

18 May 2021

Tom Georg and team  
Electricity Authority  
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By email: [wholesaleconsultation@ea.govt.nz](mailto:wholesaleconsultation@ea.govt.nz)

**Dear Tom and team**

**Re: Consultation Paper-Internal transfer prices**

Flick appreciates the opportunity to submit on the Electricity Authority's (Authority) proposal to require disclosure of vertically integrated gentailers' internal transfer prices<sup>1</sup>, the methodology for deriving these prices, the rationale for this methodology and gross margin information.

Flick is a signatory to the joint independent retailers' submission and support the recommendations.

Our focus in this submission is on the significant importance of robust transfer pricing to enable thriving competition for the long-term benefit of consumers.

The transfer price underpins any analysis or comparisons the Authority or interested parties undertake of the gross margin information proposed to be disclosed, as the other cost components are determined by third party charges that are equivalent across all retailers.

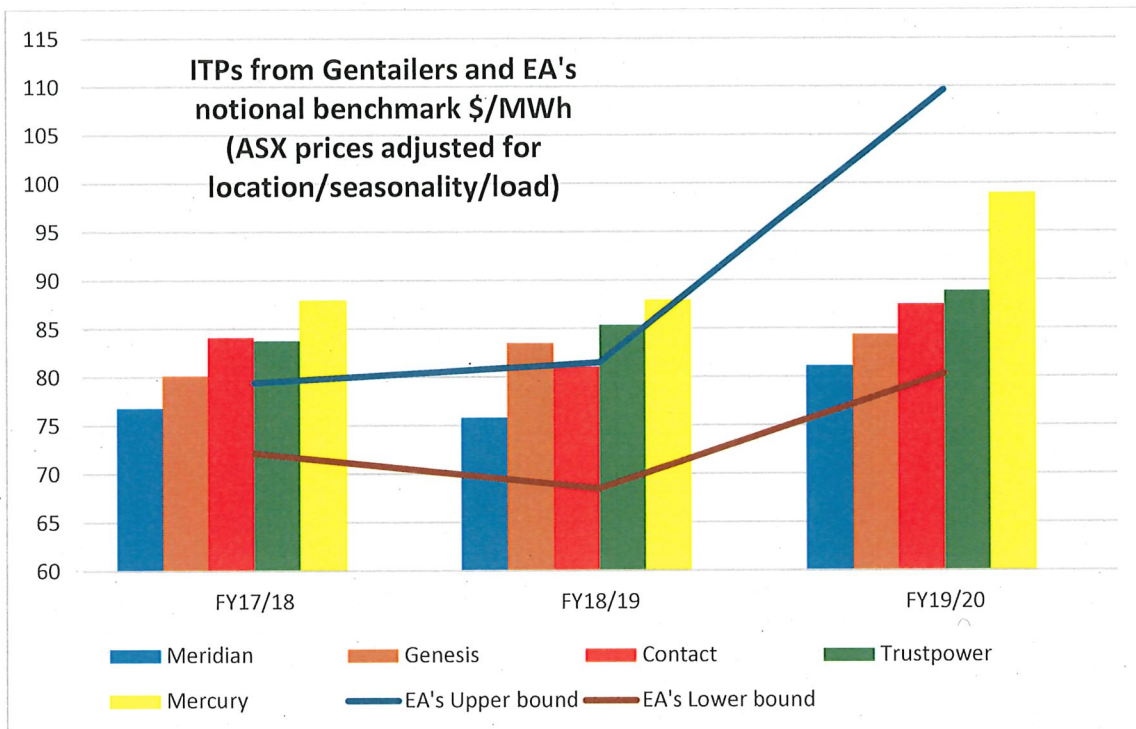
We have redrawn the Authority's Figure 2 updated with the "plausible" notional benchmark range adjusted for location/seasonality/load as provided by the Authority – showing a range \$30/MWh between the upper and lower bound.

As discussed previously, we disagree that a range of "plausible" ITPs of \$30/MWh is justifiable. Reporting gross margin using a \$30/MWh range of electricity costs will be meaningless. We estimate this is the equivalent of 1-1.5 times the gross margin of an independent retailer. This range just demonstrates that the vertically integrated gentailers benefit from internal hedging arrangements that represent inefficient barriers to independents/new entrants competing with established participants.

Further, the Authority's Figure 2 has compared the incumbents' ITPs against prices that they could obtain, rather than comparing the prices available to incumbents versus prices available to independents.

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<sup>1</sup> Namely Meridian, Genesis, Trustpower, Nova, Contact and Mercury



Flick submits that the Authority should be comparing the prices available to incumbents through self-supply versus the prices reasonably available to:

- a) an existing prudent and efficient independent retailer (which would include a backward looking element); and
- b) a prospective new entrant retailer (which would be entirely forward-looking).

The extent to which the incumbent versus independent/new entrant prices (or price ranges) overlap would help inform whether there are barriers to competition.

Flick has attempted to develop a reasonably available price for an independent retailer described in a) and b) above.

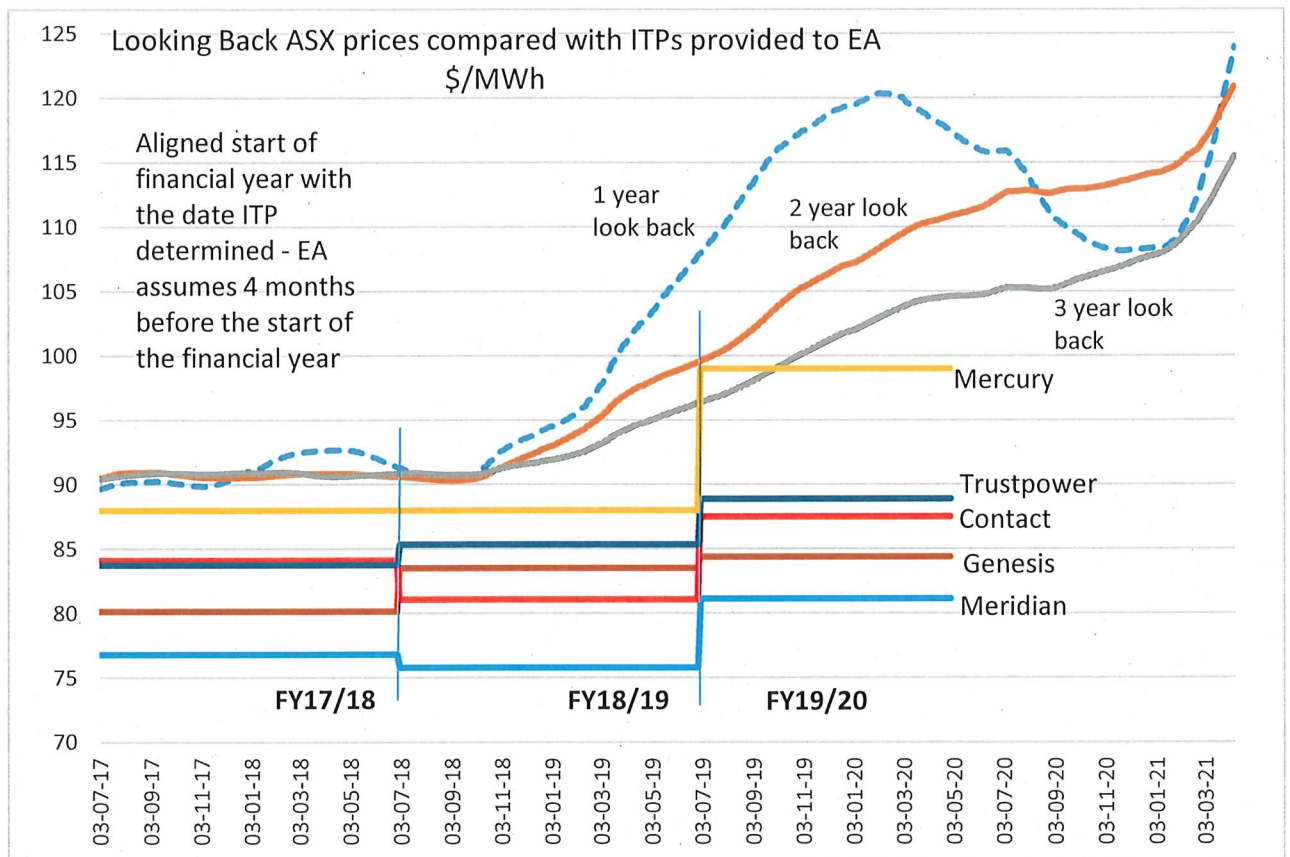
The assumptions/data used to estimate a National Hedge price are:

- daily ASX prices from EMI database for BEN and OTA
- weighting BEN and OTA prices by demand over the twelve months to 28 February 2021 (38% / 62% respectively)
- the 'ShortDated' and LongDated prices as calculated in the EMI database looking forward on each day
- weighting the ShortDated price at 20% and the LongDated price at 80% to get a National hedge price – reflecting a hedging strategy to lock in 80% of load at least 12 months in the future
- adjusted for a location factor of 1.04

- adding an 8% premium to achieve a Fixed Price Variable Volume contract arrangement
- adding a 2.5% premium for the costs of capital tied up with securing hedge contracts
- adding a 5% premium for distribution losses<sup>2</sup>

Using the above calculated National Hedge price, the following graph attempts to demonstrate the price available to independent retailers in a) above.

The National Hedge price is used to get a 1, 2 and 3 year rolling average. That is, forward looking prices on each day over 1, 2 and 3 year periods are averaged and recalculated for each day on a rolling basis.



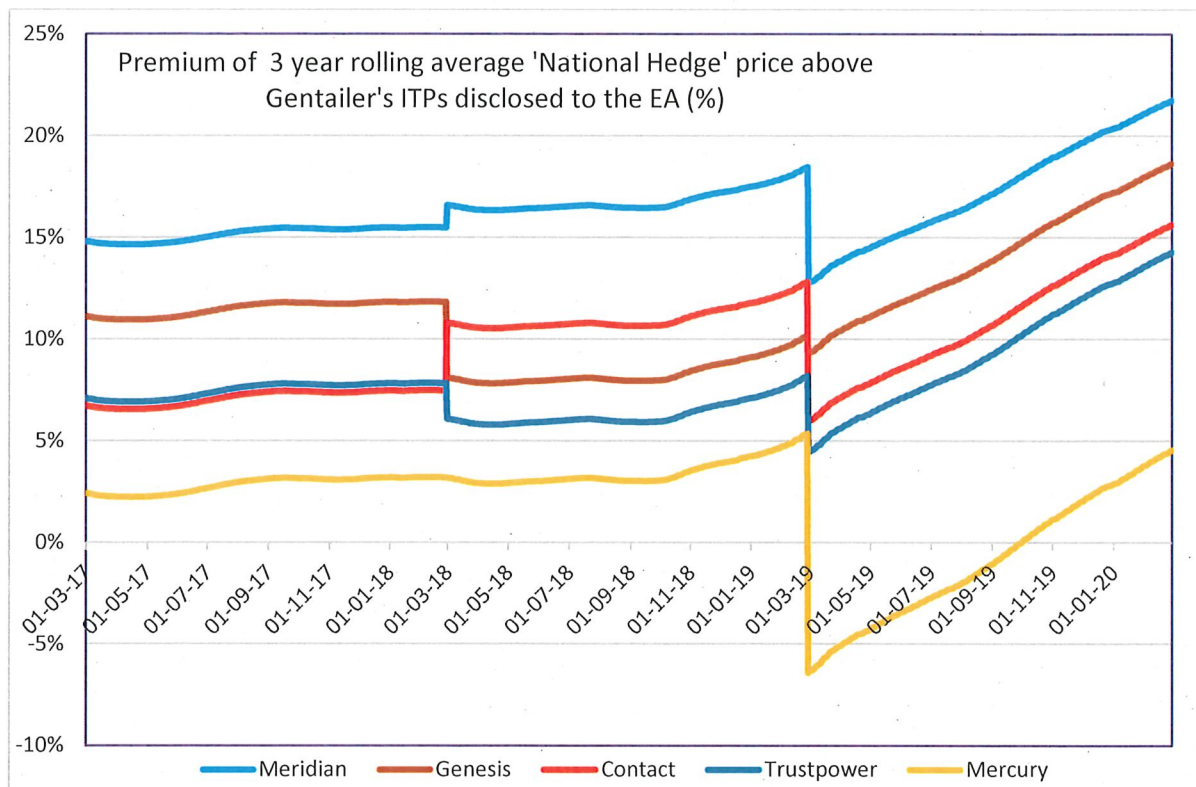
The Authority did not request gentailers' Internal Transfer Prices for FY20/21.<sup>3</sup> This graph clearly indicates the trajectory for gentailers' transfer prices in FY20/21.

<sup>2</sup> Electricity losses averaged 5.2% across all network companies in FY20. Source Commerce Commission [https://comcom.govt.nz/data/assets/excel\\_doc/0017/233360/Electricity-distributors-information-disclosure-data-2013-2020.xlsm](https://comcom.govt.nz/data/assets/excel_doc/0017/233360/Electricity-distributors-information-disclosure-data-2013-2020.xlsm)

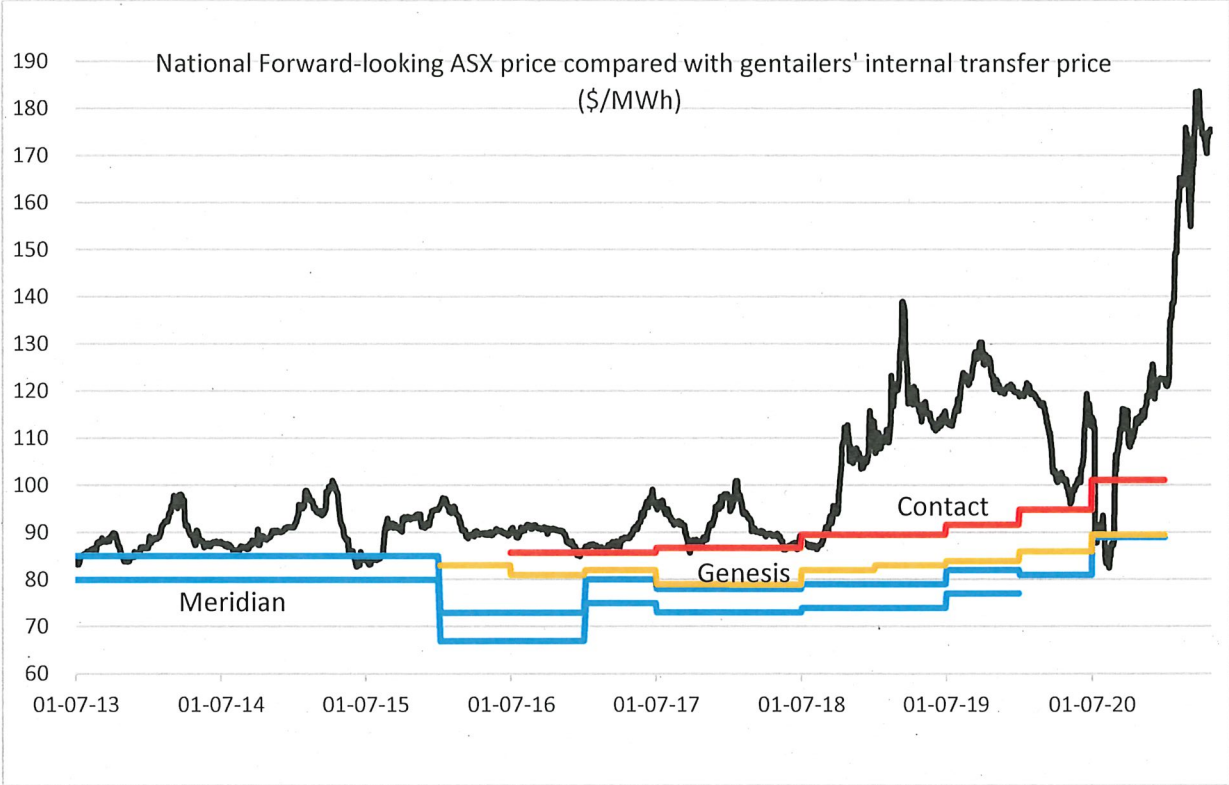
<sup>3</sup> This is despite the gentailers likely already knowing that number at the time of the August 2020 information request (the Authority said that gentailers normally set their internal transfer prices about 4 months before the start of the financial year)



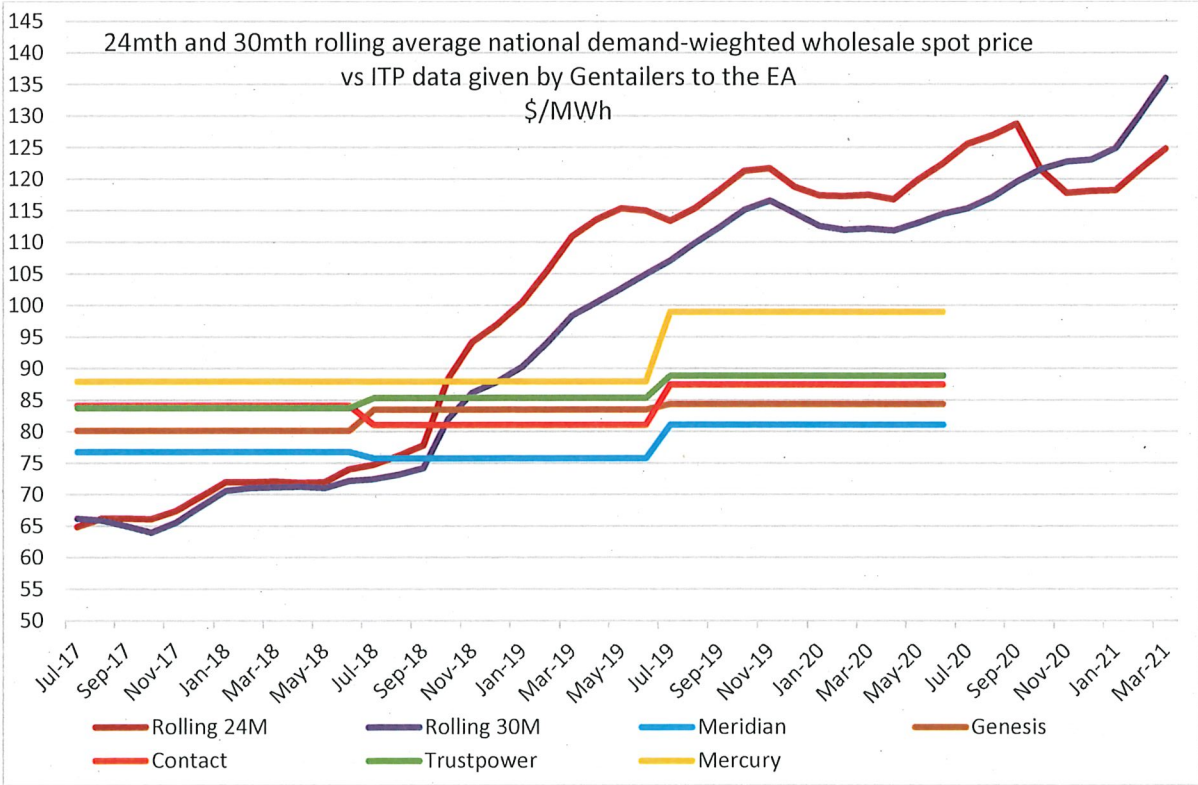
The following graph compares the gentailers' ITPs with our 3-year rolling average National Hedge price – showing the actual market prices are increasingly above the gentailers' ITPs. This difference is accelerated if the ITPs are unchanged into FY21 and FY22. The current National Hedge price is at a premium of 30% above Meridian's FY19/20 ITP.



For b) above the entirely forward-looking price is shown in the graph below based on our estimate of a National Hedge price. This shows the calculated National Hedge each day (this is totally forward-looking). We have compared this National Hedge price with the internal transfer prices or retail electricity cost published by 3 gentailers over a longer timeframe (to December 2020). This shows that the prices available to a prospective new entrant retailer have been well above the prices available to a gentailer's retail business since mid-2018.



Alternatively, the gentailer's fixed price variable volume internal risk management arrangement between generation and retail is equivalent to purchases of any volume on any term from the spot market. The other option, is therefore to compare gentailers' ITPs with a rolling average spot market price.



The above graphs demonstrate that since mid-2018 there has been no overlap, except for Mercury, in the extent to which incumbent versus independent/new entrant prices (or price ranges) overlap. Flick urges the Authority to use this information to investigate barriers to competition.

### ***UK comparison***

For comparison, the Internal Transfer Price disclosed by the six incumbent gentailers in the UK is within a £2-3/MWh range.<sup>4</sup> These gentailers use the International Accounting Standards to guide their ITP methodology. In addition, the generator licences require these companies not to cross subsidise their operations as well as requiring them to offer non-discriminatory pricing to third parties. It is clear from their published methodologies that the ITP is based on arms' length transactions and on forward prices available at the time of the transaction.

### ***Internal transfer prices and the hedge market***

The Authority states the efficiency of the hedge market is "outside the scope of this investigation"<sup>5</sup>. However, the hedge market<sup>[2]</sup> (alongside the spot market for unhedged load) is the market independent retailers rely on to manage risk, unlike the internal arrangements within vertically integrated companies<sup>[3]</sup>. Further, Flick's experience is that any CfD sought from generators is closely tied to a forward ASX price.

If hedge market efficiency is outside the scope of this consultation, we query why the Authority included extensive analysis of the difference between hedging products available to independents and gentailers. We submit it is inappropriate for the Authority to detail why gentailers shouldn't sell FPV<sup>[4]</sup> contracts to independent retailers in the consultation paper.<sup>6</sup>

We submit that the Authority's focus on hedge market development and credible risk management practices is meaningless if the Authority is not interested in ensuring a level playing field where all retailers are able to manage risk using the same products and markets.

We welcome further engagement on this topic and strongly submit there should be an opportunity for cross submissions.

Yours



**Steve O'Connor**  
Chief Executive

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<sup>4</sup> <https://www.ofgem.gov.uk/gas/retail-market/retail-market-monitoring/understanding-profits-large-energy-suppliers>

<sup>5</sup> Paragraph 1.4

<sup>6</sup> Paragraphs 3.27 to 3.33