Lisa Rautenbach

From:	Michael Wigley [redacted]
Sent:	Wednesday, 6 November 2024 8:07 am
To:	TaskForce
Subject:	Submission re level playing field scope

You don't often get email from [redacted]

Dear Task Force,

I have written a series of three articles relevant to scoping here, here and here. They may assist the Task Force to establish scope.

A timetable to mid next year inevitably involves substantial compromise even on the simplest of objectives and thus a real possibility of regulatory failure. The expedited objectives might be laudable but a road map beyond mid next year will be important. The tortoise gets there faster than the hare.

Regards

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Wigley Law feedback -1D level playing field measures

3 Articles referred to in feedback:

Contact faces big hurdles to buy Manawa

Michael Wigley

Thu, Oct 17 2024

Two sharebrokers predicted Contact had odds of 50 per cent and 80 per cent respectively of getting Commerce Commission clearance to acquire Manawa.

I don't agree. The odds are not that high for multiple reasons, many of which are ducked in Contact's application submissions.

The starting problem for Contact is the argument that acquiring Manawa further concentrates the power of the vertically integrated gentailers, taking out an independent generator.

An independent can disrupt and add to competition, and, in turn, encourage new/expanded investment, even if it is a small player. Manawa generates only 4.3 per cent of the market.

Vertically integrated operators in many industries have strong incentives to keep out other upstream suppliers, retailers and new entrants.

For example, they can have big incentives to favour their own downstream retail operations ahead of independent retailers when wholesaling essential upstream inputs to those retailers.

They can do this by high wholesale pricing to independent retailers, for example. That is "margin squeeze," forcing retailers to charge more at retail relative to the vertically integrated retailers' retail prices.

That can have the effect of making them uncompetitive and even pushing them out of the market.

Supply constraint

Another method is constraining supply to the independents. That is particularly relevant in the power sector, both to independent generators and independent retailers.

I have often seen those strategies play out in my telco-work, where the problems ultimately led to the structural separation of Telecom into a network and a retail company.

Even four competing vertically integrated operators can have relatively limited incentive to compete with each other to attract the independent retailers by dropping wholesale prices and by making their upstream inputs available to them.

They can also have strong incentives to curtail investment across the board, especially investment by independents and by new entrants. Regulators have a big focus on that area.

One of the key issues is whether that holds true in electricity, such that the acquisition would, in the words of the commission's clearance test, substantially lessen competition (or SLC).

There are increasingly strong signs that there may be these problems with the gentailers.

We only need to look at the recently announced scope of the ComCom/EA Energy Competition Task Force to see where the regulators are heading, with a strong focus – albeit at a scoping level – on solutions to address failure in the retail markets due to gentailer conduct.

While Contact quotes a recent report by the commission indicating no gentailer margin squeeze problem, there appear to be major concerns still, as the task force scope shows.

Big-three

Contact's application leads off with "three core benefits" for competition from acquiring Manawa. These seem thin, implying weakness in other submissions.

To the first "core benefit": Contact adding Manawa's complementary winter-centric hydro to its summer-centric portfolio enables it to offer more fixed-price contracts to other players and new entrants.

That, says Contact, is good for supporting the likes of wind and solar generators and new entrants, who need firming contracts, and good for independent retailers.

Sounds great, until you look at the numbers. The expert economics report lodged in support quantifies the additional fixed-price contracts from the acquisition as the equivalent of benefitting 30,000 to 40,000 residences.

With around 2 million residences, that is only 1.75 per cent – almost irrelevant, compared to other, bigger competition effects of the acquisition, plus and minus. Yet this is the point on which Contact leads off on its application, implying it is the strongest point.

Particularly notable is that Contact has elected not to put in economists' or any other reports on other parts of its application, beyond a report as to the specific area of gross pivotal period analysis.

Thus, the other benefits and detriments are neither supported by independent economists, nor are they quantified. There's only submission. While not decisive, that is telling, as applicants frequently lodge such reports, including quantifying benefits.

Maybe Contact couldn't garner expert support?

Decarbonisation

Contact's second "core benefit" is the "goal" of decarbonisation. While such a goal may be laudable, that is irrelevant to a clearance application, yet Contact leads on it as its second "core benefit" in the summary.

Clearance applications are solely about whether or not the transaction substantially lessens competition, or SLC. That is solely about comparing the competition position in the future as between (a) the transaction proceeding and (b) the transaction not proceeding.

Thus, the "goal" of reducing decarbonisation, and the benefits as a result, do not bear upon the SLC question.

Importantly, there is another form of application to the commission to approve a transaction that does allow such public benefits like decarbonisation to be addressed.

That is the net public benefits authorisation application. But Contact appears to have concluded it won't succeed on an authorisation.

Decarbonisation can be relevant to the clearance application, as to whether it leads to SLC. For example, where thermal generation infrastructure is end-of-life, too expensive to operate, or there are regulatory restraints on use of thermal generation.

But that is not the basis of the second "core benefit": that is only about the "goal" of decarbonisation.

Contact's third "core benefit" is "unlocking potential generation development". In regulatory economics, new entry and also incentives to invest play a major role.

Investment

Contact submits the acquisition supports that for two main reasons. First, freeing up more "fixed-price contracts" enables others to invest in new generation infrastructure. But as I note above, the impact of that is minimal, relative to other bigger factors. So that can be largely ruled out.

The other main reason given is that this transaction will increase scale and enable investment by Contact, including Contact "accelerat[ing] investment in renewable development".

That is difficult to follow and accept: surely if Contact acquires seasonally complementary hydro generation under this deal, its incentives to build out more generation capacity are reduced in any form?

If it doesn't acquire that complementary generation, is it likely to invest in new infrastructure to achieve complementary firming? Yes it will still invest due to the big increase in demand coming up. But this is reduced by acquiring existing capacity.

Additionally, this has Contact investing, not independents including new entrants, thus keeping the investment within the gentailer family. This exacerbates the existing problems.

Contact says that increased scale makes additional investment by it more efficient and less costly (eg the cost of capital reduces).

A potentially good point but, in the scale of things, that is not likely to have major pro-competitive effects. The benefits are not quantified and this would still have a gentailer keeping investment in the gentailer family.

This also is not an auspicious start to lead with, especially as these are just submissions made by Contact. It has elected not to lodge a detailed quantitative and qualitative economics report to justify what appears to be a decidedly counterintuitive submission on a core consideration for the commission.

Alternatives

As I note above, a core part of any clearance application is comparing what happens with the transaction proceeding, as against the transaction not proceeding.

Currently, Manawa has long-term supply/hedging contracts with its former retail arm, Mercury, which start to finish this month.

Manawa has stated it will replace those contracts with other long-term contracts, so that, says Contact, the effect on competition is neutral, if Contact takes over instead.

So it is said there is no competition problem when comparing the with-and-the-without transaction scenarios.

It is difficult to understand why Contact has not raised other and more granular counterfactuals that are particularly significant.

For example, it is one thing to continue the status quo – long-term supply to one of the gentailers – and entirely a different thing to lock up supply to an independent generator on a firming basis and/or to an independent retailer.

Contact is silent on this obvious point.

A new entrant or expanding solar and/or wind generator may need to firm its offering with complementary sources such as hydro.

The latter seems to be a decidedly pro-competitive outcome, compared to locking up supply with a gentailer.

Yes, the commission approved such long-term contracts with Mercury as the gentailer when clearing that transaction. I don't agree with that conclusion back then, but anyway, would the same approach apply today? The task force's review terms suggest not.

New entrant?

And what of the option of Manawa selling its business, such as to a new entrant, which possibly has firming complementary solar and/or wind?

Or to an existing stand-alone generator to enable expansion such as to enable a complementary firming offering.

Wouldn't such new entrants or existing independents looking to expand want the easier, quicker and more certain entry/expansion via Manawa's existing plant?

Contact does not raise these obvious options.

And Contact doesn't address what appears to be a major potential problem with Manawa's avowed intention to supply only on long-term agreements, if to a gentailer.

It seems possible that such agreements themselves would lead to breach of SLC provisions in the Commerce Act by Manawa and counterparty gentailers, and so cannot happen.

Contact is not the only game in town to be addressed in the counterfactual. Manawa has said that several other parties are interested. Contact doesn't mention that.

I have only touched the sides as to Contact's challenges. There there are multiple other issues, including the big problem that heavily surfaced this year: supply to large electricity users.

Michael Wigley is a solicitor specialising in utility regulatory and competition issues.

Structural separation missing in regulatory reviews

Michael Wigley

Tue, Oct 22 2024

Today, the Energy Competition Task Force has asked for submissions on what to include in-scope to implement a level playing field between gentailers and retailers.

It should include structural separation; my view is that so far, regulatory treatment of that issue is undercooked.

The Electricity Authority's Market Development Advisory Group's major report last December is strong in many respects.

But gentailers' structural separation into generation and retail businesses is dispatched in only two sentences:

"We have also considered whether a retail-generation split would improve competition for flexible supply. The short answer is no, because the source of the market power (ie a concentration of ownership for flexible supply assets) would be unchanged by such a split."

In other words, MDAG says the problems are only at the upstream wholesale market level, not in the downstream retail market level, so separating generation and retail won't solve the problem.

The MDAG makes hardly any mention of downstream retail market competition issues in its report.

There is nothing said, for example, about issues arising from gentailer dominance in upstream flexible generation and the impacts on retail competition.

This approach is unfortunate, in my view, and ignores a market reality that is important to have an appropriate assessment.

Control

As I overviewed in my article last week, gentailers have concentrated control over wholesale flexible upstream inputs, a point acknowledged in the MDAG quote above.

Those inputs are essential to independent retailers, namely flexible power and, using MDAG wording, flexible power supply contracts.

Unconstrained, gentailers have incentives to favour their own downstream retail operations by (a) pushing up the prices paid by independent retailers to make them less competitive with their downstream operations (ie margin/price squeeze) and (b) withholding such supplies, again to make independent retailers less competitive.

Additionally, often four vertically integrated suppliers of essential upstream services in industries won't compete with themselves to drop wholesale pricing and availability for independent retailers.

Such problems are well-known in regulatory economics and law. They get close focus in many utility regulatory reviews and actions.

While the EA had been lukewarm on whether there are such problems with the gentailers, in my view this major issue cannot simply be ignored in the MDAG review.

It needs to be addressed. Narrow terms of reference for that MDAG review, for example, cannot be an answer.

I am not saying there are, in fact, such issues here. That requires close analysis, but that analysis should have been undertaken on the review, as without it, big pieces in the puzzle are omitted.

If indeed there are such problems, MDAG's 31 recommendations may well not solve the market issues.

The margin squeeze and supply problem lead into the option of structural separation, addressed in more detail below.

Energy Competition Task Force

That MDAG report is the foundation of much of the scope for the EA/ComCom Energy Competition Task Force.

However, the task force's scope does go further and directly addresses gentailer competition issues at retail level, such as the option of non-discrimination between gentailers' downstream retail operations and independent retailers (which I will address in another article).

Structural separation is missing in the task force scope too, although there is room to bring it in. That should happen, adding to the options being considered.

It's helpful to set out the project planning for the task force work and then address where structural separation fits.

Picking up on the MDAG report and the classic approach by regulators, the task force has a series of ever-more intrusive steps, sequentially applied.

Critical to the strategy is having regulatory backstops, such as: "If you, the industry, cannot agree voluntarily to contracts and services that sufficiently reduce competition and market problems including investment challenges, we will regulate A and B obligations. If A and B don't work, we'll regulate the more intrusive C and D obligations."

Sequential

This sequential regulatory backstop strategy recognises the risk of regulatory overreach and regulators getting it wrong. The task force aim is to speed up that sequential process, from what normally takes years into a few months.

For example, the task force encourages industry to agree terms to avoid regulation, while the regulators contemporaneously prepare regulatory steps A to D.

The idea is that having regulatory steps ready to go encourages voluntary solutions, reduces gaming opportunities and delay, while in fact being ready to regulate quickly.

Thus, as a first step, the task force scope has the regulators encouraging industry to agree firming and other contracts aimed at hydro firming of wind/solar and also supporting independent retailers.

Regulatory options are in play too in this regard, and they are to be developed. At the same time, the regulators are developing what MDAG called a "virtual disaggregation" regulatory model in case that doesn't work.

It beats me why that fancy "virtual disaggregation" wording is confusingly used for what can simply be described as "must supply" regulation: gentailers must supply, in the words of the task force scope, "a minimum volume of their flexible generation base to buyers in the form of risk management contracts".

This, of course, raises pricing issues too. That is a tough issue to address, with workable solutions not readily apparent from the MDAG report.

If all that doesn't work, the scope calls for investigating level-playing-field measures such as non-discrimination which, as that scope states as to gentailers, *"would require generators to treat the retail arm of their operations the same as they treat other retailers."*

It's here that the task force has room to add structural separation of gentailers into (a) generators and (b) retailers.

Structural separation

As I will outline in my next article, there are potential challenges with regulatory solutions, such as wholesale supply regulation and non-discrimination regulation.

It is possible that the problems will end up being so negative that structural separation is the only option.

But in the status quo, that would be years away, particularly as it is not in play now as an option.

In the meantime, problems may continue to build, which is a particular issue in electricity given the criticality of expensive investment, including timing and the long lead-time to build.

I can understand the task force narrowing focus on what is already a very difficult – if not impossible – regulatory programme to achieve over such a short period.

Additionally, detailed cost-benefit analysis may show this is not the best option, a point well illustrated by such analysis by MBIE in regard to supermarkets.

After all, there are benefits as well for consumers in having vertically integrated operators, the issue being whether the negatives outweigh them.

However, this should be on the table as an option sooner than later. Having it as an option now may expedite resolution one way or another, such as bringing that backstop pressure into play more quickly.

Politics

There has, of course, been strong and speedy regulatory and political reaction to this year's energy crisis. On its own, setting up the task force with its ambitious agenda and collaboration between regulators, after years of much slower pace, is remarkable.

The Telecom experience is salutary. A big negative reaction by Government in 2006 led down a path of no-return for Telecom.

As Government saw it, Telecom's high-handed approach pushed things too far once too often. Prime Minister Helen Clark and Communications and Information Technology Minister David Cunliffe largely switched against Telecom overnight.

Operational separation resulted. That sophisticated variation on the non-discrimination theme had major failings, just as non-discrimination may not work in electricity.

That ultimately led to Chorus and Telecom (now Spark) being structurally separated, albeit voluntarily in the end.

For gentailers, 2024 looks to be a similar pivoting point, which may lead – inevitably - to major change.

As Trustpower stood to gain from structurally separating, maybe it won't hurt too much for other gentailers to do it.

And that brings in the political dimension. After all, the Government majority-owns three of the four gentailers, so this, subject to Government mixed-ownership duties, enables action by it in the context of the ultimate benefit to consumers.

The Government can do more besides, such as taking major change out of the regulators' hands, as happened with Telecom's operational separation.

While there seem to be different coalition voices, maybe this will fly?

Vertical separation

The EA has addressed structural separation, although with a primary focus on horizontal, not vertical, separation, where only a vertical split (ie retail from generation) would, in my view, be effective.

Most recently, it elected in May last year not to proceed down that path.

But the analysis was decidedly light and, in my view, insufficient in the context of the issues arising from the gentailers.

In particular, there should be a comprehensive quantitative and qualitative cost-benefit analysis of the pros and cons. Expensive yes, but a tiny cost compared to what is at stake.

And, of course, we're now more than a year on from the EA's rejection of structural separation.

Things have changed, as the task force scope reflects, and the regulators have more information on the success or failure of other regulatory interventions.

It is possible the Government will call this, instead of the regulators, particularly if the regulators continue their relatively limited analysis of the separation option.

The Ministry of Business, Innovation and Employment might commission the sort of cost-benefit report it commissioned for the supermarket sector and then take action.

Whether the outcome is for or against structural separation, at least the optimal position will be known.

I'm not saying that structural separation is necessarily right, but rather that the option should be on the table and closely analysed quantitatively and qualitatively.

There's nothing like a crisis to drive quicker and stronger change.

Michael Wigley is a solicitor specialising in utility regulatory and competition issues. In his next article he will address another level playing field issue for the task force – non-discrimination and its sophisticated variant, operational separation.

Is a non-discrimination rule the answer?

Michael Wigley

Wed, Oct 23 2024

Would a non-discrimination obligation on gentailers make a difference to competition in the energy market?

That's one of the options in front of the Energy Competition Task Force, which has this week called for input on what level-playing-field measures it should be considering in a regulatory backstop if other steps to improve the performance of the energy market don't work.

As its scope states, a non-discrimination rule "would require [gentailers] to treat the retail arm of their operations the same as they treat other retailers".

Often, vertically integrated operators in industries that wholesale to retail competitors essential inputs not available elsewhere can use market power against those competitors.

There are signs that gentailers may be doing that to independent retailers, including indications from the task force's scope and the call for submissions on this.

Solving such problems has major challenges. For example, solutions requiring gentailers to supply retailers under flexibility contracts, such as hedging, can be challenging. A non-discrimination obligation may help.

If that works well, margin/price squeeze is largely avoided and the gentailer must supply volumes in the same way it supplies its own downstream arm.

The gentailer can't push up wholesale prices for other retailers in a way that makes their services to users uncompetitive, relative to prices the gentailer is charging its own retail customers.

Relevantly, these customers include big business customers like pulp mills, and not just homes and smaller business.

Theory

Sounds great in theory. In practice it can be difficult to get right. Even then there can be challenges, although it's worth noting that no regulatory solution is perfect.

The complexity of hedging and other contracts in multiple scenarios is only one of the difficulties, as the Market Development Advisory Group report shows.

Another is how you treat the different volume needs, such as when supply is tight.

The starting point is getting the source data right, such as the gentailer's cost of supplying its downstream retail arm.

In that way, the cost of supplying power inputs to the downstream retailer arm can be compared to wholesale pricing to independent retailers, so the retailer arm and the retailer are treated in the same way. Similarly with non-price terms, which are important too.

The Electricity Authority already collects relevant data on input pricing for gentailers' downstream retail operations, but some have strong views that the dataset chosen by the EA is not reliable and not relevant.

I see, for example, that the New Zealand Institute of Economic Research has written a report firmly criticising the EA's dataset choices. Regulators the world over can face big challenges in this area, and that should be in scope here too.

Tiwai

There can be judgment calls, too, as to how to allocate cost where so much in gentailer operations is common cost.

Take a big-end-of-town example: supply to New Zealand Aluminium Smelter's Tiwai smelter. Say the non-discrimination model in the future allows for lower pricing, such as to NZAS, based on volume. A similar issue arises when comparing volumes between, say, a downstream retail arm and a smaller independent retailer.

The attributable cost-saving for the generator of such volume services can be gamed unless carefully defined.

How do you apportion common cost on a rational basis based on volume? Do you increase price based only on marginal cost difference, such as marketing, contract management, supply cost savings, admin etc? Or not?

Do you use another methodology? Delve into the world of equivalence of inputs and equivalence of outputs? What if this is not defined?

Thus, the reported far-lower prices being paid by the Tiwai smelter (a high-volume customer) relative to independent retailers and large commercial customers raise the sort of tensions that can apply.

Plus, that Tiwai concern raises cross-subsidy issues, which has had EA focus. All big concerns.

Operational separation

A more sophisticated variant of non-discrimination terms is operational separation, which the Government forced on Telecom.

The gentailer still owns the full top-to-bottom business in this scenario. It is not structural separation; it entails a detailed separation of the upstream generation operation, the wholesale operation selling to independent retailers and the downstream retail operation, which would include the retailers supplying to big users.

For example, incentives are set up for management of each of the three units, so they are incentivised only by the results of their specific unit.

This goes some way to solve the problems of vertical integration, where the retail arm competes with retailers to which the gentailer wholesales a key upstream input (and where the gentailer wholesales to standalone generators, including firming etc).

But operational separation has problems, as I have seen when acting for clients in the telco space, including the reality that the vertically integrated operator still has strong incentives to favour its own operations, no matter how the operational separation barriers are set.

In the end, the net-outcome for the business, reflected in ultimate profits and dividends, can dominate incentives in the real world.

That sort of problem relating to Telecom's operational separation was a major cause of the subsequent structural separation of Telecom into truly separate companies, Chorus and Spark, albeit voluntarily in the end.

Journey

That implies there can be a regulatory journey that starts with product price and non-price terms and ends up with structural separation, perhaps via stepping stones such as non-discrimination terms and operational separation.

As earlier regulatory solutions fall short, there are more intrusive interventions; all things being equal, that can take years.

As to power, the complexity and multiple factors make this very challenging in a regulatory context, as illustrated by the numerous issues in MDAG's December 2023 report, a core basis for the task force's work.

Michael Wigley is a solicitor specialising in utility regulatory and competition issues. In his last article he looked at the issues involved in structural separation of the gentailers.