

# s9(2)(b)(ii) & s9(2)(ba)(i)

Ritchie Hutton  
Head of Strategy, Intelligence and Advocacy  
Commerce Commission

By email: s9(2)(a)

CC: Sarah Gillies (CEO - Electricity Authority)

Dear Ritchie,

We are writing to express our concern over pricing behaviour by dominant, vertically integrated players in the electricity retail market. s9(2)(b)(ii) is concerned that innovation in the retail market is being curtailed by pricing practices of market participants with significant market power, and which prevent or deter independent retail businesses from being able to compete.

s9(2)(b)(ii) requests that the Commerce Commission (the **Commission**) investigates the pricing behaviours in the electricity retail market. We are advised that this may constitute predatory pricing in breach of s36 of the Commerce Act.

s9(2)(b)(ii) & s9(2)(ba)(i)

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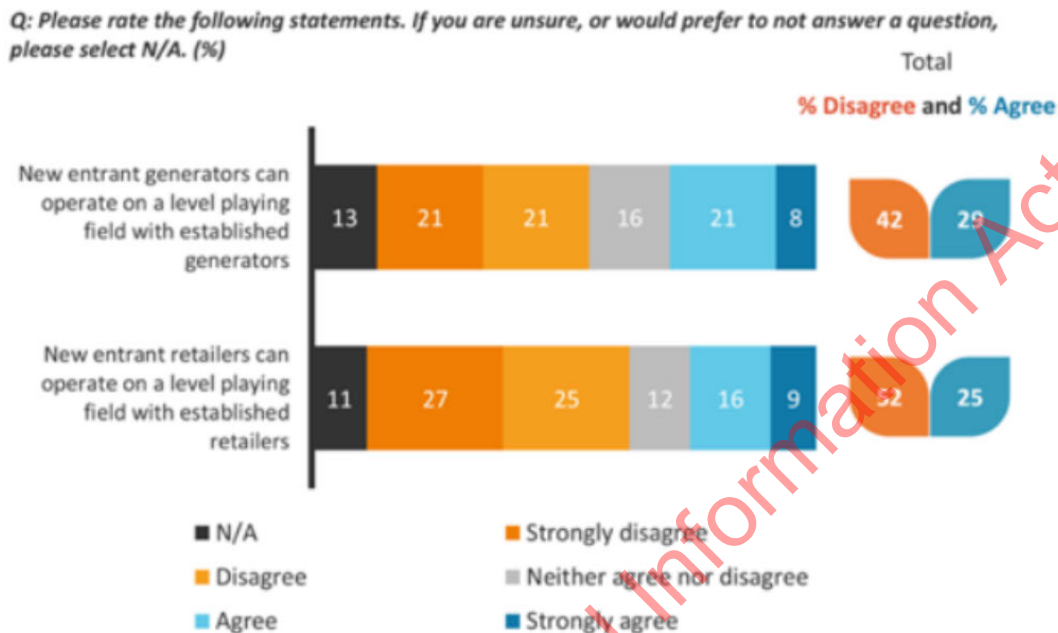
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## Background about the electricity retail market

In order for the electricity retail market to function competitively, the expectation is that there is a level playing field for inputs (equivalence of inputs). This means that the retail arm of vertically integrated generator retailers (**gentailers**) would price their retail products based on a cost base that could reasonably be attained by an independent market participant following a comparable hedging strategy to purchase electricity for resale.

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Confidence in the retail market is low, with only 25% of respondents to the Electricity Authority's (the **Authority**) recent market perception survey agreeing that new entrant retailers can operate on a level playing field.



Gentailers' retail businesses are typically supplied with electricity at an internal transfer price (ITP) for all volume 24/7 from their generation businesses.

The Authority's recently published gentailer ITP methodologies raised questions regarding how gentailers are setting their retail prices.

We met with the Authority s9(2)(b)(ii) & s9(2)(ba)(i) who advised us that they have no interest or expectations about how gentailers set their retail pricing as it is a competition matter which is governed under the Commerce Act and regulated by the Commission.

## s9(2)(b)(ii) & s9(2)(ba)(i) observations

### There is no visibility over how gentailers' retail prices are set

It is unclear what methodology gentailers are using to price their retail book. The following comments were disclosed as part of the Authority's [ITP disclosures](#):

- "Meridian's ITP is not used to price mass market retail customers"
- "Mercury views the ITP as primarily an accounting concept for allocating costs across two business units and has limited application in commercial decision making, such as pricing new business"

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- “Mercury may periodically manually adjust this ITP if it is deemed the price outlook is unreliable or volatile. Mercury may also use its own internal view on futures and adjust the ITP accordingly, for example generation investment decisions”

It seems that gentailers are pricing retail offers based on general retail market prices, regardless of their cost of electricity for onsale, the ITP. At the same time the gentailers’ generation businesses are selling the balance of their volumes to independent retailers at spot and hedge prices significantly above the Long Run Marginal Cost (**LRMC**) of new generation supply. s9(2)(b)(i) 3 suggests gentailers may be leveraging their vertically integrated position to suppress independent retail competition.

A report by Concept Consulting for the Authority in July 2022 is the latest illustration of the difference between ASX futures prices and the LRMC of new generation. Concept concludes “Notwithstanding the uncertainty about the [LRMC] estimates, it is clear that contract prices exceed longer-run costs of new supply”.<sup>1</sup>



<sup>1</sup> Page 5

<https://www.ea.govt.nz/assets/4-Monitoring/Information-paper-Generation-Investment-Survey-2022-Concept-Consulting-report-for-the-Electricity-Authority.pdf>

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The calculation of ITPs do not appear to factor in risk and costs worn by the generation business that an independent retailer incurs

Based on the published methodologies and available market data, we have calculated what the ITP should be for the year ended 30 June 2022 for baseload contracts, adjusted only for a location factor. The ITP price calculated is **\$105.71/MWh**. The average of the disclosed ITPs for the gentailers for the same period was **\$103.79/MWh**.

	Manawa	Contact	Meridian	Genesis	Mercury	Average
Disclosed ITP for July 21 - June 22	\$ 101.60	\$ 107.55	\$ 99.62	\$ 111.16	\$ 99.00	<b>\$103.79</b>
Variance to synthetic ITP	-\$ 4.11	\$ 1.84	-\$ 6.09	\$ 5.45	-\$ 6.71	<b>-\$ 1.93</b>

Prima facie, this indicates that other costs have not been included in the calculation of ITPs. Other costs include but are not limited to:

- Shape factor cost - Gentailers' ITPs are a fixed price for variable volumes. Independent retailers buy ASX contracts for flat baseload volumes. Additional contracts are needed to buy electricity that matches customers' peaky load profile - we estimate this additional cost for 'shape' to be at least 5%
- Costs to manage the position, given that they essentially get a perfectly shaped hedge to their load profile - for example, ensuring supply of electricity to the retail business if output from the gentailers' generation assets are not available/sufficient
- Trading team employee costs
- Trading management system costs
- Trading governance costs
- Margin costs from exchange traded derivatives.

Some gentailers' methodologies suggest these costs are included but it is not consistent. Meridian have stated that they do not include any administrative fees.

Mass market retail prices offered to new customers appear to be significantly below gentailers' ITPs

Gentailers are able to hold prices high for "loyal" non-switching customers to subsidise cheap rates for new customer acquisition. Independent retailers do not have an 'incumbent' customer base and are continuously fighting for market share. We have also seen gentailers do this

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through different retail brands (for example Frank Energy - owned by Genesis and Powershop - owned by Meridian). This creates a large barrier to entry for independent retailers.

The table below shows our calculation of the difference between our estimation of the current 2022/23 year ITP (\$125.86/MWh) and the price per MWh gentailers are selling energy to new customers at, as advertised on Consumer's Powerswitch. This is presented based on different gross margin per ICP levels.

A negative number with a gross margin of \$0 indicates that the retail business would be gross margin negative for these customers. That is, the cost of electricity (ITP) is more than the sale price to new customers.

<b>Weighted Average across Auckland, Wellington and Christchurch</b>				
<b>Gross Margin \$/ICP</b>	<b>\$ -</b>	<b>\$ 160.0</b>	<b>\$ 240.0</b>	<b>\$ 320.0</b>
Powershop (Meridian)	-\$4.90	-\$23.30	-\$32.50	-\$41.70
Mercury	-\$7.19	-\$25.60	-\$34.80	-\$44.00
Contact	\$12.46	-\$5.94	-\$15.14	-\$24.34
Frank (Genesis)	\$12.51	-\$5.90	-\$15.10	-\$24.30

For context, the following table shows our calculation of the Gross Margin per ICP for the gentailers over the past 4 full financial years across their full customer base<sup>2</sup>:

## **Annual Gross Margin per ICP - Electricity Retail segment**

	<b>FY22</b>	<b>FY21</b>	<b>FY20</b>	<b>FY19</b>	<b>Average</b>
Mercury	\$ 294	\$ 316	\$ 241	\$ 324	\$ 293
Genesis	\$ 267	\$ 478	\$ 383	\$ 330	\$ 365
Contact	\$ 157	\$ 266	\$ 277	\$ 310	\$ 253
Meridian	\$ 391	\$ 364	\$ 428	\$ 405	\$ 397
					<b>\$ 327</b>

This analysis suggests that:

- Based on our calculation of gentailer ITPs for 2022/23, Meridian and Mercury are selling power to new customers at a rate which generates a negative gross margin
- Assuming the average gross margin for the past 5 years of circa \$320 delivers a fair return on investment, gentailers are selling electricity to new customers at between \$24 and \$44 per MWh lower than our estimated cost of electricity (ITP) for 2022/23.

<sup>2</sup> Customer numbers sourced from EMI

## Gentailers continue to announce strong profits, with falling electricity retail margins

- Contact reported that retail segment EBITDAF (including gas and broadband) for 1H23 decreased by \$15m on 1H22 to a total of \$1m, driven by sustained high wholesale prices. Contact is explicit that their \$36m increase in electricity costs was not fully passed through to customers<sup>3</sup>.

In addition, Contact's electricity retail Gross Margin dropped 41% from \$41m to \$24m. The residential segment gross margin declined \$14m to \$21m and the SME segment gross margin declined \$4m to \$3m. This indicates that their retail pricing is not keeping pace with increased costs and their retail prices are lower than what should reasonably be expected.

- Mercury reported in their 1H23 announcement that "retail customers prices increased by an average of 2% across lines and energy and further increases would be limited to 3% and 5% for the coming year".

It is generally known that, nationally, line charges are increasing for mass market connections by 3.5% and based on our ITP calculations energy costs for gentailers should be increasing by 19% over 2022/23. This indicates that Mercury is planning to lift prices below the rate of underlying cost increases. s9(2)(b)(ii) & s9(2)(ba)(i) view is Mercury's retail business is essentially being subsidised by their generation business to support Mercury's competitiveness in the retail market against independent retailers.

## Gentailers' retail businesses may be running at a loss, subsidised by their generation businesses

It can be difficult to determine this with certainty based on publicly available information, however using reported 1H23 results we can reasonably determine that Genesis and Contact's electricity retail businesses are running at a loss.

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<sup>3</sup> Page 22

<https://contact.co.nz/-/media/contact/pdfs/about-us/investor-centre/annual-and-half-year-reports/fy23-interim-financial-statements-presentation.ashx>

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## Gentailer electricity retail profitability

### Electricity retail P & L

Revenue

Costs of goods sold

Gross margin

Electricity operating costs apportioned based on revenue

EBITDAF

Genesis		
1H23	1H22	Change
\$ m	\$ m	%
677	685	-1%
639	614	4%
38	71	-47%
65	59	10%
- 28	12	-330%

Contact		
1H23	1H22	Change
\$ m	\$ m	%
482	448	8%
459	407	13%
23	41	-44%
30	28	4%
- 7	13	-154%

### Electricity retail P & L

Revenue

Costs of goods sold

Gross margin

Electricity operating costs apportioned based on revenue

Estimated EBITDAF

Mercury		
1H23	1H22	Change
\$ m	\$ m	%
621	345	80%
540	293	84%
-	-	-
81	52	56%
71	40	76%
10	12	-14%

Meridian		
1H23	1H22	Change
\$ m	\$ m	%
975	883	10%
900	808	11%
-	-	-
75	75	0%
35	33	6%
40	42	-5%

## NOTES

- Numbers sourced from the unaudited interim financial statements for 1H23
- Opex has been apportioned based on revenue as no breakdown is provided
- Mercury's 1H23 results include the acquisition of Trustpowers retail business

## Our key observations

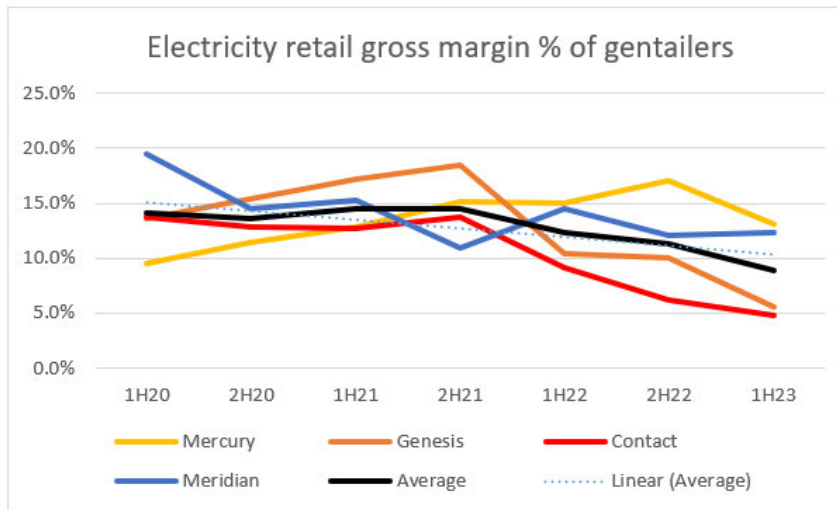
- Genesis and Contact's electricity retail businesses appear to be running at a loss
- Mercury's electricity retail EBITDAF has decreased 14% despite an 78% uplift in scale through the Trustpower acquisition
- Based on our calculations, all gentailers have had a decrease in electricity retail EBITDAF of at least 5%
- Meridian's EBITDAF decreased the least (5%).<sup>4</sup> We note that their stated ITP for 1H23 was \$104/MWh which is significantly lower than our expectation of \$125.86 and Contact's stated residential electricity energy cost for the same period of \$128.70.

In our view, the only reason for a retailer of scale to be operating at a loss would be to price competition out of the market.

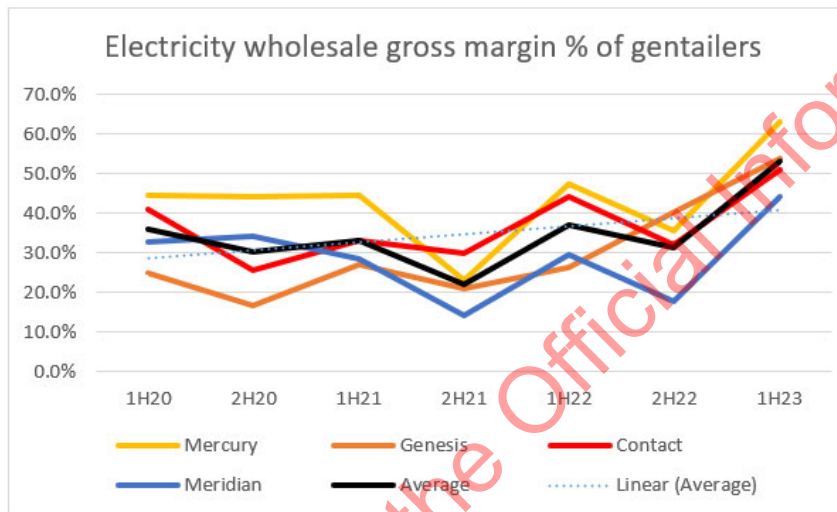
In addition, we have also observed trends of gentailer wholesale profits increasing, and retail profits decreasing despite the cross subsidisation. The graphs below highlight this well:

<sup>4</sup> This EBITDAF is directly from their segment reporting in the financial statements and did not require any estimation.

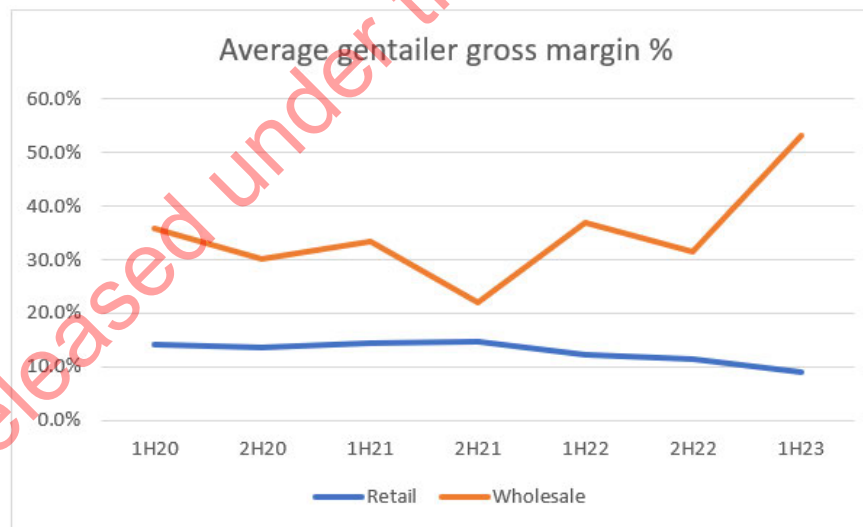




The linear average shows retail gross margins dropping from 15% to 10% over the past 3 years (a decrease of 33%). This is more pronounced in the past 2 years.



The linear average shows wholesale gross margins increasing from 30% to 40% over the past 3 years (an increase of 33%). This is more pronounced in the past 2 years.



Gentailers are making large wholesale margins and subsidising retail profitability through low transfer pricing. This is impacting independent competition.



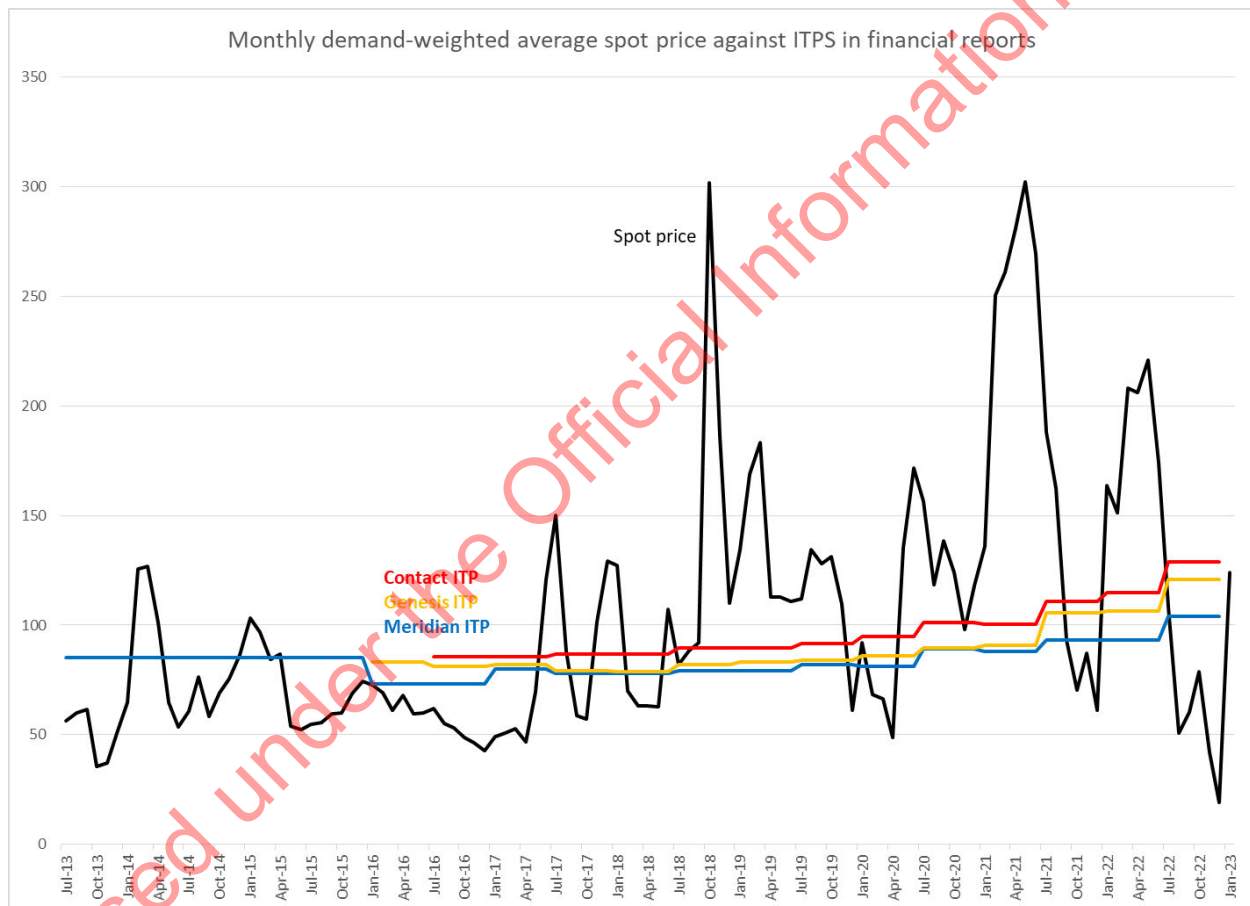
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Over the past 15 years gentailers have consistently sold around 80% of their generation to their retail business through their ITP.

The remaining 20% of the generation volumes are sold on the spot or futures markets (to independent retailers, other gentailers or industrials).

We consider the spot market a reasonable proxy for what gentailers are receiving for the 20% of load not supplied to their retail business, noting that in recent history that spot prices have settled well below futures contracts for the same period.

The following graph shows the difference in price received from their ITPs and the spot market.



The difference between the ITP and the spot price is a proxy for the amount the gentailers' generation business is subsidising its retail business. It is clear that this subsidisation has increased since independent retail competition entered the market.

The gentailers say their retail pricing has 'shielded' customers from the impact of higher wholesale prices. Another description is 'smoothing' retail prices relative to elevated wholesale prices. Mercury noted in their FY21 results announcement that:

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“You can certainly see a market in the pricing chart around channel yields. You've got futures prices, spot prices well above the net yields that Mercury are selling into mass markets”

This has become more evident in the subsequent 18 months to date. Other gentailers have made similar comments publicly. See Appendix 1 for details.

It is clear from the graph below that gentailer pricing practices are shielding customers from the impacts of higher wholesale prices. The NZ average retail + energy component of residential prices<sup>5</sup> has increased but not by anywhere near the increase in the cost of buying electricity from the spot market. This is analysed by looking at the difference between the price from selling electricity to residential consumers - the retail + energy price - and the cost of buying all your electricity for resale from the spot market (using the demand-weighted national average monthly spot price).

- From August 2015 to May 2017 the difference between these two prices was consistently in the range \$95 - 120/MWh and averaged \$110/MWh.
- Between June 2017 and February 2023 this average difference almost halved to \$61/MWh.
- The graph below shows the cost of buying electricity is more than the price received from selling it when the red line is above the blue line. This monthly spot price data reveals the cost of electricity was above retail prices for 11 months between June 2017 and February 2023, including 5 consecutive months February 2021 to June 2021 and 3 consecutive months March 2022 to May 2022.

Meanwhile, comparing the difference between the same price from selling electricity to residential consumers and the cost of buying electricity for gentailers from their generation business - their ITP - has remained relatively flat, averaging \$95/MWh. This difference was \$92/MWh in August 2015 and increased to \$103/MWh in June 2022.

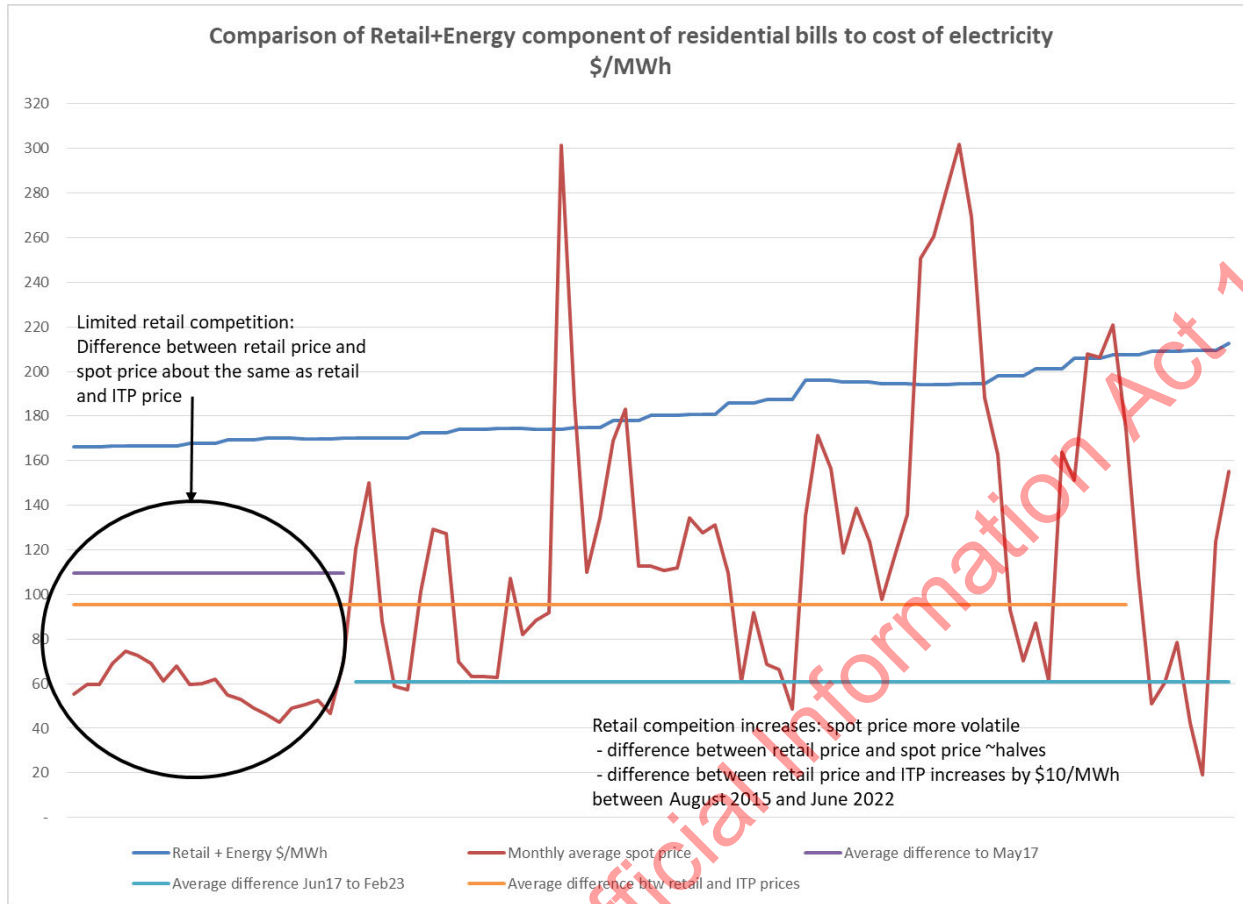
We suggest this demonstrates that retail prices are increasing at a slower rate than underlying costs. We query whether ‘shielding’ or ‘smoothing’ is appropriate in a competitive market when the structure of the business (vertical integration) enables this shielding to occur.

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<sup>5</sup> MBIE's Quarterly Survey of Domestic Prices

<https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/energy-prices/electricity-cost-and-price-monitoring/>

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## The forward outlook and need for further monitoring

Gentailers' retail prices have been slow to rise to follow wholesale prices, and therefore should be equally slow to follow wholesale prices back down. They should logically also continue to rise for around 2 years after wholesale prices start to fall.

Based on market data and the published ITP methodologies, we expect ITPs to rise as follows for the years to June 2023 and 2024:

### ITP calculation

	BEN average	OTA average	ITP
July 21 - June 22	96.74	111.22	\$ 105.71
July 22 - June 23	112.54	134.03	\$ 125.86
July 23 - June 24	127.34	153.46	\$ 143.54

Note that these prices are before adjusting for shape factor and other costs (discussed on page 4).

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Contact's residential electricity energy cost disclosed in their 1H23 announcement was \$128.70/MWh and Genesis 1H23 ITP in their financial statements was \$120.95/MWh. This indicates that our model is relatively accurate in terms of predicting the ITP.

The lack of clarity regarding the setting of gentailers' retail pricing and the potential for gentailers to lower retail pricing too quickly (or artificially hold retail pricing) when wholesale conditions ease warrants continued monitoring.

## Next steps

We wish to be constructive and collaborative and are happy to share any further information or insight that we have that may be useful to the Commission's understanding of our position. We would also appreciate the opportunity to meet and discuss the matters raised.

We look forward to hearing from you in due course.

Regards

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## Attachments:

"ITP Analysis.xls" - Calculations of forward ITPs based on market data

"Gross Margin workings.xls" - Calculation of gross margin for gentailers and related information

"Gentailer new customer pricing.xls" - calculation of new customer energy sale prices

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## Appendix 1: Public gentailer comments

Meridian's FY21 result [presentation](#):

And lastly, the hedging strategies adopted by most retailers have meant the vast majority of customers have been insulated from these higher wholesale prices, that we've seen of late.

Meridian FY21 Interim result presentation<sup>6</sup>:

NEAL BARCLAY: "I think we all look beyond the immediate wholesale market. We see that as being driven by, as would you know, concerns and constraints in the gas market. We're hoping that some forward investment starts to resolve that. But, certainly, also this build programme that's been announced with ourselves and our competitors, must have a softening impact on the forward price curve I would have thought. So I think long-term, I would not expect to see significant change in retail pricing in this country because the underlying economics won't take you there. " [emphasis added]

Mercury FY21 interim result [presentation](#):

"When we look at those across networks throughout New Zealand, we certainly can see quite a disparity in pricing between Mercury's offers and the cheapest offers from other major gentailers.

So those deltas are quite large, ranging between \$20- \$60 a megawatt hour. So, a very large gap, with a note calling out that based on segment reporting, retail operating cost running at about \$25 a megawatt hour. So certainly again, on the chart on the prior page, you're seeing some quite large negative gross retail margins against that" [emphasis added]

Mercury FY21 year end result presentation:<sup>7</sup>

"You can certainly see a market in the pricing chart around channel yields. You've got futures prices, spot prices well above the net yields that Mercury are selling into mass markets"

Contact Energy FY22 year end result presentation:

From power point [presentation](#): "Continue to smooth the impact of higher electricity costs for customers" p22

From verbal presentation:<sup>8</sup>

<sup>6</sup> <https://www.youtube.com/watch?v=qStjxy60yc>

<sup>7</sup> Page 7

[https://issuu.com/mercurynz/docs/mercury\\_nz\\_annual\\_results\\_analyst\\_briefing\\_2021\\_tr?fr=sYiA3YzQxNjE3MzA](https://issuu.com/mercurynz/docs/mercury_nz_annual_results_analyst_briefing_2021_tr?fr=sYiA3YzQxNjE3MzA)

<sup>8</sup> Retail division discussed at 29 to 33 minutes <https://www.youtube.com/watch?v=a7XB0gGH9Ho>

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'disconnect between the market and consumer prices. In retail electricity consumer gross margin declined \$43 million. Retail tariffs increased 2% or \$5 a megawatt hour but transfer price into that business was up \$13 a megawatt hour.' (at 41-42 minutes)

'From retail price seen the market behave very well and protect the consumer from some very volatile swings in the wholesale market compared to what they have actually experienced' (from 1:12:37 to 1:13:07 minutes)

Contact Energy FY21 year end result [presentation](#):

"Continue to smooth the impact of higher electricity costs for customers: ... Retail energy tariffs - will need to rise to reflect elevated wholesale electricity, gas and carbon costs " (page 21)

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