



Electricity Authority

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Via email: wholesaleconsultation@ea.govt.nz

17 May 2021

To whom it may concern:

Octopus Energy NZ Limited submission on consultation paper: Internal transfer prices and segmented profitability reporting

Octopus Energy NZ Limited (“OENZ”) welcomes the opportunity to comment on the Electricity Authority’s consultation paper.

About Octopus Energy NZ Limited

OENZ is a wholly owned subsidiary of Octopus Energy Group Limited (Octopus Group). The Octopus Group is committed to supporting the low carbon transition internationally by using technology to solve consumer problems and deliver exceptional service.

We started as an energy retailer in the UK market and are now also providing technology and operational transformation services to energy retailers internationally. We serve more than 2 million Octopus Energy retail customers and over 17 million customers through contracted accounts for our entech platform, Kraken. In addition to this we have invested in technologies that support the clean energy transformation, including electric vehicle charging networks and renewable generation projects in Europe. Our excellent service and commitment to being a ‘good’ operator are endorsed by being Which?’s recommended provider of energy in the UK for the 4th year in a row, and our accreditation as a socially responsible BCorp.

We are interested in entering the New Zealand electricity market as part of our international growth strategy. We believe there is an opportunity to deliver better services for electricity consumers in the market, and it also provides an excellent testbed for product development.

Competition frameworks within the New Zealand electricity market

We are supportive of the Electricity Authority’s proposal to introduce segmented reporting and monitoring of internal transfer prices as an improvement to the current regulatory framework for monitoring competition. However, we believe a more granular approach to reporting requirements would allow the Electricity Authority (and Commerce Commission

and energy market related policy makers) to monitor competition and market health more effectively.

More critically, alongside the proposal, there are some important and simple additions to the regulatory framework that can be made by the Electricity Authority to bolster the integrity of a level playing field for a competitive retail market. These changes address the incentives of large vertically integrated firms to use their position to the detriment of independent competition and ultimately energy consumers.

While we see the New Zealand retail market, like many electricity markets around the world, as ripe for innovation we are concerned that the market lacks basic regulatory requirements that provide integrity to the competitive process, in particular measures that ensure equivalent wholesale access for independent and vertically integrated players alike. As a result, we are concerned that those retail firms who can deliver the most efficient and best experiences for customers cannot grow effectively, and it would be incredibly challenging to enter the market as an independent retailer of large scale through acquisition of a 'retail book'.

Improving the competitive framework is important because the Electricity Price Review highlighted the two speed market and that many New Zealanders are missing out on the benefits of competition, often suffering from what must objectively be regarded as inequitable levels of price discrimination by the dominant incumbent players. It's also important because demand-side energy technologies and the economics of them are changing. Realising the potential benefits of these new innovations will require firms with new skills and the motivation to disrupt current ways of work, it's unlikely that the current dominant firms can do this. With improvements to the competition framework, consumers would benefit from more vigorous innovation and price competition.

Internal transfer pricing and segment reporting form part of a framework for monitoring a level playing field, but they need to be underpinned by obligations on vertically integrated firms that prevent discrimination of access to wholesale supply and cross subsidisation by the generation segment. These obligations are common features of regulatory regimes in vertically integrated industries with competitive markets¹. They are part of the licencing conditions within the UK energy market² where we have successfully entered and grown, specifically the generation licences for vertically integrated businesses in the UK include the following conditions:

¹ For example the New Zealand telecommunications market: Non-discrimination is defined in Parts 2A and 4AA of the Telecommunications Act. Non-discrimination prohibits a network operator from treating access seekers differently, or if the network operator supplies itself with a relevant service, from treating itself differently from other access seekers.

https://comcom.govt.nz/__data/assets/pdf_file/0014/231071/Non-discrimination-information-sheet-22-December-2020.pdf (edited)

² Refer Generation Licence conditions applicable to vertically integrated firms

https://www.ofgem.gov.uk/system/files/docs/2021/02/electricity_generation_standard_licence_conditions_consolidated_29_11_2020.pdf:

- Condition 17 Prohibition of discrimination in selling electricity; and
- Condition 17A Prohibition of Cross-Subsidies

Discrimination of access to wholesale supply means an internal retail business has access to supply on terms that an independent retail business could not access. A potential outcome of this is that competition in the retail market by independent players is throttled, this is to the benefit of vertically integrated firms and ultimately to the detriment of consumers who could have benefited from the independent firm's competition either directly by taking advantage of an offer or through the pressure it puts on their existing provider to provide a good service at a competitive price. From our observations and conversations with market participants and market analysts we believe this is a genuine concern in the New Zealand market. Additionally, statements made by some vertically integrated firms imply that they believe discrimination of access is acceptable³.

Introducing an obligation on vertically integrated players to provide equal access to wholesale supply and demonstrate no discrimination establishes a clear expectation for how vertically integrated players must behave and is likely to stimulate liquidity in the wholesale market as they seek to fulfil this obligation (and support the Authority's ongoing Hedge Market Enhancements program). This is the case in the UK where the market is used actively, it's also resulted in a convergence of transfer prices between vertically integrated firms which contrasts starkly to the current picture in New Zealand. A positive obligation on vertically integrated firms also reduces the burden on the Electricity Authority (or Commerce Commission) to detect anti-competitive behaviour as it puts the onus on firms to demonstrate they are providing equal access, rather than the current scenario where the burden is on regulators to prove they are not.

Prohibiting cross subsidisation between the wholesale and retail business is equally important because it has the potential to undermine, and if it persists for long enough foreclose independent retail competition, this is ultimately to the detriment of consumers. As with the non-discrimination obligation we believe there needs to be a positive obligation on firms to demonstrate they are not cross subsidising. Vertically integrated firms should have an onus on them to demonstrate they are using a market based wholesale input cost/ or internal transfer price as part of their retail pricing. It's quite possible that vertically integrated firms are currently using the supernormal profits they are receiving from their generation business to fund customer acquisition offers well below wholesale market costs, an example would be signing long term contracts with SME's now that are below market costs and with a significant sign-up incentive.

The Electricity Price Review identified the need for more scrutiny of competition and the market in order to provide more confidence to participants and consumers. We believe implementing the tried and tested conditions outlined above would support competition

³ In the Electricity Authority "Briefing for Internal transfer prices and segmented profitability" 29 April 2021 comments were made by Meridian Energy to the effect that "if independent players have concerns around access they could go and build their own generation"



and monitoring of the market by placing the onus on vertically integrated firms to demonstrate that they are competing fairly. Given the practical challenges of monitoring conduct in this market, and the value at stake in this market and the broader economy from ineffective competition, we believe a burden of demonstrating compliance on vertically integrated firms is justified. These conditions could be implemented by making fairly straightforward code additions introduced with the proposals regarding internal transfer price and segmented reporting to create a more robust framework for competition.

In addition to this letter we have provided brief answers to the questions posed in your consultation paper in the appendix attached. If you have any questions about this submission, or our experience operating in other markets, we would be pleased to discuss them with you.

Yours sincerely,

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APPENDIX: Answers to consultation questions

	Question	Octopus Energy Response
1	Do you agree the issues identified by the authority are worthy of attention?	Yes, we agree the issues are worthy of attention. The measures are a basic and necessary ingredient for monitoring competition and market health in a market with vertical integration.
2	Do you agree with the objectives of the proposed amendment? If not, why?	We support the objective of enabling greater transparency and scrutiny of vertically integrated firms.
3	Do you agree that disclosure of ITP by large generator-retailers is important for trust and confidence in electricity markets?	<p>Vertical integration gives rise to incentives that can have a detrimental impact on competition. These incentives need to be controlled through regulation and compliance with them monitored. Monitoring the Internal Transfer Price, segment accounts and retail prices are a basic and critical part of a framework for monitoring competition in the market.</p> <p>We believe the current arrangements are inadequate so we're supportive of the proposal as a step forward, but have provided additional recommendations that we believe are necessary in order for fair competition to take place and for the market to be scrutinized effectively.</p> <p>As outlined in our covering letter, in order to provide a robust competition framework these reporting measures need to be coupled with obligations on vertically integrated firms not to provide their own retail business preferred access to wholesale supply. These should be positive obligations so that the onus is on the firm to demonstrate compliance, we have highlighted the UK Generation licence supply conditions as an example.</p>
4	Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?	Yes, we agree that there are benefits in mandating this requirement, if the requirements were voluntary firms could choose not to make the disclosures which would undermine the benefits of this disclosure regime.
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?	<p>Yes, this links to the prohibitions on discrimination and cross subsidy that we have outlined. Internal transfer prices should be reflective of the market/ arm's length cost of wholesale supply.</p> <p>These should reflect a notional wholesale input cost that forms part of the retail price. Where different transfer prices are used for different segments e.g customer load profiles or locations, the specific transfer price should be noted.</p>
6	Do you agree that ITP disclosure requirements should encompass the price, pertinent details of the methodology used, the major	Yes, we agree the ITP should describe the component, this should include details of the contracts: hedges, futures that also make up the ITP.

	components which the prices comprises, and terms and conditions?	We believe a methodology that is forward looking and reflects an arms length arrangement should be required.
7	Do you have any comments on the specifics of the information requirements with respect to price, methodology, component parts, which terms and conditions?	If internal transfer prices should be regarded as the wholesale input cost for retail pricing by vertically integrated firms. The must then be forward looking and based on an arms length market reflective cost.
8	Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?	Yes.
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?	No, we disagree. If a common ITP is used by the businesses then it is acceptable, if the ITP for a business or segment of customers differs then this should be disclosed separately with the methodology explaining the rationale for the difference.
10	Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?	Yes.
11	Do you agree it would be helpful if the Authority published prices for a series of benchmark hedging strategies for the purpose of evaluating whether generator- retailers internal pricing reflects the cost of electricity? Are there any specific strategies you would like to see published?	Yes. Any strategy needs to be achievable. We recommend that the Electricity Authority also collects data on offers made for hedges. This will provide important insight into the depth and liquidity of the market and ensures that the 'cost' of any strategy put forward by the Electricity Authority is truly market reflective.
12	Do you agree that to be a fair reflection of the cost of electricity, large vertically 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?	ITPs should include the additional costs and risks retail arms would face if they were not part of an integrated business. A level playing field/effective competition necessitates equivalence of access to wholesale supply, if the market requires independent retailers to post prudential etc then so should the retail businesses of vertically integrated firms account for this in their ITP. These operational costs should be itemised.
13	Do you agree the respective cost and risk profiles largely explain any variation in appetite, pricing, and terms and conditions offered	No the variation is significant, if the ITP's were reflective of market costs there should be a convergence on price. The variation probably reflects the divergent use of internal transfer prices. If it was clear that firms have

	by generators to internal parties, commercial and industrial clients, independent retailers?	obligations to price at arms length we believe there would be more convergence.
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 may 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.	Yes.
15	Do you support electricity retail segment profitability reporting?	Yes.
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?	Yes. These businesses will report by segment internally.
17	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?	Yes. We support gross margin reporting. i) A negative gross margin would imply a competition or market health concern e.g margin squeeze, retail market foreclosure, supply shortage, that requires investigation. ii) In order to ensure differences aren't misconstrued there should be an obligation on firms to demonstrate why their conduct is not a cross subsidisation. If there is a legitimate commercial reason then this should be disclosed. The onus should be on the vertically integrated firm to demonstrate it's not anticompetitive.

<p>18</p>	<p>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>	<p>a) We believe the gross margin should be reported by brand/ retail business by network company. Additionally the energy costs should be broken down to show what is attributable to ITP, Hedge, spot.</p> <p>b) Yes.</p> <p>c) Yes.</p> <p>d) Yes.</p> <p>e) Yes.</p> <p>f) No, as described above where a retail business or trading brand (eg. Energy Online or Powershop) has more than 1% market share we believe it should also be reported separately. It would be valuable to analyse the level of price discrimination between brands. It is possible that one brand is used for executing a price squeeze on competitors while the other is used to maintain incumbent margins.</p>
<p>19</p>	<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> <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>As suggested above we believe it would be preferable for gross margin to be reported by brand/ business at a network level. This would provide the Electricity Authority more meaningful insight into market health and competitive dynamics. This information is also fairly easy to compile as pricing is executed on a brand and network level.</p> <p>This increased granularity would allow the Authority to analyse behaviours that would otherwise be lost in averages. It will also allow the Authority to detect any market issues with a particular region - e.g negative gross margin and limited competition in a region might reflect generation issues or transmission constraints in an area.</p>
<p>20</p>	<p>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</p>	<p>Yes, this would provide a more accurate picture of market health and competitive dynamics.</p> <p>As described in our cover letter, given the value at stake in this sector, the onus should be on vertically integrated firms to demonstrate they are competing fairly.</p>

	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?	
21	Do you agree the benefits of the proposed amendment outweigh its costs?	Yes.
22	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 change is an improvement on the current situation and we believe it will be further enhanced by the suggestions we have proposed.
23	Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?	Yes.
24	Do you have any comments on the drafting of the proposed amendment?	<p>We would recommend amendments to the drafting to include:</p> <ul style="list-style-type: none"> - A prohibition on discrimination, and - A prohibition on cross-subsidies <p>We also recommend changes to enable the more granular collection of information by network, segment, brand as discussed.</p>