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Internal Transfer Prices (ITP) and Segmented Profitability Reporting

Genesis Energy Limited (**Genesis**) welcomes the opportunity to provide feedback on the Electricity Authority's (**Authority**) consultation paper *Internal transfer prices and segmented profitability reporting* dated 8 April 2021.

In submissions to the Electricity Price Review Panel, we supported improved and appropriately standardised, disclosure of transfer prices and segmented reporting. We reiterate that support and agree in principle, with the Authority's proposed changes to facilitate this.

We also agree that improved disclosure should:

- (a) Help allay any concerns that gentailers use their ITPs to favour their retail business or otherwise engage in anti-competitive practices.
- (b) Together with the Authority's other initiatives (such as its wholesale and forward market reports, wholesale information disclosure rule changes), foster greater confidence in New Zealand's electricity market.

Our responses to the consultation questions are set out in the Schedule to this letter.

Please don't hesitate to contact me should you wish to discuss any of the matters raised in our response further.

Yours sincerely

A handwritten signature in blue ink that reads "Williams".

Warwick Williams
Senior Regulatory Counsel and Group Insurance Manager

SCHEDULE

Question	Genesis response/comment
<p>Q1. Do you agree the issues identified by the Authority are worthy of attention?</p>	<p>Yes.</p> <p>In submissions to the Electricity Price Review Panel, we supported greater, and appropriately standardised, disclosure of transfer prices and segmented reporting. We reiterate that support. In relation to segmented reporting, we would support a framework that: (a) is consistent with applicable accounting standards; (b) does not impose material additional compliance costs; and (c) minimises the risk of confusion with segmented reporting in existing financial reporting.</p> <p>We reject assertions that Genesis uses its ITP to unduly favour our retail businesses. As previously discussed with the Authority, the ITP is an accounting measure that is principally used for business unit performance measurement and long term business planning, and to ensure that price volatility risk resides primarily with the business unit best placed to manage that risk.</p> <p>We agree with the Authority however that improved disclosure should help allay any concerns that gentailers use their ITPs to favour their retail business or otherwise engage in anti-competitive practices. The improved disclosure, together with the Authority's other initiatives (such as its wholesale and forward market reports, wholesale information disclosure rule changes) should foster greater confidence in New Zealand's electricity market.</p> <p>We also commend the Authority's intention to undertake a post-implementation review after an appropriate period has passed.</p>
<p>Q2. Do you agree with the objectives of the proposed amendment? If not, why not?</p>	<p>Please see our response to Q1.</p>
<p>Q3. Do you agree that disclosure of ITP by large generator retailers is important for trust and confidence in electricity markets?</p>	<p>As discussed in our response to Q1 above, we support improved disclosure.</p> <p>We suggest however that the obligation should apply to all gentailers. Transfer prices are already calculated for accounting and financial reporting purposes. The disclosure of ITPs, with an appropriate explanation of the methodology, should not be unduly onerous or materially increase compliance costs for any gentailer, and, over time, will provide a more useful dataset for the Authority and the industry.</p>

<p>Q4. Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?</p>	<p>Please see our response to Q1.</p>
<p>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?</p>	<p>Industry participants will have differing views on what a “fair reflection of the cost of electricity” means. Factors influencing their view include their respective portfolios and commercial objectives.</p> <p>Genesis is comfortable disclosing its ITP for its residential market segment for the reasons discussed above. We also agree, subject to our comments in Q7 below, that the ITP should be accompanied by an explanation of how it is set. This should improve the general understanding of how ITPs are calculated and dispel misconceptions concerning their use.</p>
<p>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?</p>	<p>Yes – please see our response to Q5 above. In relation to the exercise of Executive discretion this, as with methodology changes discussed in Q11 below, should be qualified by materiality. That is, where the exercise of discretion results in a variation of 25% or more from the calculated ITP.</p> <p>Please see also our responses to Q7 (component terms and reasonable person standard) and Q11 (materiality threshold) below.</p>
<p>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?</p>	<p>We agree in principle with the proposed disclosure requirements.</p> <p>However, we disagree with the requirement to provide a breakdown of components as set out in clause 13.256(3)(a) and (b) in dollars and cents per MWh. Locational and load profiles adjustments, for example, are not outputs in those terms and would: (a) potentially reveal details of a retailer’s customer base; and (b) likely cause confusion when compared with other gentailers and retailers. In our view, the disclosure of the ITP, together with a description of the methodology in clause 13.256(3)(c) provides sufficient disclosure given the objective of the proposed Code amendments.</p> <p>We also ask that:</p> <p>(a) Clause 13.256(3)(e) be amended to simply require that the gentailer set out the purposes for which the ITP is used. If it is used for residential pricing then this would be disclosed. The clause in its current form is unduly broad and ambiguous.</p>

	<p>(b) The Authority clarify that “reasonable person” in this context is to be interpreted in the same way as that set out in paragraph 7.9 of the Wholesale Information Disclosure Rules.</p> <p>That is, that a ‘reasonable person’ for the purpose of clause 13.256 of the Code:</p> <p>(i) is not ‘the person on the street’; and</p> <p>(ii) is a sophisticated market participant familiar with the wholesale, retail and hedge markets.</p> <p>We recommend that this definition is inserted in Part 1 of the Code for the purposes of applying clause 13.256.</p>
<p>Q8. Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?</p>	<p>Please see our response to Q3 above.</p>
<p>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?</p>	<p>Yes.</p>
<p>Q10. Do you agree that it would be valuable if the ITP disclosures were reported on the Authority’s EMI website?</p>	<p>Yes - we strongly support a central repository for this information. The Authority’s EMI site is preferred as it contains other information relevant to the integrity and performance of the wholesale and retail markets.</p> <p>We recommend that:</p> <p>(a) Clauses 13.2456 and 13.257 are amended to reflect that provision of information to the Authority under clause 13.257 satisfies the obligation to make the information publicly available.</p> <p>(b) Clause 13.257(b) and (c) be deleted as they would be unnecessary given the change in (a) above.</p>

<p>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 of electricity? Are there any specific benchmark strategies you would like to see published?</p>	<p>It is difficult to assess whether benchmarking is helpful and note that the Authority has not provided details of the hedging strategies and assumptions underlying its benchmark pricing. Industry participants' approach to hedging will vary based on a range of factors, including their strategic/commercial objectives and risk appetite. There would also be a wide range of views for example on what hedging strategies should be included and the weighting given to each in developing the benchmark range. In addition, as the Authority recognises in the consultation paper a range of factors can also affect the ITPs notwithstanding the particular hedging strategy underpinning them.</p> <p>Given the above, and the purpose of an ITP, we query: (a) the usefulness of a benchmarking range; and (b) whether the Authority is best placed to, or should, be the arbiter of what an appropriate ITP range is. In our view, what is important is the standardised disclosure of all gentailer ITPs and the trend over time.</p>
<p>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?</p>	<p>Please see our responses to Q3, Q5 and Q11 above. Further, an ITP is an accounting concept and a company is free to choose how it is calculated and reported, having regard to applicable accounting standards.</p> <p>We strongly disagree that the Authority should mandate what ITPs should be or should include. We also disagree that the ITP should include the additional costs and risks that a gentailer's retail arm would face if they were not part of an integrated business. This would introduce additional and unnecessary complexity (e.g. assumptions around credit risk), is artificial and does not reflect commercial reality or the purpose for which ITPs are used.</p> <p>As discussed above, what is important is the standardised disclosure of all gentailer ITPs and the trend over time.</p>
<p>Q13. Do you agree the respective cost and risk profiles largely explain any variation in appetite, pricing, and terms and conditions offered by generators to internal parties, commercial and industrial clients, independent retailers?</p>	<p>As discussed above and previously with the Authority, ITPs are principally used for business unit performance measurement and planning purposes.</p> <p>The pricing and terms on which electricity is offered for sale to customers depend on a range of factors including: the customer's needs and objectives; and our strategic and commercial objectives, risk appetite, market conditions (including ASX futures prices) and portfolio at the relevant time.</p>

<p>Q14. Do you agree that where a generator-retailer changes change 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?</p>	<p>We recommend a 25% or greater impact on the ITP for the current reporting year as the appropriate materiality threshold. This should capture material changes rather than refinements to the methodology or tools to calculate the ITP.</p> <p>We disagree that there should be a requirement to disclose the impact on the preceding three financial years. This adds compliance costs and produces information that is irrelevant and unrelated to the purpose for which an ITP is calculated.</p>
<p>Q15. Do you support electricity retail segment profitability reporting?</p>	<p>Yes. In submissions to the Electricity Price Review Panel, we supported appropriately standardised segmented reporting and reiterate our support for this. We believe that the guiding principles should include ensuring that any such reporting: (a) is consistent with applicable accounting standards; (b) does not impose material additional compliance costs; and (c) minimises the risk of confusion with segmented reporting in existing financial reporting. Our responses to Q16 – Q22 below proceed on this basis.</p>
<p>Q16. 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?</p>	<p>From a Genesis perspective, we can report on an unbundled basis.</p>
<p>Q17. Do you support requiring gross margin electricity retail segment reporting?</p> <p>a. If so:</p> <p>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.</p> <p>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> <p>b. If not:</p>	<p>Yes, subject to the principles discussed in Q17 above and our response to Q18 below.</p>

<p>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?</p>	
<p>Q18. 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>Given the objectives of the proposal and the principles discussed in Q17 above, we consider the line items should reflect existing financial reporting. We recognise, however, that not all participants publish financial statements and that participants describe or categorise line items differently. It is also unclear, given the background to the proposed disclosures, why transmission and other costs should be specified.</p> <p>We suggest a simpler approach to calculating the retail residential gross margin:</p> $ \begin{aligned} & \text{Retail electricity revenues (Residential)} \\ & \text{Less: Cost of Electricity} \\ & \quad \text{(i) Total internal costs (i.e. the ITP)} \\ & \quad \text{(ii) Total external costs (including transmission, distribution, and metering costs)} \\ & \quad \quad \quad = \text{Retail Gross Margin} \end{aligned} $ <p>We agree that firms with more than 1% market share should be subject to these obligations and as discussed above, that reporting should be provided through the EA's EMI website.</p> <p>We consider, however, that all retailers should be treated consistently. That is, either all retailers are identified, or none are named, with reporting anonymised in a manner similar to that used for the EA's market maker performance reports.</p> <p>We support reporting on a consolidated basis and on nominal dollar terms.</p>
<p>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:</p> <p>a. What categorisations would you propose?</p>	<p>Yes.</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>Q20. 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 illustrations.</p> <p>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>	<p>Given the background to these proposals, we agree with the Authority's approach to focus on the residential segment.</p>
<p>Q21. Do you agree the benefits of the proposed amendment outweigh its costs?</p>	<p>Yes, subject to the preceding responses and the principles discussed in Q17.</p>
<p>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.</p>	<p>Yes, subject to the preceding responses. We agree with the Authority that the alternative options of retaining the status quo or mandating an ITP methodology are both undesirable for the reasons set out in the consultation document.</p>
<p>Q23. Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?</p>	<p>We agree that the improved disclosure, together with the Authority's other initiatives (such as its wholesale and forward market reports, wholesale information disclosure rule changes), should foster greater confidence in New Zealand's electricity market.</p>
<p>Q24. Do you have any comments on the drafting of the proposed amendment?</p>	<p>Please see our responses to Q7 and Q10 above.</p>