal terms. The advantage of having a mass-market residential customer base is that with scale, the aggregate demand over time is relatively predictable. Even with commercial clients, with sufficient scale aggregate demand can be predicted with some confidence. With industrial clients and independent retailers, the expected demand volatility over the term of the agreement is highly specific to the circumstances, but there is always a high level of uncertainty whether a contract will be renewed on expiry. In such circumstances the terms of an agreement can determine how the volume risk and price is traded off, for instance in the renewal terms, benchmarking, optionality etc. In respect of supply to the internal retail arm of a generator-retailer; there is in a financial sense an implied put and call option between the generation arm and retail arm that extends well beyond the typical term of futures contracts. This is difficult to replicate between a generator and independent retailer. We agree with the analysis that by internalising the risks associated with transactions cost for an integrated player, ITPs may be lower than what they would otherwise be, to the benefit of the consumer. Integration of retail and generation within a business reduces

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		transaction costs and risks and prevents double margins being imposed on consumers and as such they are better off as a result.[1]
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?	No, because: a) we do not agree with the look back option analysis in para's 3.34 to 3.38. We would be surprised if participants changed their internal transfer pricing methodologies on a retrospective basis. They make take into account recent sales activity against the backdrop of wholesale market conditions, but that is not unique to generators/retailers, b) the added costs of compliance could impact on the generator-retailers decision on whether to review their methodology with implications for market efficiency, and c) if parties change their ITP then that is likely to be in response to changes to future market conditions and not the past, so reporting impacts on historical results will not be meaningful or could be misleading.
Q15.	Do you support electricity retail segment profitability reporting?	No. In Nova's view and consistent with the points raised in the consultation document there are far too many complexities and differences in retailers' activities to make the analysis particularly meaningful. Non-electricity products, different market segment focuses, locational factors, etc are all factors that will create different levels of revenue, cost of sales and margins.
Q16.	Do you believe that for multiple product line retail businesses, the costs and revenues specific to electricity can be unbundled from other product	This should be feasible at a gross margin level, however, as noted in para 3.57 of the Discussion Paper, parties will likely vary on how they treat discounts that apply to bundled products in their margin calculations.

[1] Page 44, Preparing Electricity regulation for disruptive technologies, business models and players – in the long term interests of consumers, August 2018, Dr Richard Meade, Cognitus Advisory Services. https://cedf2c8a-aefa-4f90-be62-efeee5080c3f.filesusr.com/ugd/022795_8a4dd149d595494c8a36d724fec3e585.pdf

Q No.	Question	Response
	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?	As discussed in response to Q.11, the cost of electricity applied in the gross margin calculation depends on the time frame used to determine the ITP. As such, it is difficult to see how gross margin electricity retail segment reporting can be applied as evidence of 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?	a. b. c. Yes d. Yes e. Yes, but the threshold for anonymity should be 10% f. Yes The requirement that parties with over a 5% market share threshold of ICP's should be amended to be consistent with the requirement to publish their ITP, i.e. the threshold that should apply to publication of ITP's and gross margin should be 10% of ICPs.

Q No.	Question	Response
	d. That reporting should be centralised on the Authority's EMI website? 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? f. That entities with more than one retail business can report on a consolidated basis?	This threshold will capture the largest gentailers that supply ~85% of the market. There is no need or benefit in capturing others
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?	Yes, it should be.
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	No. Nova agrees that gross margin reporting for generators with different plant types and mix is difficult to compare due to the differing levels of capital involved and fuel cost structures. We also agree that reporting on industrial and commercial segment margins is problematic give the predominance of 2-5 years contracts terms against ITP's that most likely change annually for retailers. Prices in these sectors tend to be more volatile over time as ASX futures prices move around. Commercial and industrial customers also change their purchasing policies from time to time, which impacts on the market's overall exposure to low or high hydro conditions.

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	reasons won't be misconstrued as evidence of anti-competitive practices?	
Q21.	Do you agree the benefits of the proposed amendment outweigh its costs?	It is hard to see how the benefits as outlined in para 3.63 will crystalise given current market conditions. However perhaps in more normal hydro conditions this might be the case. Nova accepts that the proposal may have net benefits for consumers. It is wary however of the possible unintended consequences, such as: • encouraging convergence of gross margins to a level that is possibly higher than parties currently operate on. • Or leading to more volatile mass market pricing as ITP's become more aligned with shorter term ASX futures prices.
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.	Yes
Q23.	Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?	Yes
Q24.	Do you have any comments on the drafting of the proposed amendment?	Definition of "generator retailer" - the thresholds contained within the definition of a generator retailer should be increased from 5% to 10% on both the retail ICP's and generation sold limbs. 13.261 (1) - Should refer to publishing the reports submitted by retailers with 10% or greater of total market share and anonymised reports for all other **retailers**. The difference is minimal, but is significant for Nova Energy, which currently has just over a 5% share of ICPs but only a small share of generation and therefore does not have market power.