

# Risk Management Review

Reviewing risk management options for electricity retailers –  
Update to the Board 30 April 2024

In Confidence

## Purpose of this update

These slides provide an update the Board on the risk management review (RMR), and particularly seek to ensure that the Board understands:

- The core risk management market analysis that we are currently spending much of our effort on
- The broader retail market competition analysis that provides context for this review
- How the changing wholesale market environment (generation mix) is relevant to the risk management review.

We are seeking Board feedback now to ensure that we are aligned to avoid staff carrying on down paths that the Board does not consider to be highest priority.

# Guide to the slide pack

## Ensure Board/staff alignment on

- The rationale for the RMR work (slides 3-5)
- The importance of substitutability of risk management options, ie, market definition (slides 8-11)
- How the RMR interacts with the broader context, including: (slides 13-16)
  - Expectations of retail market competition, particularly:
    - The costs and benefits of different types of retailer participation
    - The impact of the transition to a low emissions economy
  - Other drivers impacting competition now or (likely) in the future, eg, increasing scarcity of flexible generation

## Emerging themes

- The centrality of market power (which sits behind the margin squeeze claim) to the RMR (slides 18-19)
- The related post-implementation review of the internal transfer prices (ITP) and retail gross margin (RGM) disclosure regime (slide 20)

## Update to the Board on initial analysis (slides 22-28)

## Why we initiated this work

- The RMR logically follows up earlier Authority work on market making and the wholesale market review.
- Both the wholesale and forward/hedge markets benefitted from analysis and/or change. This includes the introduction of mandatory market making; and the increased focus on trading conduct.
- The complaints regarding pricing and availability of OTCs are also relevant considerations:
  - The OTC RFP data initially provided by non-integrated retailers suggests further enquiry is warranted
  - Risk management is a core part of operating a sustainable retail electricity business. If non-integrated retailers are unable to manage their spot price risk, they will ultimately exit and consumers may be worse off
  - The complaints raise key framing questions the Authority should articulate a clearer position on, eg, expectations of retail competition.
- The RMR aligns with the Authority's statutory objective (promoting competition) and the Board's stated priority regarding demand side flexibility – incentives to develop demand side flexibility are impacted directly by the availability of other risk management options.

## Purpose of the risk management review

*To test whether the availability of OTC contracts, in the context of other risk management options, is creating a barrier to entry or expansion in the retail electricity market and therefore harming competition*

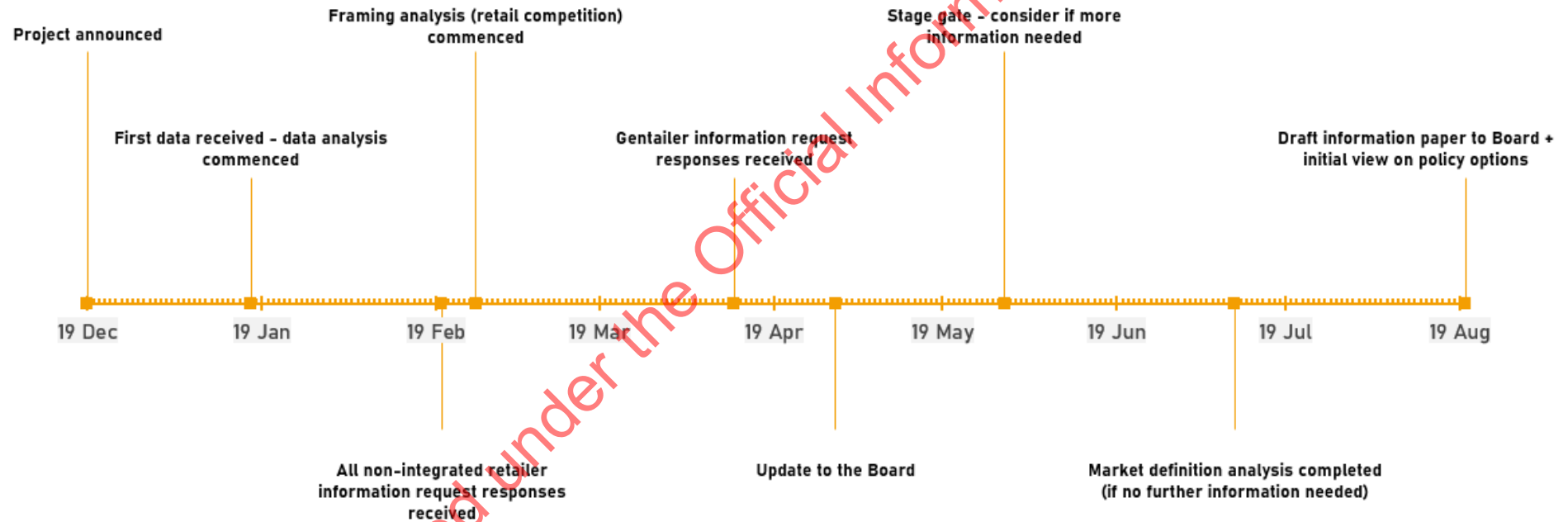
[Refer programme initiation document: [Risk\\_Management\\_Review\\_PID\\_final.pdf](#) (ea.govt.nz)]

Two problems claimed by non-integrated retailers:

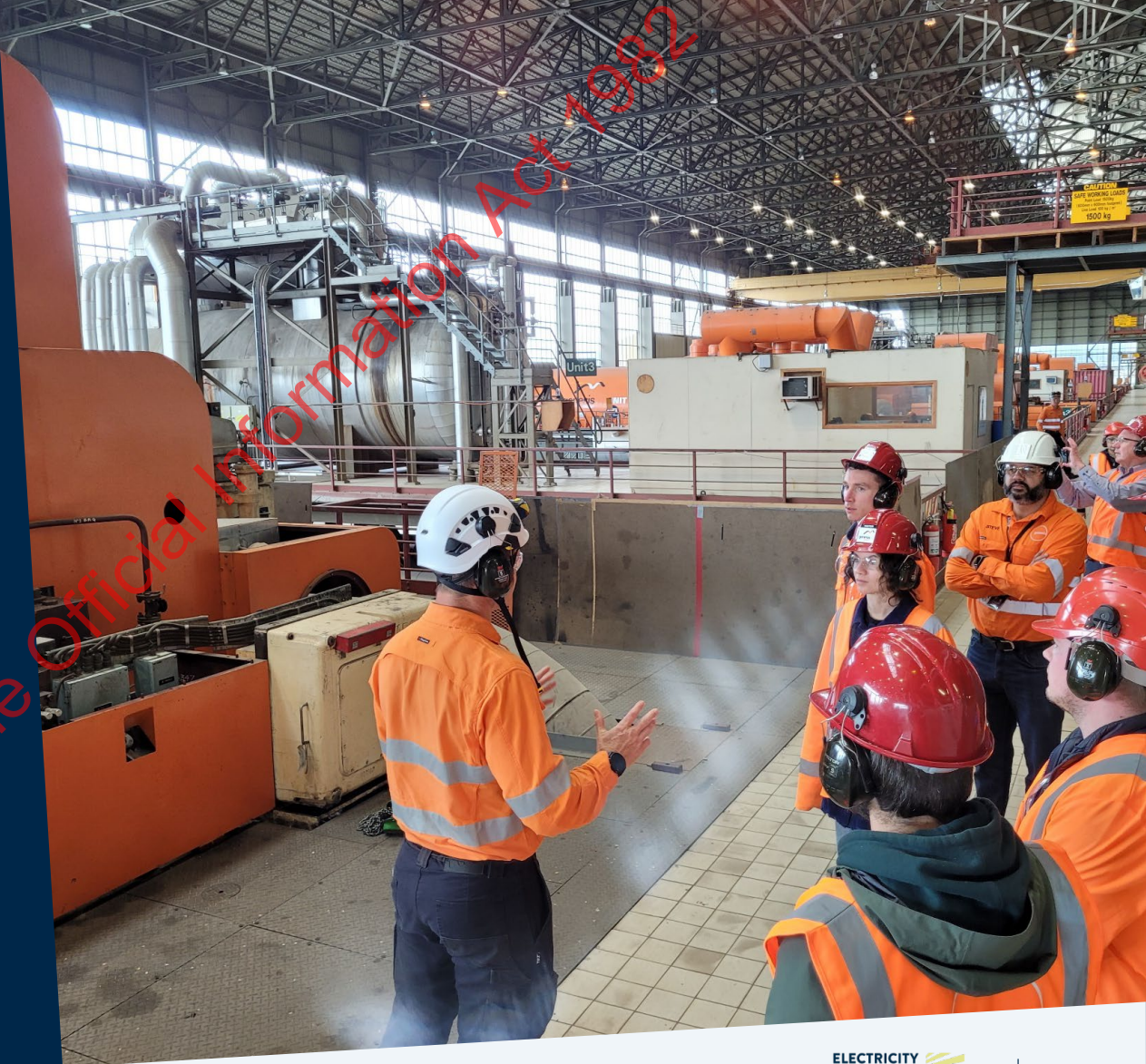
Refusal to supply OTC hedge contracts (availability, shape or price)

Margin squeeze via a combination of hedge contract prices and retail prices offered by gentailers.

# Risk management review indicative timeline



# MARKET DEFINITION AND KEY RELATED QUESTIONS

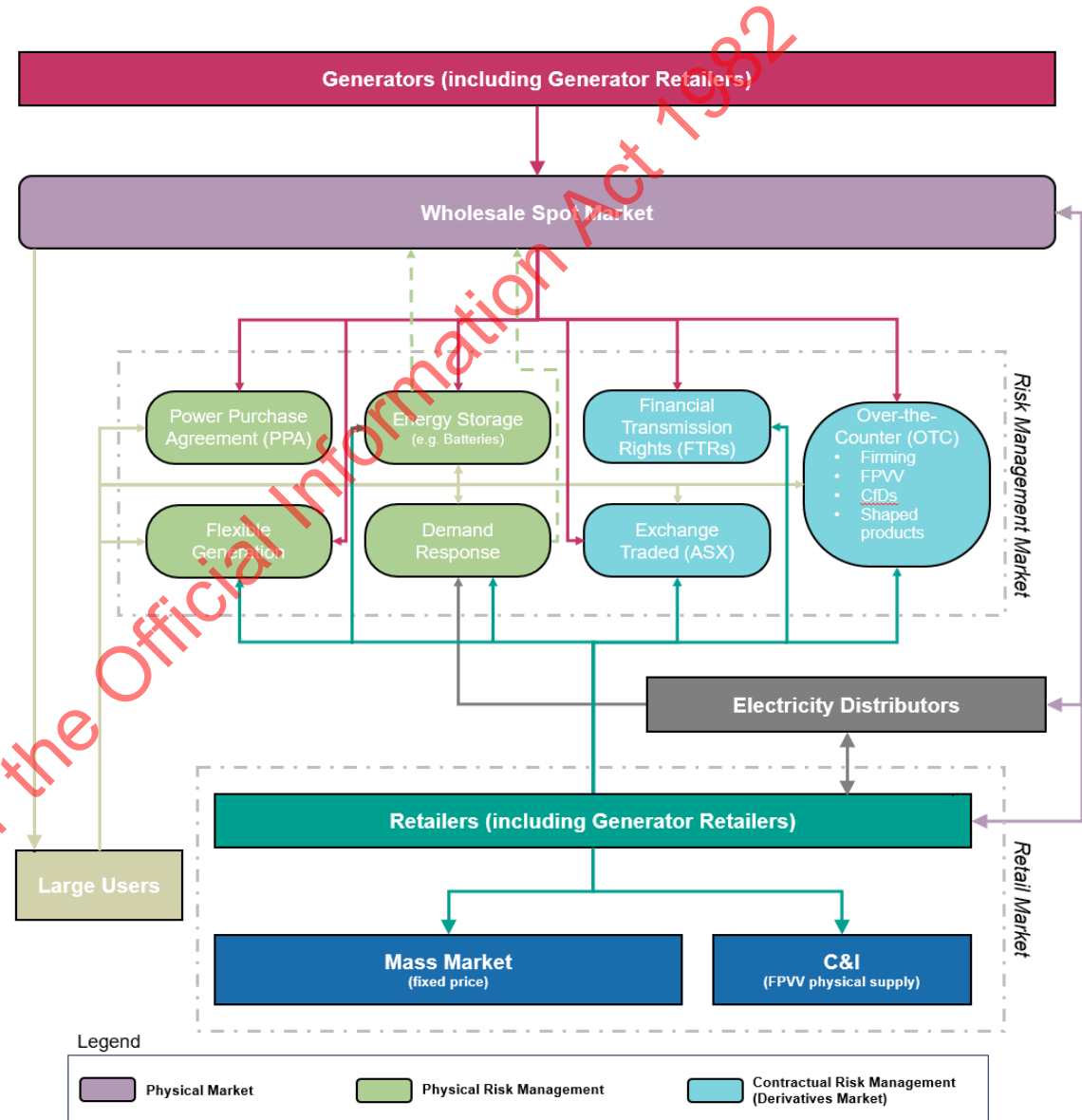


## Market definition – why do we care?

- Defining the market for a good or a service is a key part of any economic competition analysis.
- Defining the market for risk management depends on the portfolio of options available to retailers. The market for risk management is broadened by any substitutes for OTCs (potentially demand response, batteries, generation/quasi-integration/PPAs, ASX, other business models) that are included.
- There is an established competition law test for whether another product is a substitute (SSNIP test).
- The breadth of the market/availability of substitutes materially impacts the analysis of competition issues – and the extent to which OTC availability and pricing matter
  - It may be that other risk management options are not complete substitutes for OTCs, but form part of a complementary risk management portfolio – we are still considering the implications of that, but the market definition in this case is likely to be complex as retailers currently use a range of tools
- Market definition will be built on:
  - Quantitative analysis of pricing and availability data (from current information requests)
  - Qualitative analysis
  - Previous Authority work on flexibility.

**Question for the Board:** Do you have any views on the market definition?

# MARKET DEFINITION – INITIAL VIEW



# Key related questions about the effectiveness of the market (1)

Alongside defining the market for risk management, we are also considering how effective competition is for risk management products.

Questions we are considering include:

- Are there barriers to entry or expansion for electricity retailers for obtaining risk management products?
  - Are there any constraints on expansion of supply of risk management products?
  - Are there any problems with availability and accessibility of substitutes?
- Are any information problems (eg, information asymmetry) impacting access to risk management products?
- Is participant conduct hindering (or could it hinder in the future) competition for risk management products:
  - For OTCs this includes conduct by suppliers (gentailers); conduct by customers (retailers), eg, Section 9(2)(g)(i) Free and frank ; conduct by third parties (eg, brokers)
  - Consider for other risk management options

## Key related questions about the effectiveness of the market (2)

- What is the impact of regulation/legislation on the supply of risk management products and/or on competition amongst providers of these products?
- Do electricity retailers need a certain cost or business structure(s) to access the risk management options they need to sustainably compete? Does this negatively impact consumers?
- Will market evolution (growth, technological development, transition to 100% renewables) promote or hinder competition for risk management products?

**Question for the Board:** Are there any other key questions we should consider at this stage?

# CONTEXT FOR RISK MANAGEMENT

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## Context for risk management

As we undertake the risk management review, staff are keen to highlight at this stage two key issues that staff are considering related to context for the review:

- The expectations the Authority has for retail competition (i.e. what does good retail competition look like?)
- These expectations in the context of the transition to electrify the economy

No decisions on these issues have been made.

# Expectations of retail market competition

The Authority's expectations for the development of retail market competition have not been set out in detail before. They are framed by the Authority's 2011 interpretation of its statutory objective (see Appendix 1):

- Entry/exit from the market can be disorderly, including periods of declining competition, where prices may be above competitive levels until new suppliers enter or consumers find ways to reduce demand
- There are large consumer benefits from entry by innovative suppliers and efficient investment.

We are particularly interested in the impact (costs and benefits) of different types of retailers on competition in the retail market. This will influence the threshold for intervention.

Section 9(2)(g)(i) Free and frank

# The transition to electrify the economy (1)

- The Board is aware of the importance of flexible generation, ie, the firming support it provides to the increasing amount of intermittent solar and wind generation.
- The OTC/risk management question is another aspect of that, focussed on retailers wanting to manage spot price exposure (eg, during still winter nights) while flexible generation is becoming more scarce.
- Testing OTC availability/price, in the context of other available risk management options, is important for retail competition. If we find that there is a case for intervention in relation to risk management (whatever the form), the Authority should act.

Section 9(2)(g)(i) Free and frank

## The transition to electrify the economy (2)

Section 9(2)(g)(i) Free and frank

## EMERGING THEMES

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# Misuse of market power vs promoting competition (1)

- Perceived gentailer market power, in generation and retail, is at the heart of non-integrated retailers' complaints, eg, margin squeeze.
- We will look at market power after the market for risk management has been defined; it is useful to consider.

Section 9(2)(g)(i) Free and frank

## Misuse of market power vs promoting competition (2)

Section 9(2)(g)(i) Free and frank

## Post implementation review of ITP/RGM disclosure

- This post implementation review (PIR) is testing whether the 2021 disclosure regime for gentailer internal transfer pricing (ITP) and retail gross margins (RGM) has achieved its stated objective:

*"The reporting obligation is expected to have several positive effects on market outcomes – it will facilitate comparability of key ITP and revenue metrics; it will reduce information asymmetry and will improve trust and confidence in the electricity market"*

- The PIR is relevant to RMR: a key non-integrated retailer claim (margin squeeze) is pegged to the gentailers' ITPs.

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# EVIDENCE GATHERING AND INITIAL ANALYSIS



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## Engaging with the sector

- We have taken an open, transparent and responsive approach to the RMR since it commenced, acknowledging that much of the information we hold is sensitive.
  - That has included proactively disclosing information, eg, our information requests to OTC participants.
- Our aim in taking this approach has been to:

Section 9(2)(g)(i) Free and frank

- Ensure that we and they are well informed – taking opportunities to better understand and ask further questions.
- We have been engaged regularly by non-integrated retailers on the scope and focus of the RMR. We've also received four OIA requests to date. This testing is to be expected, and will likely continue – there is a lot at stake for retailers and hedge providers.
- We are responding pragmatically where we can, but maintain tight control of our processes and information – that's necessary for a robust RMR outcome.
- Our approach is to welcome engagement, provide updates, and respond to queries, while maintaining our flexibility.
- Ultimately progressing and releasing our substantive analysis as soon as possible will be the best way to respond to the points raised by non-integrated retailers (and any other stakeholders).

# APPENDICES

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# Appendix 1 – framing retail competition expectations

Extracts from *Interpretation of the Authority's statutory objective*, 14 February 2011, Appendix A, from para A13 onwards:

- “The Authority interprets *competition* to mean *workable or effective competition* ... Under workable competition, for example, sellers compete on price, quality, location and/or service, or by differentiating their goods or services from their rivals, or through their sales and marketing effort, or via a combination of those activities.”
- “... competition is not necessarily orderly or constant over time. There can be periods when competition declines as competitors exit markets as they discover they are unable to operate profitably, and this can happen in a disorderly manner.”
- “... however if disorderly situations undermine confidence in an electricity market or other markets, or in the electricity industry or New Zealand industry more generally, then that can inhibit efficient entry and investment decisions and these dynamic efficiency effects should be taken into account when evaluating proposals ...”
- “... workably competitive markets can bring very large benefits to consumers over the long term if they are conducive to entry by innovative suppliers and conducive to efficient investment.”