VOCUS

INTERNAL TRANSFER PRICES AND SEGMENTED PROFITABILITY REPORTING

Submission to the Electricity Authority

PUBLIC VERSION

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INTRODUCTION

1. Vocus welcomes the opportunity to submit in response to the consultation paper *"Internal transfer prices and segmented profitability reporting",* 8 April 2021.

2. If you would like any further information or have any queries about this submission, please contact:

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VOCUS DOES NOT SUPPORT IMPOSING REGULATION TO ADDRESS MARKET POWER CONCERNS ON RETAILERS WITHOUT MARKET POWER

3. Vocus supports full introduction of the Government's decision to adopt the Electricity Price Review (EPR) recommendation that *"the Electricity Authority require vertically integrated companies to report separately on the financial performance of their retail and generation operations using a common set of rules"* [emphasis added].[1] We agree with the Government view that profit disclosures are needed due to *"ongoing questions about whether integrated generator-retailers are making excessive profits"*.[2]

4. The disclosure requirements should only apply to vertically-integrated operators or retailers with market power and actual ability to extract excessive profits. Vocus does not support the Authority proposal to require disclosure by retailers with no market power (market share of 1% or more).

5. Information about small and independent retailer profits is not needed to establish whether vertically-integrated operators are making excessive profits from their retail or generation businesses. The Authority comment that *"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"* is relevant to its Internal Transfer Price (ITP) analysis but not for determining whether the incumbents are extracting excessive profits.

THE AUTHORITY'S IS ONLY PARTIALLY IMPLEMENTING THE GOVERNMENT'S REFORMS

6. While we support the Authority's proposals to require vertically-integrated operators with market power to disclose ITPs and gross retail margins this is only a partial implementation of the Government's EPR decision.

[1] Ministry of Business, Innovation and Employment, Electricity Price Review: Government Response to Final Report, 3 October 2019.
[2] Ministry of Business, Innovation and Employment, Electricity Price Review: Government Response to Final Report, 3 October 2019.

7. The consultation paper only makes reference to part of the EPR recommendation: *"Make Generator-Retailers release information about the profitability of their retailing activities"*. This was the short-hand header for the full recommendation that the reporting include both retailing and generation/wholesale financial performance:

> **D3: Make generator-retailers release information about the profitability of their retailing activities**
>
> 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. This is a longer-term initiative, to be completed within 12 to 18 months.

8. The Government was equally clear it was adopting the EPR recommendation that *"the Electricity Authority require vertically integrated companies to report separately on the financial performance of their retail and generation operations using a common set of rules"* [emphasis added].[3]

THE AUTHORITY'S VIEWS ON VERTICAL-INTEGRATION ARE OUT OF STEP WITH OTHER INDUSTRY AND COMPETITION REGULATORS

9. The Authority was clear in the introduction of the consultation paper *"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*" and *"The efficiency of wholesale pricing and hedge markets are outside the scope of this investigation"*.

10. Despite this clear scope, the Authority's principle focus is on justifying the vertically-integrated operators' Internal Transfer Price arrangements, and self-supplying on a Fixed Price Variable Volume (FPVV) basis while refusing to supply third party retailers on the same basis.

11. The Authority's view that vertical-integration isn't a problem is out-of-step with evidence in the market other industry regulators, in electricity, telecommunications and other network sectors.

12. The issues we are facing in dealing with and competing against vertically-integrated suppliers are well articulated, for example, by the ACCC in its Retail Electricity Pricing Inquiry.[4] The ACCC recognised wholesale market concentration and vertical-integration are problem that inhibit independent retailers ability to hedge and compete. The EPR final report reached similar conclusions.

13. If the Authority wants to determine whether vertical-integration is a problem there is a wealth of international precedent on vertical price squeezes, equivalence and non-discrimination testing and regulation to draw on. We have previously referenced the

[3] Ministry of Business, Innovation and Employment, Electricity Price Review: Government Response to Final Report, 3 October 2019.

[4] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018.

equivalence of inputs and non-discrimination rules in the Telecommunications Act as examples.

14. The comparison in the consultation paper of the vertically-integrated operators' ITPs versus prices they could *"plausibly"* obtain through self-supply, including through FPVV arrangments which they don't provide to independent and new entrant retailers, sheds little light on this topic. The Authority has commented that *"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"* but this is not reflected in its Figure 2 analysis.

15. A tighter scrutiny of the level of competition and barriers to competition, particularly in the wholesale electricity market, is needed if the Authority is going to achieve its strategic ambitition of *"thriving competition"*. We do not consider the Authority adopting a 'nothing to see here' approach to the wholesale electricity market and vertically-integrated operator arrangements, while dismissing the barriers to competition and growth that independent and new entrant retailers face as *"perceptions"*, will elicit trust and confidence in the market or in the Authority's *"kaitiaki of the market"*. We do not consider competitive forces are being afforded the protection associated with kaitiakitanga.

THE COMMERCE COMMISSION RETAIL FUEL AND GROCERY INVESTIGATIONS HIGHLIGHT VERTICAL-INTEGRATION ISSUES WELL

16. The Commerce Commission market investigations could be useful to draw on, as they dealt with issues common to the electricity industry and are complementary to the *"structure-conduct-performance"* approach detailed in the Authority's Market Monitoring Framework.

17. For example, the Commerce Commission found in the fuel market that *"The combination of vertical integration and restrictive wholesale supply arrangements that has emerged since deregulation has prevented the emergence of a workably competitive wholesale market. Vertical integration can generate significant efficiency benefits. However, it also reduces or eliminates competition at the wholesale level and limits competition to the retail level, which in this sector is likely to be less intense"*.[5]

18. The Commerce Commission also used segmented cost/margin/profitability measures to establish whether *"evidence suggests that prices are above competitive levels and that the majors are persistently earning returns in excess of what we would expect in a workably competitive market"*.

[5] Commerce Commission, Market study into the retail fuel sector, Final report, 5 December 2019.

THE AUTHORITY NEEDS TO BE SEEN TO ACT WITHOUT FEAR OR FAVOUR IN ADDRESSING MARKET AND REGULATORY PROBLEMS IN ORDER TO BUILD "TRUST AND CONFIDENCE"

19. The Authority should be cautious that four years of high wholesale electricity prices with the large incumbent suppliers extracting high profits, which all substantially increased following the COVID19 lockdowns last year, inevitably attracts significant public interest and result in concerns about how effective competition is at curbing electricity prices.

20. The issues of trust and confidence in the effectiveness of competition are particularly stark given the high level of market concentration in the wholesale electricity market (with an HHI around 2,000), and the size of Meridian (about 35% of New Zealand's generation capacity and 55-60% of hydro capacity). The consultation paper at least acknowledges the large vertically-integrated operators are *"dominant"* and have *"control over substantial amounts of generation"*.

21. A starting point for addressing these issues, and to build trust and confidence, is to make sure there is good information available about the performance of the market. This includes reporting on market concentration statistics for the wholesale electricity market and not just retail,[6] and ensuring transparency of the profits and financial performance of operators with market power in the electricity sector. Absent information on the vertically-integrated operators' wholesale and retail profitability, the Authority isn't in a position to address the Ministers concerns about whether wholesale electricity prices *"need to be as high as they have recently been?"* or *"to correct …. misperceptions in the public on high spot electricity prices"*.

22. Disclosure of gross retail margins won't reveal much about whether profits are excessive. It could simply reflect the level of ITPs are such that the profits notionally sit in the generation business. For example, in Australia, the ACCC's *"analysis of the transfer prices vertically integrated businesses use to allocate electricity costs between their retail and wholesale businesses … suggests that wholesale profit is currently prioritised over retail competitiveness"*.[7] Figure 2 in the consultation paper shows that Meridian's retail business would appear profitable relative to Mercury because it uses a substantially lower ITP for reporting purposes.

[6] The Authority's EMI website provides a lot of excellent information, but currently only provides market concentration statistics (HHI and Concentration Ratios) for retail.

[7] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018.