7 May 2025

Electricity Authority
WELLINGTON

**By email only:** levelplayingfield@ea.govt.nz

## Feedback on Level Playing Field measures

1. This submission is made on behalf of independent electricity retailers 2degrees, Electric Kiwi, Octopus Energy and Pulse Energy (together **IERs**).

2. The IERs strongly support Option 2 (non-discrimination obligations) as a vital step toward ensuring a fair and competitive electricity market. However, to deliver enduring and effective competitive outcomes, the Electricity Authority (**EA**) should adopt Option 4 (Corporate Separation).

3. Corporate separation would embed the non-discrimination principles of Option 2 within a clearer, more enforceable framework — leveraging existing arm's length rules under Part 6A of the Code. It would promote entry and investment in new generation, create a more liquid and accessible hedge market (particularly for OTC products), and ensure all retailers can compete on equal terms. By removing information asymmetries and simplifying compliance, this would offer a regime that is easier to implement, monitor and enforce — delivering long-term benefits for consumers and the wider market.

4. The attached submissions set out:

    4.1 Why non-discrimination obligations are necessary or desirable to promote competition in, and the efficient operation of, the electricity industry;

    4.2 The complexities of, and considerations for, developing non-discrimination principles that will be effective to achieve the EA's aims;

    4.3 Why corporate separation together with arm's-length rules and non-discrimination obligations would be a more effective solution and should be the preferred option to address the issues with the supply of hedge contracts; and

    4.4 Why corporate separation and arms-length rules would address other competition harms that exist in the markets and is therefore the best option to **promote workable and effective competition** for the **long term benefit of consumers in** New Zealand.

Yours sincerely,

| | | | |
|---|---|---|---|
| Emma-Kate Greer | Huia Burt | Margaret Cooney | Sharnie Warren |
| Chief Customer Officer | Chief Executive Officer | Chief Operating Officer | Chief Executive |
| [redacted] | [redacted] | [redacted] | [redacted] |

# Independent Retailers' Submissions on Level Playing Field Measures Options Paper

## 7 May 2025

## Executive Summary

5. The Electricity Authority Level Playing Field Measures Options Paper dated 27 February 2025 (**Options Paper**) articulates the problems and risks relating to the supply of hedge contracts well, noting:

> *"It is clear that shaped hedges are important for increasing competition and generation investment."*
>
> *"The evidence demonstrates a risk of competition issues in the hedge market"*
>
> *"Gentailer actions may be negatively impacting both wholesale and retail competition"*
>
> *"Our current view is that the non-discrimination obligations should be implemented as soon as possible to promote competition in, and efficient operation of, the electricity industry."*

6. The IERs support that conclusion and urge the Electricity Authority (**EA**) to move without delay to address the significant competition harms identified.

7. The market power of the gentailers has been well-documented and accepted by the Commerce Commission (the **Commission**),[1] and the liquidity and pricing risks are clear and have eventuated. In these circumstances, **non-discrimination rules are necessary or desirable to address these harms and promote competition**.

8. In addition, implementing non-discrimination rules is consistent with the recommendations made in:

 8.1 Electricity Price Review (**EPR**) Final Report dated 21 May 2019 (**EPR Report**);[2] and

 8.2 Market Development Advisory Group (**MDAG**): Price discovery in a renewables-based electricity system – Final Recommendations Paper dated 11 December 2023 (**MDAG Report**).[3]

9. However, the Options Paper has understated the risks of Option 2, (non-discrimination obligations) while overstating the perceived negatives to Option 4, (corporate separation). There will be some complexities and challenges in developing non-discrimination obligations that will be effective, in particular:

 9.1 non-discrimination obligations must apply to all hedge contracts, as any narrow application leaves open the risk of discrimination in other products;

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[1] Commerce Commission, Investigation Report – Commerce Act 1986 s 27, s 30 and s 36 Electricity Investigation (22 May 2009), at para ii; similar views were reached by Oliver Browne, Stephen Poletti & David Young (2012) *Simulating market power in the New Zealand electricity market,* New Zealand Economic Papers, DOI:10.1080/00779954.2011.649566.

[2] Electricity Price Review: Final Report (21 May 2019) (**EPR Report**), see *Section D: Reinforcing wholesale market competition* at pp.41 onwards).

[3] MDAG, Price discovery in a renewables-based electricity system – Final Recommendations Paper (11 December 2023) (**MDAG Report**).

9.2 the rules must be broad enough to avoid creating loopholes that can be exploited;

9.3 the rules must include obligations on gentailers to construct an initial hedge position for their retail business;

9.4 the rules should not allow any deviation from the non-discrimination obligations; and

9.5 the rules will require strong monitoring, reporting and enforcement from the EA, including meaningful penalties for failure to comply, which will be a significant cost to the EA and ultimately to the taxpayer.

10. We are encouraged and strongly supportive of the Commission's urgency in implementing Level Playing Field measures, and the IERs stress that Step 1 (basic non-discrimination rules), should act only as a temporary measure until stronger rules (Steps 2 and 3) are ready to be implemented and should be supplemented with corporate separation (Option 4) and arms-length rules.

11. **Corporate separation (Option 4) together with arms-length rules should be the preferred option** to address the issues with the supply of hedge products in the Options Paper because:

11.1 Rules imposing corporate separation and arms-length obligations already exist in Part 6A of the Electricity Industry Participation Code 2010 (the **Code**)[4] and could quickly and easily be amended to apply to the generation and retail businesses of the gentailers.

11.2 Reforms by the EA in relation to hedge access issues[5] have consistently fallen short of what is needed. While some reforms have been individually helpful, collectively they have been inadequate to address the substantive problems in electricity markets and retail competition performance has deteriorated over this time.

11.3 Principle-based non-discrimination rules alone will not result in the enduring changes the EA is seeking, as the gentailers are inherently incentivised to discriminate and act in their own self-interest and in an economically rational way.

11.4 The negatives of corporate separation have been overstated:

11.4.1 There is no clear evidence of specific vertical efficiencies in electricity markets, and no evidence that these vertical efficiencies are passed on to consumers.

11.4.2 The "significant costs" of corporate separation are not evidenced and are private costs (ie costs to the gentailers) which appear to be prioritised over costs to consumers and taxpayers from the increased oversight and monitoring required of the non-discrimination rules outlined in Option 2. They are also overstated relative to other options, given that all of the options in the Options Paper will require operational change with some associated cost.

11.4.3 We disagree that primary legislation is "likely required". The EA has wide powers to amend the Code, and imposing corporate separation obligations of the same nature as those in Part 6A of the Code is something the EA can do, if

[4] Part 6A of the Electricity Industry Participation Code requires corporate separation between distribution and retail business and imposes arms-length rules

[5] For example, changes made in 2019 (eg reducing the maximum bid-ask spread), introduction of more obligations in 2020 following the Electricity Price Review, introduction of commercial market making in 2022 and a voluntary shaped product in 2025.

it is necessary to promote competition. The IERs have sought an expert legal option from Jenny Cooper KC on this issue, which is attached as **Annex B**.

12. In addition, there are wider benefits from corporate separation that would address competition harms in a more holistic way.

13. There are a number of issues that evidence problems within the wholesale and retail electricity markets (in addition to the lack of liquidity in hedge markets) including:

    13.1 lack of investment in new generation, despite significant projected increases in demand;

    13.2 refusals (or constructive refusals) to supply hedge products; and

    13.3 retail margin squeeze.

14. Separation is internationally recognised best practice to deal with the competition harms arising from vertical integration and to promote **workable and effective competition in markets**. In December 2024, the OECD recommended that New Zealand consider requiring gentailers[6] to divest their retail assets, stating:[7]

    "*Despite previous reforms to improve competition, electricity futures prices are high and above the threshold considered sustainable for the economy in the long run. These reviews should re-examine separating the generation and retail operations of large electricity companies to boost competition in the futures market and provide industry with more hedging options*"

15. Corporate separation and arm's-length rules would promote and improve competition in the electricity industry for the long-term benefit of consumers by:

    15.1 Creating incentives for entry/expansion of generation capacity.

    15.2 Creating a liquid market for hedge products (particularly OTC products).

    15.3 Ensuring all electricity retailers can compete on a level playing field.

    15.4 Removing information asymmetries for both:

        15.4.1 industry participants (including increasing investor confidence in the industry and promoting the necessary investments in generation); and

        15.4.2 the EA as the industry regulator, easing monitoring and compliance costs.

16. The assumption that that non-discrimination measures will "maintain investment incentives" is not supported by evidence.

    16.1 The big 4 gentailers have been slow to increase supply. Their incentives are to avoid growing output because it will reduce the return across their portfolio and it is not profit-maximising to materially increase output. The lack of investment in generation by gentailers is a key factor in the current scarcity issues.

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[6] The term 'gentailers' is used to refer to the 4 major generator/retailers Contact Energy Ltd, Genesis Energy Ltd, Meridian Energy Ltd and Mercury NZ Ltd, who together account for approximately 86% of generation and 84% of the retail market.

[7] OECD *Economic Outlook, Volume 2024 Issue 2, No 116* (December 2024), p.215.

16.2 By contrast, in a workably competitive market, generators would be incentivised to increase output to increase returns.

17. Corporate separation plus arm's-length rules[8] would allow the EA to address competition harms in a more wholistic way, and avoid further costly, expensive and piecemeal regulation.

18. Anything less than corporate separation and arm's-length rules would not resolve the current significant challenges in electricity markets because:

18.1 The gentailers will continue to have incentives to limit additional generation capacity to match their retail books.

18.2 With anything less than corporate separation, there remains a lack of transparency and information asymmetries which will require regulation to resolve.

18.3 Disclosure obligations imposed by the EA (for example in relation to ITP and retail gross margin) have not achieved the stated purpose. It is unclear how the EA proposes to create "a new, robust ITP methodology".

18.4 Other forms of regulatory oversight impose significant cost and inefficiencies and are less effective.

18.5 Electricity Authority reforms in relation to hedge access issues including:

18.5.1 changes made in 2019 (e.g. reducing the maximum bid-ask spread),

18.5.2 the introduction of more obligations in 2020 following the Electricity Price Review,

18.5.3 the introduction of commercial market making in 2022; and

18.5.4 the introduction of a voluntary shaped product in 2025

have consistently fallen short of what is needed.

18.6 An effective solution is overdue, given that the EPR recommended in 2019 that separation be considered if its other recommendations did not resolve the identified harms. 6 years on, competition harms remain and are worsening.

19. The IERs do not support the negotiate-arbitrate model (Option 3) and there are some incorrect assumptions in the Options Paper.

20. We expand on these points below, and attach the following supporting documents:

20.1 Annex A: A response from the IERs in the "Format for Submissions" set out in Appendix E of the Options Paper.

20.2 Annex B: Opinion from Jenny Cooper KC

20.3 Annex C: Report from Link Economics

[8] As set out in the Electricity Industry Participation Code, Part 6A, Schedule 6A.1.

20.4 Annex D: Matthews Law letter dated 7 August 2024, including the Urgent Code Change request (which is yet to be acted on)

20.5 Annex E: The IERs submission on Risk Management Review Issues Paper, dated 20 December 2024

## Non-discrimination obligations are necessary or desirable

### *Current market conditions are not workable or effective competition*

21. The EA's main objective under the Electricity Industry Act 2010 (**EIA**) is "*to **promote competition** in, **reliable supply** by, and the efficient operation of, the electricity industry **for the long-term benefit of consumers**.*"

22. The Commerce Act 1986 defines "*competition*" as "*workable or effective competition*".[9]

23. The projects undertaken by the EA (including the wholesale review, risk management review and the Options Paper among others), fail to properly consider whether there is workable and effective competition in electricity markets for the long term benefit of consumers.

24. Neither wholesale or retail electricity markets are functioning in a workably competitive manner, which has been documented in both the EPR[10] and MDAG[11] Reports (given the underlying structural issues arising from the vertical integration of the four gentailers).

25. More detail on why there is not workable and effective competition is set out above at paragraphs 70-71 below and in previous submissions including the Matthews Law letter dated 7 August 2024 attached as **Annex D** and the IERs submissions on the Risk Management review attached as **Annex E**.

26. In summary:

    26.1 Supply has not kept up with demand.

    26.2 Wholesale prices have increased rapidly since 2018 and remain well above the long run marginal cost (LRMC) of generation.

    26.3 Retail prices are below wholesale prices.

    26.4 IERs are unable to expand or compete in the way you would expect to see in a workably competitive market and many have exited the market in recent years.

    26.5 There is low liquidity in hedge markets, and access to risk management products is difficult.

27. The EA has the power to amend the Code where the amendments are "*consistent with the objectives of the [EA] and are **necessary or desirable to promote … competition** in the electricity industry*", reliable supply to consumers, efficient operation of the electricity industry.

[9] section 3(1).
[10] EPR Report, p.2.
[11] MDAG Report, p.12 –13.

28. The High Court has noted that the EA's powers are broad and should not be interpreted narrowly. The overall goal is the long-term benefit of consumers and the Act provides a framework for the regulation of the "electricity industry" as a whole.[12]

29. The IERs welcome the EA's acknowledgement that access to risk management products, and in particular peak hedge products, is an issue that is impeding competition and needs to be addressed urgently.

30. The IERs agree with the EA's current view that non-discrimination obligations must apply to all hedge contracts, as any narrow application leaves open the risk of discrimination in other products. The EA should also consider whether the non-discrimination rules should apply to all trading, including PPAs.

31. Non-discrimination obligations are necessary and desirable changes the EA should action under the Code to address the harms identified in the hedge markets.

### *Non-discrimination rules consistent with the EPR recommendations*

32. The EPR Report made several recommendations which sought to address market structure issues, including:

    32.1 D1: Improve availability of wholesale market information;

    32.2 D2: Introducing mandatory market-making obligations unless the sector develops an effective incentive-based scheme;

    32.3 D3: Make generator-retailers release information about the profitability of their retailing activities; and

    32.4 D4: Monitor contract prices and new-generation costs more closely.

33. Some of these recommendations have been implemented by the EA, for example requirements on the gentailers to disclose internal transfer prices (**ITPs**), the purpose of which was to introduce some transparency and allow the EA to determine whether or not the gentailers were self-preferencing.

34. However, the EA recently concluded the ITP was merely "*a regulatory requirement of limited, if any, benefit*".[13] These disclose requirements have failed to deliver the anticipated benefits.[14]

35. Non-discrimination rules are the next logical (but not sufficient) step.

### *Non-discrimination rules consistent with the MDAG recommendations*

36. The MDAG Report concluded that tools to manage risk are a key pillar of a well functioning wholesale electricity market, together with accurate pricing, competition and public confidence.

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[12] *Manawa Energy Ltd v Electricity Authority* [2022] NZHC 1444 at [61], [69].

[13] EA, Reviewing risk management options for electricity retailers – issues paper (7 November 2024), Chapter 7, at para 6.8.

[14] The failure of the ITP disclosure rules highlight the information asymmetries that exist and the ability of the gentailers to obscure or distort information. This is a reason why the IERs believe that nothing short of corporate separation will address the problems within the electricity markets.

37. Relevant statements include:

*6.18. "our system will be more sensitive to the weather…Spot prices will become more volatile… we do need to make sure participants have access to the necessary tools to manage and mitigate increased spot price volatility."*

*7.26 "A thinning of competition for flexibility products could tear at the fabric of the broader market. That is because flexibility products provide a critical bridge to integrate intermittent supply into products suitable for retail consumers. Put simply, weaker competition for flexibility products could also undermine competition in the retail and new investment markets."*

*7.27 "Our view is that the risk of declining competition for longer-duration flexibility contracts must be proactively managed – rather than adopting a 'wait and see' approach."*

38. The report made a total of 31 recommendations including:

38.1 A requirement for hedge market transparency;

38.2 Market making obligations for flexibility products;

38.3 Development of a competition dashboard.

39. MDAG recognised the need for flexibility (hedge products):[15]

*"Flexibility products are becoming increasingly important as the system shifts to renewable generation sources but there is no market-making in this type of contract."*

40. The non-discrimination obligations proposed as Option 2 in the Options Paper are consistent with these recommendations, and are a measure to respond to the harms identified in the MDAG Report.

## Practical and drafting considerations

41. While the IERs strongly support the EA's view that level playing field measures need to be implemented urgently, it is acknowledged that there will be some complexities and challenges with developing non-discrimination obligations that will be effective to achieve the EA's aims.

### Expediting and implementing Steps 2 and 3 of Option 2

42. While the IERs welcome the EA's urgency in implementing Step 1 (basic non-discrimination rules), this should only act as a temporary measure until stronger rules (Step 2 and 3) are ready to be implemented (although at the same time we would urge the EA to prepare these steps urgently).

43. Lessons should also be learnt from the ITP disclosure rules. Allowing gentailers to design the non-discrimination provisions[16] risks the same ineffective result.

44. The requirement to sell and purchase all hedging products via a market platform (along the lines of Step 3) is necessary to preventing implicit or informal hedging, or gentailers continuing to

[15] MDAG Report, Recommendation 24.
[16] Options Paper, at para 6.12(c).

prefer self-supply of informal hedge arrangements. This would provide a tool in real time that would help identify any instances of discrimination.

## Drafting considerations

45. While the IERs are supportive of the implementation of non-discrimination principles as a next best option to corporate separation, the suggested amendments in Annex B of the Options Paper require some changes to have the best chance at success. Some of the concerns with the drafting are highlighted below, and illustrate the need for tightening of the language to prevent abuse, avoidance or ineffective regulation:

    45.1 The draft principles in Appendix B of the Options Paper prohibit discrimination "without a cost-based, objectively justifiable reason". This would allow the gentailers to avoid compliance with the non-discrimination rules and would undermine the effectiveness of the principles.

    45.2 The draft principles in Appendix B of the Options Paper assume that the gentailers have internal hedge contracts. The IERs have strong concerns that the gentailers are unlikely to have any formal internal hedge contracts in place, and therefore the rules need to be broad enough to capture informal and ad hoc arrangements within the gentailers' businesses.

    45.3 The EA needs to consider and develop transition rules that require the gentailers to construct an internal hedge position, and that this is done in such a way that does not tie up all available capacity before the regime comes into force. Mandatory market making, or requiring all hedge products to be traded, may be able to resolve some of these concerns.

    45.4 The non-discrimination rules may need to apply to all trading conduct (eg including PPAs and physical electricity sales), not just to risk management products, in order to prevent avoidance or conduct which would reduce the effectiveness of the regime.

    45.5 Non-discrimination rules should explicitly prohibit cross-subsidisation between generation and retail arms. Any exceptions or carve-outs will undermine the purpose of the level playing field measures.

    45.6 Non-discrimination rules should explicitly require Equivalence of Inputs (EoI), requiring external parties to receive hedge contracts on a like for like basis with internal retail units. We would expect this equivalence to include terms relating to the prioritisation when allocating capacity internally and externally. This includes not just price and term, but also timing of availability and product types (eg shaped products, long-duration hedges).

46. Drafting bespoke non-discrimination rules that will achieve the stated aims, will be difficult, given the inherent complexity of how gentailers construct and manage risk management positions. By contrast, corporate separation and arm's-length rules already exist in the Code and could be re-purposed. This structural solution avoids the need for bespoke behavioural rules, removes the conflict at its source, and creates a cleaner, more enforceable regime that supports transparency, competition, and innovation.

## Strengthening Monitoring, Reporting, and Enforcement

47. There are some intrinsic challenges of monitoring and enforcing non-discrimination principles, which arise because 'arm's length' prices for flexibility products are unlikely to be readily available, ie:

    47.1 vertically integrated gentailers cannot be expected to contract internally (much, or at all) for formally-specified flexibility products, ie, the essence of a 'natural hedge' is that such arrangements are not part of the ordinary course of business;

    47.2 there are relatively few third party transactions (particularly in relation to the newly developed, standardised super-peak product), and those transactions are themselves likely to be affected by the underlying problem of market power in flexible generation; and

    47.3 accordingly, there are likely to be significant challenges associated with assessing 'the current terms of (implicit) trade' between the generation and retail divisions of the incumbent gentailers.

48. However, in order to have any effect, the EA must monitor and enforce the non-discrimination rules and there needs to be meaningful penalties for non-compliance.

49. A retrospective notification obligation and annual report is not sufficient.

50. The EA should consider:

    50.1 Independent audits of gentailers' compliance with non-discrimination rules (individual audits of generation and retail business units rather than at a group level).

    50.2 A clear, accessible third-party compliance mechanism. For example, independent retailers must be able to raise concerns where they suspect discriminatory conduct, such as withheld volumes, delayed offers, or internal-only shaped products, and have confidence that these will be investigated fairly and promptly.

    50.3 Automatic penalties for non-compliance, including financial penalties and/or restrictions on future hedge transactions, and reputational consequences (eg publication of breaches).

    50.4 In line with the EA's current thinking,[17] ITP disclosure must be publicly available. Public transparency (and monitoring) will give industry participants confidence in gentailers' compliance and opportunities to raise complaints or flag issues earlier.

    50.5 A certification regime, where directors would be held liable for any failure to provide correct and accurate certification of ITPs and compliance with the non-discrimination rules. Certifications should include details such as confirmation of compliance, that there has been no breaches, and there are no uncontracted volumes.

[17] Options Paper, para 6.18(f).

## The Options Paper overstates the benefits and effectiveness of non-discrimination measures

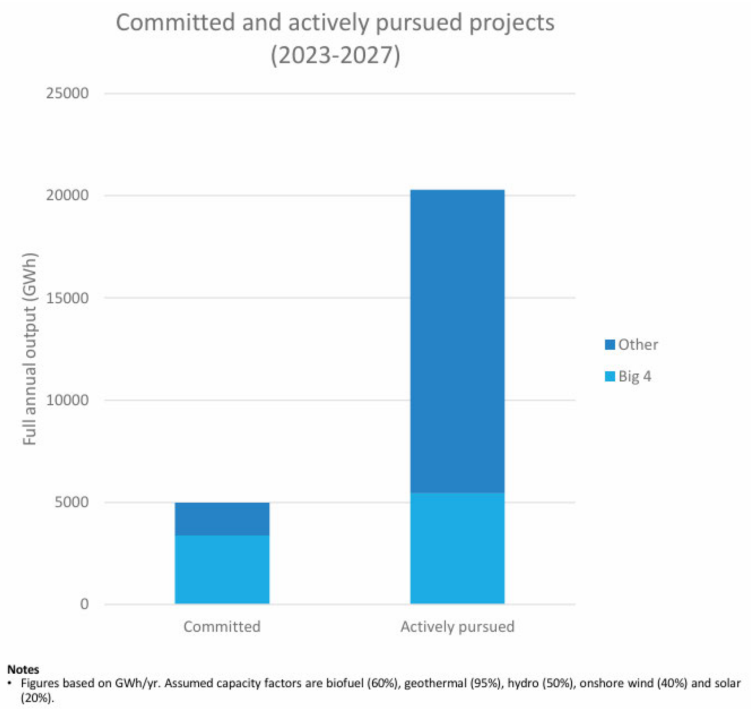
51. The assumption that current market conditions are "***maintaining investment incentives** and security of supply*"[18] (as a benefit of non-discrimination obligations compared to corporate separation) is not supported by evidence.

    51.1 Incumbent gentailers have no incentives to expand output given their internal hedge (balanced supply and demand) and this would reduce returns and expose them to the need to find additional demand.

    51.2 Wholesale prices have been sustained above long run marginal cost (**LRMC**) since 2018.

    51.3 The lack of investment in generation by gentailers has resulted in the current scarcity issues.

    51.4 The EA's own data (from its 2023 survey) shows that 51% of committed new generation projects are by parties other than the gentailers, and the EA expects that the majority of investment in new generation is expected to come from independent generators.[19] This is illustrated by the following table from Concept Consulting's 2023 Invest Survey:[20]




    51.5 This is surprising given the gentailers currently account for approximately 84% of all generation in New Zealand.[21]

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[18] Options Paper, p.5.
[19] See the EA's Investment Pipeline data here – filtering by Year: 2023, Group by: Developer type, Status: Committed. Noting that this figure increases to 78.2% for actively pursued new generation.
[20] Concept Consulting - Generation Invest Survey 2023 update, p.47
[21] This will increase to approximately 90% following Contact's acquisition of Manawa Energy, which has recently been cleared by the Commerce Commission.

51.6 By contrast, in a workably competitive market, generators would be incentivised to increase output to meet expected increases in demand and increase returns.

52. The Options Paper appears to assume that the **accounting separation** regime will be capable of effectively revealing the extent and terms of internal hedging conduct. From an economic perspective, this is not clear cut because:

52.1 internal hedging is provided implicitly through joint ownership and control of generation assets and a retail book, respectively, rather than through explicit contractual arrangements that can be examined;

52.2 to the extent that gentailers make themselves internal hedging offers to comply with accounting separation requirements, these will only represent transfers of value between different segments of their business and won't change the fundamental economics of their hedged position; and

52.3 such internal hedging offers would be prone to strategic manipulation as to terms and so may not necessarily be a good or effective benchmark against which to assess arm's-length transactions with third parties such as independent retailers.

53. **Impact of the standardised flexibility product**: the Options Paper assumes that the standardised flexibility product will facilitate the trading of shaped hedges and have a material impact on the hedge availability.[22] The standardised flexibility product is an improvement on the current situation, however there are still a number of flaws and it will not address all of the issues: [23]

53.1 The IERs experience is that this does not appear too different from earlier OTC offers from gentailers.

53.2 The price is unlikely to be sustainable or acceptable (therefore impacting any growth/future acquisition plans).

53.3 There is only a limited volume traded.

53.4 Longer-term products are not available.

53.5 Barriers to entry remain (including the need to have previously entered into an ISDA).

54. The IERs are concerned that this product is causing a normalisation of high prices. For example:

54.1 On average, the actual spot prices for morning and evening peak for the last 5 winters were around \$200 but the offers have been above \$300.

54.2 On average, the TP factor for morning and evening peak for the last 5 winters was around 20% but the offers are about 35% higher than the ASX baseload prices.

55. Market making obligations need to be extended to these products to enhance their effectiveness.

[22] Options Paper, para 5.6(a) and 5.6(b).
[23] See further Electric Kiwi's submissions on the Contact/Manawa Statement of Issues, at para 9.

## Corporate separation (option 4) together with arms-length rules should be the preferred option

### Separation is internationally recognised best practice

56. Separation has resulted in "*structurally more competitive markets and stronger competition*" in markets in various jurisdictions and there has not been obvious examples where separation resulted in harm to competition in the market.[24]

57. Economic evidence from the EC supports greater degrees of separation (ie full ownership unbundling) as the "*most effective means*" to ensure choice for consumers and encourage investment.[25]

58. The OECD acknowledged that "*[f]or legislators and sector regulators, structural separation offers a more durable resolution in cases of persistent market failure*."[26]

59. The New Zealand electricity sector continues to face persistent market failures (which have been evidenced as early as 2009[27]). Corporate separation "*can provide the means by which to remedy market problems that behavioural regulation alone may fail to prevent*".[28]

60. The OECD has recently made recommendations that New Zealand consider separation in its electricity markets:

    60.1 in May 2024:[29]

    > *"If the voluntary code is judged as insufficient and competition appears to remain inefficient in the electricity market, this might call for a vertical separation of generators and retailers. The development of electricity storage might reinforce the need for such a remedy. Overall, the question of the effectiveness of competition in the wholesale market warrants further investigation."*; and

    60.2 again in December 2024:[30]

    > "*Despite previous reforms to improve competition, electricity futures prices are high and above the threshold considered sustainable for the economy in the long run. These reviews should re examine separating the generation and retail operations of large electricity companies to boost competition in the futures market and provide industry with more hedging options*"

61. The EA's continued efforts to manage the wholesale electricity market through detailed and complex regulation on a project-by-project basis will be expensive, difficult to implement, administratively burdensome and may not be effective.[31]

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[24] Kwoka and Valletti (2021) "Unscrambling the eggs: breaking up consummated mergers and dominant firms." *Industrial and Corporate Change*, *30*(5), 1286-1306 at 4.4 (p.1299).
[25] European Commission, Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and Electricity sectors (Final Report) COM(2006) 851 (**EC Art 17 Inquiry into European gas and Electricity sectors Final Report**) at 55.
[26] OECD *Report on Experiences with Structural Separation* (2011) at p.11.
[27] see NZCC May 2009 Investigation Report and Oliver Browne, Stephen Poletti & David Young (2012) *Simulating market power in the New Zealand electricity market*.
[28] OECD *Report on Experiences with Structural Separation* (2011), at p.11.
[29] OECD *Economic Survey – New Zealand* (May 2024), pp. 65 and 76.
[30] OECD *Economic Outlook, Volume 2024 Issue 2, No 116* (December 2024), p.215.
[31] Indeed, ineffective and expensive regulatory burdens are highlighted as a key reason for considering separation measures. See OECD *Structural separation in regulated industries - Report on implementing the OECD Recommendation* (2016), at p.9; see also EC Art 17 Inquiry into European gas and Electricity sectors Final Report at 55.

62. **Creating a liquid market for hedge products (particularly OTC products):** Corporate separation, together with arm's-length rules, would require the retail companies of the gentailers to manage their risk in the same way that independent retailers do. Gentailers would not be constrained in their ability to offer hedge products by the need to supply their own retail book. This would increase the amount of trading activity for hedge products of all types and improve the liquidity of the market.

## The Options Paper overstates the perceived negatives

63. The Options Paper sets out the following negatives/disadvantages to corporate separation:[32]

63.1 Lost efficiencies of vertical integration due to separation;

63.2 Significant costs associated with separation into two entities (including systems change to meet arm's length requirements);

63.3 Would likely take years to design and implement; and

63.4 Would likely require primary legislation.

64. However, these perceived negatives are overstated, and not supported by any evidence.

65. **Loss of vertical efficiencies**

65.1 There is no evidence of vertical efficiencies set out in the Options Paper, and, aside from the natural hedge, it is not clear what vertical efficiencies in fact exist for the gentailers.

65.2 In addition, it is also not clear that the benefit of any vertical efficiencies is being passed on to consumers.

66. **Significant costs**

66.1 There is no discussion in the Options Paper on why corporate separation would involve "significant costs" and what those costs would be.

66.2 Most of the operational change costs are going to be necessary with non-discrimination obligations alone.

66.3 The significant costs appear to be costs of the gentailers ie private costs. However the costs to consumers and taxpayers from the increased oversight and monitoring required of the non-discrimination rules outlined in Option 2 are not given any weight. It is inconsistent with the EA's stated objectives to prefer gentailers over consumers when considering possible costs of each of the options.

66.4 It can in fact be more efficient to require corporate separation, particularly where there are information asymmetries:

66.4.1 The OECD acknowledged that "[f]*or legislators and sector regulators, structural separation offers a more durable resolution in cases of persistent market failure.*"[33]

[32] Options Paper, Table 5, page 50

[33] OECD *Report on Experiences with Structural Separation* (2011) at p.11.

66.4.2 Corporate separation has resulted in "*structurally more competitive markets and stronger competition*" across various jurisdictions and there has not been obvious examples where separation resulted in harm to competition in the market.[34]

66.4.3 The EA's continued efforts to manage the wholesale electricity market through detailed and complex regulation on a project-by-project basis will be expensive, difficult to implement, administratively burdensome and nevertheless, may not be effective.[35]

66.4.4 Economic evidence from the EC supports greater degrees of separation (ie full ownership unbundling) as the "*most effective means*" to ensure choice for consumers and encourage investment.[36]

66.5 The OECD unequivocally states that the *"…principal benefits of vertical separation when compared with access regulation are: separation limits the need for regulation that is difficult and costly to devise and implement, and may be only partly effective; it improves information; and it eliminates the risk of cross-subsidies by the incumbent from its non-competitive to its competitive segments*".[37]

67. **Time to implement**

67.1 There is no evidence to support the assertion that corporate separation would "likely take years".

67.2 There are two recent examples that would suggest that this timing is incorrect:

67.2.1 The sale by TrustPower of its retail book to Mercury Energy, and the creation of Manawa as a standalone generation business. From public announcement of the conditional binding agreement on 21 June 2021, it took just over 10 months for the acquisition to be completed, which included the restructure of the Tauranga Energy Consumer Trust.[38]

67.2.2 The recent announcement by Nova/Todd of the decision to split its generation asset from its retail offering.[39]

67.3 In addition, specific rules imposing corporate separation and arm's-length obligations do not need to be drafted as the rules already exist in Part 6A of the Electricity Industry Participation Code (which requires corporate separation between distribution and retail business and imposes arm's-length rules). These rules could quickly and easily be amended to apply to the generation and retail businesses of the gentailers.

67.4 The industry is already familiar with, and has achieved and effectively implemented, corporate separation with the lines companies' separation and so there is already precedent for this.

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[34] Kwoka and Valletti (2021) "Unscrambling the eggs: breaking up consummated mergers and dominant firms." *Industrial and Corporate Change, 30*(5), 1286-1306 at 4.4 (p.1299).
[35] See OECD *Structural separation in regulated industries - Report on implementing the OECD Recommendation* (2016), at p.9; see also EC Art 17 Inquiry into European gas and Electricity sectors Final Report at 55.
[36] EC Art 17 Inquiry into European gas and Electricity sectors Final Report at 55.
[37] OECD *Structural separation in regulated industries - Report on implementing the OECD Recommendation* (2016), at p.9.
[38] See NZX announcement: NZX, New Zealand's Exchange - Announcements, Trustpower Retail Acquisition Unconditional
[39] See Newsroom article dated 11 April 2025 Nova Energy chief quits as firm splits generation and retail arms - Newsroom

68. **Need for primary legislation**

68.1 The EA has the power to amend the Code and require corporate separation for generation and retail businesses.

68.2 The High Court has noted that the EA's powers are broad and should not be interpreted narrowly. The overall goal is the long-term benefit of consumers and the Act provides a framework for the regulation of the "electricity industry" as a whole.[40]

68.3 The IERs have sought an expert legal option from Jenny Cooper KC on this issue, which is attached as **Annex B.**

## Corporate separation and arm's-length rules would promote and improve competition in electricity markets

### *Corporate separation would promote and improve competition*

69. In the letter from Matthews Law to the EA dated 7 August 2024, which included an urgent code change request to implement corporate separation and arm's-length rules,(attached as **Annex D**) the IERs set out the reasons why corporate separation and arm's-length rules are both necessary and desirable to promote competition for the long-term benefit of consumers in New Zealand.

70. In a market study context, the Commission has considered "commonly understood indicators of whether competition is working well or not", which include:

70.1 Profitability;

70.2 Price outcomes (i.e. Prices charged to consumers);

70.3 Extent of investment / innovation;

70.4 Quality, range, services offered to consumers; and

70.5 Market features – industry structure and infrastructure, conditions of entry / expansion, behaviour of market participants.

71. Taking into account these factors, neither the electricity generation (or wholesale) market nor the retail electricity market are functioning in a workably competitive manner:

| | WHOLESALE MARKET | RETAIL MARKET |
|---|---|---|
| **Profitability** | High or record profits in gentailers' wholesale business<br><br>Wholesale prices have increased rapidly and are widely acknowledged to be well above the LRMC of generation | Losses in gentailers retail business<br><br>Other independent retailers in financial distress and either exiting the market or acquired by gentailers |
| **Price outcomes (i.e. prices charged to consumers)** | Wholesale prices above retail prices | Wholesale prices above retail prices |

[40] *Manawa Energy Ltd v Electricity Authority* [2022] NZHC 1444 at [61], [69].

| | | |
|---|---|---|
| **Extent of investment/innovation** | Insufficient investment in generation<br><br>No incentives to invest<br><br>No meaningful increase in generation capacity in the last 5 years<br><br>Independent generators disincentivised from entry | Slow uptake by gentailers of demand response technology<br><br>IERs unable to obtain scale, despite innovative offerings |
| **Quality, range, services offered to consumers** | | The lack of available hedge products has lead the IERs to limit the growth of their customer base, and the market share of the independents has stagnated or decreased, reducing customer choice<br><br>Consumer NZ has observed that Powerswitch leads are not being pursued by retailers as they used to be. |
| **Market features** | High barriers to entry<br><br>No liquid market for risk management tools | High level of market exit and the current trading environment suggests no further new entry/expansion |

72. It also appears that the four gentailers have been/are engaging in textbook incumbent conduct found in the NZCC's Misuse of Market Power Guidelines which undermines the effective operation of the wholesale electricity market:

72.1 Actual / constructive refusal to supply (eg shaped hedge products);

72.2 Price (margin) squeeze / Predation; and

72.3 Lack of investment by gentailers in renewable or other generation.

73. The EA Options Paper has limited itself to considering issues relating to the supply of shaped hedges, but we urge the EA and the Energy Competition Task Force to consider competition in all markets. Non-discrimination measures would only address a limited range of conduct, whereas corporate separation would address the core issues with market structure.

74. Corporate separation and arm's-length rules would promote and improve competition in the electricity industry for the long-term benefit of consumers by:

**74.1 Creating incentives for entry/expansion of generation capacity.**

74.1.1 Because of high concentration and low contract market liquidity, independent generators are dependent on entering into contracts with one of the four incumbent gentailers in order to obtain finance for new generation projects.

74.1.2 Generation has to been slow to meet the market signals (present since at least 2018) resulting in a withering of competition for the development of new generation capacity to be delivered when needed and at least cost. In particular, the four incumbent gentailers:

- do not face strong incentives to undertake or support an expansion of New Zealand's electricity generation capacity because this would be expected to reduce the profitability and so the value of their existing generation plant; and

- may be expected to delay or not proceed with generation projects that would otherwise be on New Zealand's least cost development path, thereby resulting in a path of generation development that is more costly and so giving rise to higher wholesale prices than would otherwise be the case.

74.1.3 These circumstances will in turn affect competition in the retail sector, with New Zealand's electricity consumers paying more for electricity than might otherwise be the case, both as a result of a higher cost generation development path – giving rise to higher wholesale costs – and higher wholesale margins (because retail competition will also be compromised).

**74.2 Ensuring all electricity retailers can compete on a level playing field.**

**74.3 Removing information asymmetries for both industry participants and the EA as regulator:**

74.3.1 The EA has acknowledged in the Options Paper that information asymmetries exist:

> *Despite having access to relevant information, those who disagreed with our competition concerns in their feedback did not present any specific evidence to support their views. Therefore, we have not seen further evidence that would disprove or reduce the competition risks.*[41]
> *…*
> *While submitters put forward a range of views for and against these findings, parties that disagreed did not present further data or specific evidence to support these views, despite having the best access to relevant information.*[42]
> *…*
> *The Gentailers have an information advantage over all other parties (including us) — vertical integration combined with ITPs that are not fit for purpose make it more difficult for any third party to assess price risks and competition issues.*[43]

74.3.2 Removing information asymmetries will increase investor confidence in the industry and promote necessary investment.

74.3.3 This will also ease monitoring and compliance costs for all parties, including the EA.

[41] Options Paper, page 3
[42] Options Paper, para 3.47,page 31
[43] Options Paper, para 3.51(d), page 32

74.3.4 With anything less than corporate separation and arms-length rules, there remains a lack of transparency and information asymmetries which will require regulation to resolve.

## An effective solution is now overdue

75. The EPR Report made several recommendations which sought to address market structure issues, including:

75.1 *D1: Improve availability of wholesale market information*;

75.2 *D2: Introducing mandatory market-making obligations unless the sector develops an effective incentive-based scheme*;

75.3 *D3: Make generator-retailers release information about the profitability of their retailing activities*; and

75.4 *D4: Monitor contract prices and new-generation costs more closely*.

76. The EPR Advisory Panel stated:[44]

> *If our recommendations do not result in the intended improvements, more far-reaching measures may be needed, such as options we did not favour.*[45]

77. One of those "*far-reaching measures*" was Option "*D5: Prohibit vertically integrated companies*" which contemplated that "*vertically integrated companies would have to split their businesses under separate ownership*" (ie structural separation).[46]

78. It is clear after more than 6 years, the EPR's recommendations have not resulted in the intended improvements and it must be time to consider separation. The IERs view is that corporate separation together with arm's-length rules should be preferred over full ownership separation.

79. The Options Paper does not once refer to the conclusions or recommendations made in the EPR Report. However, the fact that the competition harms identified in the EPR have not been resolved highlights that it is imperative that the EA acts now to avoid continued deterioration of competition. The failure to take decisive and robust measures now will result in limited impact and no lasting change.

80. The EA should set clear and measurable targets as to what right competition settings are to be considered a success, so that if we the measures adopted do not achieve these settings then the EA must act with a greater level of intervention.

81. More recently in December 2023, MDAG confirmed the underlying issues of vertical integration remain, noting the urgent need for proper functioning wholesale hedge markets given the anticipated increase in demand (c.50%) and a lack of investment in generation capacity.[47] Despite this, there has been no significant improvements in the competitive landscape in the 18 months since that call for urgent action.

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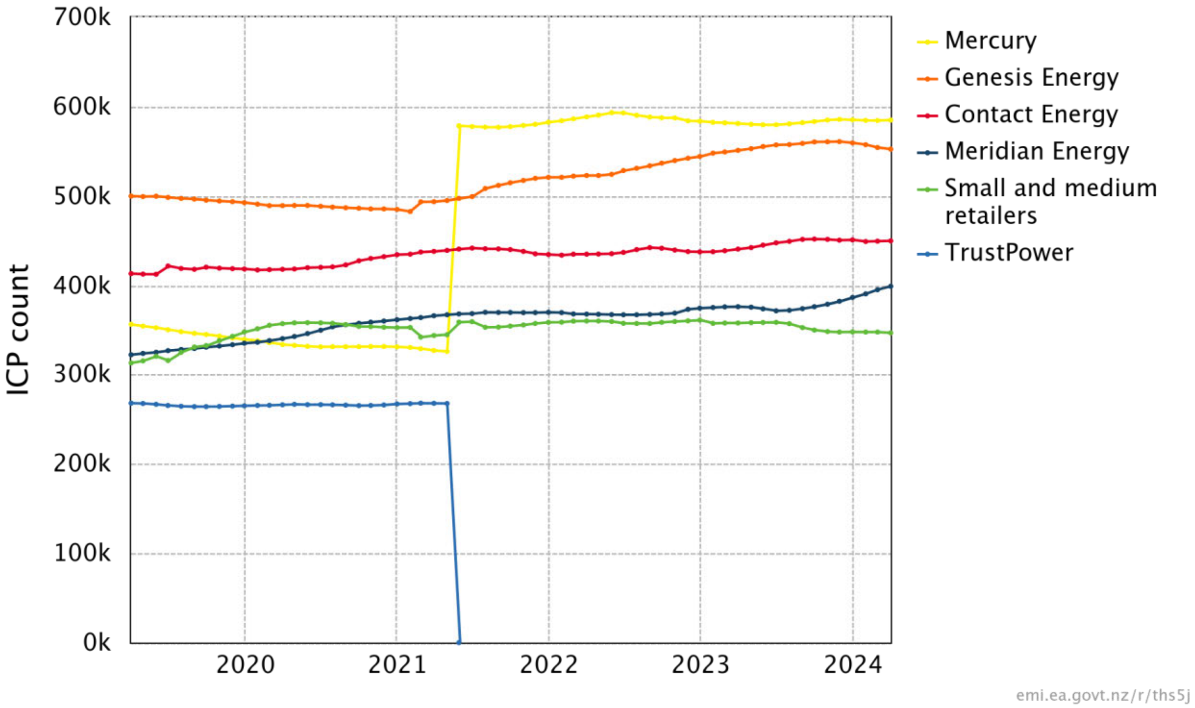
[44] EPR Report, at p.2.
[45] (fn 7 in EPR Report): See our options paper for these options, which included retail price caps, splitting vertically integrated companies and requiring small distributors to amalgamate.
[46] EPR Report, at p.21.
[47] MDAG Report, at paras 1.38–1.52.

82. In the meantime, market concentration to the gentailers in the retail market has increased at the cost of share to independent and challenger brands, as shown in the table below.[48] Without action, the market share of independent and challenger brands is likely to continue to decline or stagnate and price competition, which benefits consumers, will wane.




83. This will only be exacerbated by the increase of market concentration to the gentailers in the wholesale market following Contact's acquisition of Manawa Energy, which has recently been cleared by the Commerce Commission. Post-acquisition, the gentailers will account for approximately 90% of all generation in New Zealand.

## Other issues

### Rejection of the Negotiate-Arbitrate Model (Option 3)

84. The Options Paper outlines a 'Final offer arbitration' model as Option 3. However this does not appear to have ever been a realistic option.

85. A negotiate-arbitrate regime is ill-suited to hedge markets, as:

85.1 It is designed for standardised products, not bespoke financial instruments like hedges. The model selected appears to be used in very limited circumstances and based on negotiation of contracts for baseball players.

85.2 It is too slow and impractical, failing to address the urgency of the problem.

85.3 A negotiate-arbitrate model places the burden of compliance and enforcement on IERs or other smaller players, who do not necessarily have the resources to enter into arbitration with the gentailers for every hedge contract they require.

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48 See the EA's [Market share trends](Market share trends).

85.4 The EA's own paper suggests that mandatory market trading is a far better solution, and the IERs fully support this view.

## Assumptions

86. There are a number of assumptions or statements in the Options Paper that are incorrect, which are briefly noted below.

87. **Risk management substitutes:** The conclusion that there are several close risk management substitutes for an OTC contract-based portfolio, including batteries and demand-response is not consistent with regulatory best practice and is flawed economics. This broadens the market horizontally and incorrectly equates an input for supply with demand-side management.

88. **UK is not a case study:** The EA appears to dismiss the relevance of the non-discrimination and arm's-length rules in the UK because "*the original GB licence conditions have been in place for a long time.*"[49] This ignores the reasons why the conditions were initially imposed and the impact of these conditions, which are relevant to the EA's analysis.

89. **Improper characterisation of the TransAlta failure:** The EA references the failure of TransAlta (a large non-integrated retailer) in the early 2000s as a reason for, or benefit of, vertical integration.[50] However, the failure of TransAlta should actually been seen as an early sign of the uncompetitive state of electricity markets and the exercise of market power by the gentailers. Commentary from the time suggests that a retail margin squeeze was a key factor in the failure:

    89.1 A NZ Herald article reporting on TransAlta's significant loss of customers stated that "*while TransAlta said the recent loss had not been significant, it points the finger at state-owned First Electric for offering power at "commercially unsustainable" prices*."[51]

    89.2 Richard Bentley, the then-Chief Executive of Natural Gas Corporation (which acquired TransAlta), commented that "*state-owned enterprise generators…focused on their wholesale margins at the expense of retail to gain market share*."[52]

90. **Reliance on the EA's Risk Management Review**: the Options Paper relies on the conclusions reached in the EA's Risk Management Review. However, as the IERs previously noted, the framing of, and thinking behind, the RMR (whether by accident or design) ignores critical factual and legal context, leading to flawed conclusions, which are not consistent with orthodox approaches or international best practice.[53] The incorrect framing means the wrong questions are asked, creating a high likelihood of incorrect and incomplete conclusions being reached, which has proven to be the case. This default to the status quo is reinforced by an inconsistent approach to the evidence.

91. **Baseload hedges 'reasonably priced'**: The RMR concluded that baseload and peak hedges were likely to be "competitively priced" and are supported by the ASX market making requirements.[54]

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[49] Options paper, para 4.20.
[50] See Options Paper, para 3.7 and 3.17(g)
[51] See NZ Herald article by Fiona Rotherham "TransAlta clients leaving in droves" (14 May 2001) which reported on TransAlta losing 32,000 customers (6% of its total customers) after increasing its daily fixed line charges.
[52] As above fn 51, see NZ Herald article "TransAlta clients leaving in droves" (14 May 2001).
[53] We raised framing concerns and assumptions at the outset in relation to the PID for the RMR in our 10 April 2024 letter to the EA through Matthews Law.
[54] Options Paper, para 6.6

However, this is not consistent with the evidence put forward and the experience of the IERs. There is no evidence to support this conclusion.

92. **Potential conflicts of interest**: Some expert reports relied on may not be sufficiently independent, for example, the EA relies on two papers to support the theoretical benefits of vertical integration.[55] However, both these reports were commissioned by vertically integrated gentailers or groups of gentailers.[56]

93. **Proportionality**: The EA states "*it is unclear whether corporate separation is proportionate to the concerns identified in the Risk Management Review and ITP/RGM post-implementation review*".[57] However, proportionality is not the relevant test, and this limits consideration to the issues in the RMR, without addressing the wider competition concerns or considering the benefits to NZ consumers as set out above.

94. The EA also notes that structural change "*would be difficult to reverse.*"[58] Again, this is not applying the correct legal test, and ignores the evidence and orthodox approach to separation. In 2021, in a paper about breaking up dominant firms, Kwoka and Valletti made the following comments: [59]

> *"Despite variation in experiences, **most breakups seem to result in structurally more competitive markets and stronger competition**. Strikingly, there seem to be no examples where breaking up such firms has been attempted but failed in the sense that they were attempted but literally could not be done and in the process perhaps permanently damaged the firm as a going concern. **Nor are there obvious examples where** breakups were in fact accomplished but **the result was that market competition was harmed**. That remarkable fact by itself suggests that a breakup policy is viable, procedures are adequately understood, and some measure of success is an entirely plausible outcome."*

[55] Options Paper, para 3.17.
[56] The Nera Report was commissioned by AGL Energy Ltd in Australia, and the Cognitus Report was commissioned by the Electricity Retailers' Association of New Zealand, whose membership is made up of Contact Energy, Genesis Energy, Manawa Energy, Mercury, Meridian Energy and Nova Energy https://www.eranz.org.nz/about/.
[57] Options Paper, Table 6, page 52
[58] Options Paper, Table 6, page 52
[59] Kwoka and Valletti (2021) "Unscrambling the eggs: breaking up consummated mergers and dominant firms." *Industrial and Corporate Change*, *30*(5), 1286-1306 at 4.4 (p.1299).

# ANNEX A: IERs' response in the "Format for Submissions" (Appendix E of the Options Paper)

| Submitter | Independent retailers (Electric Kiwi, Octopus Energy, Pulse Energy, 2degrees) |
|---|---|

| Questions | Comments |
|---|---|
| **Problem definition — competition concerns from Gentailer vertical integration** | |
| Q1. What are the benefits of vertical integration between generation and retail? Do you have any evidence to better specify and quantify these benefits? In particular, we are interested in benefits that would be realised by New Zealand's electricity consumers. | Vertical integration provides a natural hedge. However, other than that, there is no evidence of material vertical efficiencies.<br><br>We remain concerned that in places the EA appears assumes these, and also assumes that they are material.<br><br>Any such benefits are private and there is no evidence that any such efficiencies are passed on to consumers.<br><br>Any such evidence should only be considered against outcomes in a workably competitive markets.<br><br>It is important to distinguish between the financial benefits of a hedge and operational efficiencies.<br><br>We also caution against claim to benefits noting the problems with information **asymmetries** acknowledged by the EA. |
| Q2. Do you agree with our description of the competition concerns that can arise from the combination of Gentailer vertical integration and market power? Why/why not? Do you have any evidence to better specify and quantify the competition risks of vertical integration? | Yes, but we consider that these concerns are considerably understated, particularly when compared to workably competitive markets which is the international norm.<br><br>Market power issues have been consistently accepted by independent commentators including the Commerce Commission since 2009 and it is accepted that market power and vertical integration leads to competition concerns.<br><br>These concerns have also been raised by the OECD.<br><br>Vertical integration (when coupled with market power) has been well recognised internationally to cause competition problems (hence the orthodox approach to vertically separate). |

| | |
|---|---|
| Q3. To what extent does vertical integration of smaller gentailers, such as Nova and Pulse, raise competition concerns? Should these smaller gentailers be subject to any proposed Level Playing Field measures? | Vertical integration gives rise to competition concerns when there is market power at one level of the market that can be leveraged to reduce competition in other markets.<br><br>In this case, it is the market power of the gentailers in generation markets that has allowed them to engage in anti-competitive conduct, including retail margin squeeze and refusals to supply hedge products. |
| Q4. Are there other specific areas (other than access to hedges) where Gentailer market power and vertical integration are causing competition concerns? | Yes.<br><br>Gentailer market power and vertical integration has resulted in harm to competition in both the retail and wholesale markets including:<br><br>1) disincentivising investment in new generation;<br><br>2) increasing barriers to entry in both retail and generation markets; and<br><br>3) allowing gentailers to engage in anti-competitive conducting including a retail margin squeeze and refusals (or constructive refusals) to supply hedge products.<br><br>Ultimately this is impacting the price of electricity, restricting customer choice and limiting innovation.<br><br>In a workably competitive markets, for example with non-vertically integrated generators, generators would be incentivised to increase output to increase returns.<br><br>The gentailers have not sufficiently invested in new generation (either renewable or flexible generation). The continued under-investment and "land-banking" consents for new generation projects is one of the reasons for the current state of the markets. |

| | |
|---|---|
| Q5. Do you agree with our preliminary view that the evidence indicates there may be good reasons to introduce a proportionate Level Playing Field measure to address the competition risks in relation to hedging/firming? Why/why not? | Yes<br><br>The IERs' position is that there is ample evidence of problems within the markets, which have been recognised for some time and urgent measures are necessary to improve competition in electricity markets for the benefit of NZ consumers.<br><br>The level playing field measures are necessary (but not sufficient) to address the concerns.<br><br>The preferred solution remains corporate separation.<br><br>Measures introduced between 2019-2025 to address the lack of liquidity in hedge markets have not resolved the issues and it is past time that stronger measures, such as corporate separation, are considered.<br><br>The statutory thresholds for changes to the Code do not refer to "proportionality". Any changes need to be necessary or desirable to promote competition and this needs to be benchmarked against **workable and effective competition**, not to the status quo. |
| **Level Playing Field options we have identified** | |
| Q6. Have we focused on the right Level Playing Field options? Are there other options that we should add or remove to the list in paragraph 4.1? | The IERs' preferred solution remains corporate separation plus arm's-length and non-discrimination rules for the reasons set out in these submissions and in the earlier urgent code change request made by the independent retailers. |
| Q7. Are there any other important factors we should consider when identifying options (see paragraphs 4.2 to 4.5)? | Any options considered must be benchmarked against workable and effective competition, not the status quo.<br><br>The Options Paper considerably understates the harm to competition and overstates the costs of corporate separation.<br><br>The Options Paper also ignores the OECD recommendations and the fact that separation is international best practice.<br><br>The Options Paper also fails to consider broader competition concerns about market structure and anti-competitive conduct of the gentailers, such as the retail margin squeeze. |
| Q8. Are there other key features, pros or cons we should consider in our description of the four Level Playing Field options? | The on-going monitoring and enforcement costs for Option 2 and these are not considered in the Options Paper.<br><br>The Options Paper also does not refer to or consider the recommendations in the EPR Report which have failed to address market issues. This is important context when considering the efficacy of the proposed options. |

| Our assessment of Level Playing Field options | |
|---|---|
| Q9. Have we identified the right criteria for assessing Level Playing Field options (Figure 6)? Is there anything we should add or remove? | Consumers are not the focus of the EA's chosen criteria, which is inconsistent with the EA's statutory objectives.<br><br>Nor does the Options Paper include a proper counter-factual analysis to assess potential impacts on competition.<br><br>This assessment appears to use the status quo as a base line, rather than a hypothetically competitive market and therefore risks ignoring measures that would improve competition for the long-term benefit of consumers.<br><br>There is an over-emphasis on process and practicality (transparency, costs and timing and workability), to the expense of a proper assessment of whether the measures would improve competition in markets. |
| Q10. Do you agree with our application of the assessment criteria (Table 5)? Are changes needed to the colour coding or reasoning? | No.<br><br>It overstates the negatives of corporate separation and the effectiveness of non-discrimination obligations and underestimates the costs and operational challenges of implementing the non-discrimination obligations.<br><br>The loss of efficiencies and costs of corporate separation are given undue weight, when neither of those factors are supported by evidence.<br><br>It incorrectly assumes that corporate separation and arm's-length rules would require primary legislation.<br><br>It does not properly consider investment incentives in economic terms. |
| Q11. Are there any other material benefits or risks that should be considered (but are currently not) in our assessment of options? | A proper competition analysis should be conducted, including the application of a counter-factual test, to assess the impact on competition from each of the options. |
| Q12. Do you agree with our selection of non-discrimination obligations as our preferred Level Playing Field measure? Why/why not? | No.<br><br>Corporate separation remains the preferred option for the IERs, for the reasons expressed in this submission and prior submissions.<br><br>However, non-discrimination obligations (without the progressive approach to implementation of the steps) are preferable to the status quo. |

| Roadmap for implementing non-discrimination obligations | |
|---|---|
| Q13. What are your views on our proposed roadmap for the implementation of non-discrimination obligations? | The independent retailers welcome the strong statements and the intention that the roadmap allows for "*relatively quick initial implementation of non-discrimination rules, which could be tightened over time if needed, and provides clarity about a future pathway for stronger regulatory intervention in future*."<br><br>It is important that work continues on each of the three steps and the principles-based non-discrimination is only a short-term measure to encourage behaviour change while tighter rules are implemented.<br><br>However, careful drafting is required to ensure the obligations are effective and this needs to be coupled with strong monitoring and enforcement. |
| Q14. Which products should any non-discrimination obligations apply to? Should all hedge contracts be captured, or should the rules be focused on super-peak hedges only? Are there are other interactions between Gentailers and their competitors which would benefit from non-discrimination rules? | All hedge contracts and trading conduct should be captured by the non-discrimination rules. |

| | |
|---|---|
| Q15. Do you have any feedback on the indicative draft non-discrimination principles (and guidance) set out in Appendix B? Without limiting your feedback, we would be particularly interested in your views on the following questions:<br><br>a. Have we got the level of detail/prescription right? For example, do you consider that the principles and guidance will lead to economically meaningful Gentailer ITPs being put in place? What would be the costs and benefits of instead applying a more prescriptive ITP methodology?<br><br>b. How far should the allowance in the principles for different treatment where there is a "cost-based, objectively justifiable reason" extend? Do you agree with the guidance that this allowance should not be extended to volume (at paragraph 13 of Appendix B)? | There are a number of drafting considerations noted at paragraph 45 above.<br><br>We do not consider that the EA has the right level of detail correct/prescription. We consider that a significant amount of work will still be required to get the right balance between consistency, workability and effectiveness. We have highlighted issues with monitoring and oversight that may call into question the effectiveness of the measure. With limited ability to monitor the EA will struggle to ascertain the effectiveness of the measures that is likely to lead to ongoing competition harms and poor outcomes for consumers.<br><br>We caution the EA on implementing a principle based regime that lacks detail and is subject to inconsistency in compliance appropriately and/or leaves too much scope for the Gentailer's to interpret the rules.<br><br>It will be important to design rules that require the gentailers to construct an internal hedge position (noting it is unlikely that this currently exists) and requires some amount of capacity to be traded.<br><br>There should be no allowance for difference in treatment, even on a cost basis, as this will undermine the whole regime. |
| Q16. Do you agree that escalation options are needed if principles-based non-discrimination obligations are implemented initially? Why/why not? | Yes.<br><br>Principles-based non-discrimination is a useful short-term measure to encourage behaviour change while tighter rules and corporate separation are implemented. |
| Q17. Are prescribed non-discrimination requirements and mandatory trading of Gentailer hedges via a common platform suitable escalations given the liquidity, competitive pricing and even-handedness outcomes we are seeking? Why/why not? What alternatives would you suggest (if any)? | Yes |

| | |
|---|---|
| Q18. What costs and benefits are likely to be involved in setting more prescriptive regulatory accounting rules which detail how ITPs should be calculated? What would be appropriate triggers for introducing more prescriptive requirements for ITPs? | ITPs should be redundant once the non-discrimination rules are in place, and interactions between the gentailers retail and generation business should be based on contract pricing like that offered to third parties. |
| Q19. Do you have any views on how the non-discrimination requirements should best be implemented to ensure that Gentailers are no longer able to allocate uncontracted hedge volumes to their own retail function in preference to third parties? What are the key issues and trade-offs? | There will need to be some prescription and a transition plan to ensure access is fair and pricing is rebalanced, rather than allowing gentailers to price up their bases and cause more of a price shock for consumers.<br>The IERs view is that the complexity and difficulty of designing, monitoring and enforcing non-discrimination obligations is clear evidence that corporate separation and arm's-length rules (as set out in Part 6A of the Code) should be the preferred option. |
| Q20. Do you have any views on the triggers for implementing the stronger regulation proposed in our roadmap? | Stronger measures are already required, as set out in this submission.<br>The EPR recommended in 2019 that stronger measures be considered if its recommendations did not resolve issues – how much longer is required to assess this?<br>Also, the OECD has recommended that separation be considered. |
| **Our current thinking on virtual disaggregation** | |
| Q21. Does our proposed approach to implementing non-discrimination obligations (as set out in the roadmap in Figure 7) sufficiently address the underlying issue that originally led to MDAG recommending virtual disaggregation? | No.<br>MDAG highlighted a market power problem that is not addressed by non-discrimination obligations alone.<br>The preferred solution is corporate separation and arm's-length rules on the same terms as set out in part 6A of the Code, in addition to the non-discrimination obligations. |
| Q22. Do you have any views on whether virtual disaggregation provides a useful response to the competition risks we have identified (relative to the proposed roadmap) and, if it does, how it should be best applied? | The MDAG Report was targeting a different competition problem than the issues identified in the Options Paper.<br>The preferred solution is corporate separation and arm's-length rules on the same terms as set out in part 6A of the Code. |

# ANNEX B: Opinion from Jenny Cooper KC

Jenny Cooper KC
Barrister

[redacted]

2 May 2025

[redacted]

**By email**: [redacted]

***Privileged and confidential***

Dear Alicia

**Level Playing Field Options: Scope of the Electricity Authority's Code-Making Powers**

1. You have sought my advice on behalf of three independent electricity retailers (Octopus Energy, 2degrees, and Electric Kiwi) (together, the **IERs**), in relation to certain issues arising from the "Level Playing Field measures – Options paper" (**Options Paper**) by Te Mana Hiko / Electricity Authority (**Authority**).[1] In that Options Paper, the Authority considers the options available to it to address "*hedge contract related competition risks*" in the electricity market, in particular, competition risks related to shaped hedges, including the high level of concentration in the supply of shaped hedging contracts. [2]

2. The Options Paper identifies four main options to address these risks:

   a) Option 1: Accounting separation, requiring the accounts of the generation and retail arms of a gentailer to be kept separate; [3]

   b) Option 2: Non-discrimination obligations, requiring gentailers to supply independent retailers on the same terms as they supply themselves internally;

   c) Option 3: Negotiate-arbitrate regulation, to encourage parties to reach commercial agreements and limit the need for regulatory intervention; and

   d) Option 4: Corporate separation, requiring the gentailers' retail and generation businesses to be split into separate legal entities and independently managed (but without requiring separate ownership).[4]

3. The IERs have previously indicated support for Option 4: corporate separation. However, in the Options Paper, the Authority observes that Option 4 "*would likely require primary legislation,*

[1] Electricity Authority, *Level Playing Field measures – Options paper*, dated 27 February 2025.
[2] Options paper, at Executive Summary.
[3] Consistent with the use of the term in the Options Paper I use "gentailers" to refer to the four large generator-retailers that control the vast majority of New Zealand's flexible generation: Contact Energy Ltd, Genesis Energy Ltd, Meridian Energy Ltd, and Mercury NZ Ltd.
[4] Options paper, at p 34.

*given the legislative history, the significance of the policy decision involved and the intervention in property rights it would entail.*"[5] In light of this, you have asked for my opinion on the following matters:

a) Do the Authority's code-making powers under the Electricity Industry Act 2010 (**Act**) allow it to impose corporate separation on vertically integrated participants in the electricity industry?; and

b) If so, when can that power be exercised by the Authority?

4. My opinion on these matters is set out below. In preparing my opinion, I have relied upon relevant reports from the Authority as well as a range of other materials as footnoted.

**Executive Summary**

5. In my view the Authority can use its code-making powers under the Act to impose corporate separation of the type proposed as Option 4. I reach this view given:

a) the natural and ordinary meaning of the words used by the legislation, which provides the Authority with broad regulatory powers, as confirmed by the Courts;

b) the statutory framework which expressly anticipates that regulatory separation (whether accounting, corporate or structural) may apply to industry participants;

c) recent amendments to the Act and the Code that show Parliament intended to place direct responsibility for monitoring, investigating and enforcing separation with the Authority; and

d) the regulatory environment, in which the Commerce Commission has declined to act on the IERs' competition-related concerns and specifically identified that the Authority is best placed to act.[6]

6. Before the Authority could amend the Code to impose corporate separation it would have to be satisfied on the basis of the evidence it had received that corporate separation was consistent with its objectives under the Act – for example, promoting competition, reliable supply and efficiency in the electricity industry - and necessary to promote any one of the matters set out in s 32(1) of the Act (which overlap with the Authority's objectives) – for example, competition, reliable supply or efficiency in the electricity industry.

7. To be able to reach the conclusion that corporate separation was necessary the Authority would likely need to be satisfied that less intrusive measures (such as Options 1, 2 or 3) would *not* be sufficient to satisfactorily achieve that same objective. This does not mean the Authority would need to test Options 1, 2 or 3 before implementing Option 4. Simply that there would need to be evidence to satisfy the Authority (and, if necessary, the Court) that:

[5] Options paper, at [4.30].

[6] Commerce Commission letter to independent electricity retailers and gentailers regarding complaints under section 36 of the Commerce Act dated 12 December 2024.

a) The status quo is not delivering satisfactory levels of competition, reliable supply and/or efficiency in the electricity industry such that intervention is necessary to promote one or more of those objectives;[7] and

b) Options 1, 2 or 3 on their own would not be adequate to promote the desired objective(s), whether because they are not likely to be effective (or sufficiently effective) to address the identified risks or because their effectiveness is uncertain and the timeframe to establish whether they are likely to be effective is too long to justify the risk of delaying Option 4, given the nature and extent of the identified risks.

8. This opinion addresses the matters above by considering, in turn, the legislation, the Court's interpretation of the code-making power, and relevant legislative history, before addressing when the Authority's code-making power may be exercised to impose corporate separation.

**The Legislation**

9. The Act was introduced in 2010 following a Ministerial Review of the Electricity Market carried out in 2009. The Act replaced parts of the Electricity Act 1992 and aimed to establish a more efficient, competitive and reliable electricity market.[8]

10. A key aspect of the Act was the establishment of the Authority as an independent Crown entity and successor to the Electricity Commission.[9] Section 15 of the Act identifies the objectives of the Authority, with the "*main objective*" of the Authority being "*to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers*."[10]

11. Part of the Authority's role under the Act is to make and administer the Electricity Industry Participation Code (**the Code**).[11] The roles of monitoring, investigating and enforcing compliance with the Code are also part of the Authority's functions.[12] Industry participants must register with the Authority and comply with the Code.[13]

12. The provisions relating to the Code are contained at Part 2, Subpart 3 of the Act. The Code is not a static document.[14] The Authority is empowered to amend it at any time,[15] subject to following a prescribed consultation process before doing so (unless the proposed amendment is urgent).[16] Section 32(1) governs the Code's content:

[7] As already noted above, the Options Paper expresses the view that the status quo presents competition risks related to shaped hedge contracts (Options Paper at Executive Summary, p 3).
[8] Act, s15; Electricity Authority website 'What we do'.
[9] Act, s12.
[10] Two further objectives are identified in section 15 of the Act: *"(2) The additional objective of the Authority is to protect the interests of domestic consumers and small business consumers in relation to the supply of electricity to those consumers";* and *"(3) The additional objective applies only to the Authority's activities in relation to the dealings of industry participants with domestic consumers and small business consumers."* These objectives were inserted in 2022.
[11] Act, s16(1)(b).
[12] Act, s16(c) and (d).
[13] Act, s9.
[14] *Vector Limited v Electricity Authority* [2017] NZHC 1774, at [24]. Simon France J also stated at [29] that *"…the core purpose of the Act [which] is to establish an Authority to regulate the industry via the Code*."
[15] Act, s38.
[16] Act, ss39, 40.

"**32 Content of Code**

1 The Code may contain any provisions that are consistent with the objectives of the Authority and are necessary or desirable to promote any or all of the following:

(a) Competition in the electricity industry;

(b) The reliable supply of electricity to consumers;

(c) The efficient operation of the electricity industry;

(d) The protection of the interests of domestic consumers and small business consumers in relation to the supply of electricity to those consumers;

(e) The performance by the Authority of its functions;

(f) Any other matter specifically referred to in this Act as a matter for inclusion in the Code."

13. Unsurprisingly, the matters which may be promoted by the Code closely reflect the objectives of the Authority under section 15.

14. On its face, the Authority's code-making power is therefore broad.[17] However, the same section confirms the code-making power is not unlimited. Under section 32(2) the Code may not:

a) impose obligations on persons other than industry participants (subject to subsection (3));

b) purport to regulate anything that is the responsibility of the Commerce Commission under Part 4 of the Commerce Act 1986 (subject to subsection (4)); and

c) purport to regulate any matter dealt with in the Electricity Act 1992.[18]

15. On the plain reading of the text, section 32 confirms that the Authority can introduce a provision into the Code if it meets the dual requirements of being (1) consistent with the Authority's objectives under the Act; and (2) either "*necessary or desirable*" to promote one of the objectives at section 32(1)(a)-(f), and so long as it is not prohibited by section 32(2).

16. However, the meaning of section 32 does not depend solely on its text. Rather, its meaning must be ascertained with regard to its purpose and its context as well as its text.[19] Purpose and context can include matters found both within the Act itself (such as other provisions and the overall scheme and structure of the Act) and outside the Act (such as other laws, reports that influenced the Act, explanatory notes and Parliamentary speeches).[20]

17. To understand the scope and limitations of this power more fully, therefore, it is useful to consider the relevant legislative history. It is also necessary to consider previous Court decisions on the Authority's code-making powers, particularly appeal court decisions as these will be binding on a High Court judge required to consider the same question.

[17] The Authority has itself declared its code-making power to be broad. *See*, for example, the Authority's decision as contained in "*Improving the framework for the Authority's information gathering*", 5 July 2022 at [4.49].
[18] None of these limitations appear relevant to the proposal for corporate separation.
[19] Legislation Act 2019, s10.
[20] Burrows and Carter *Statute Law in New Zealand 6th ed* 2021 at p325-371.

**Legislative background**

18. A potentially relevant part of the background context to interpreting section 32 is the fact that past instances of regulatory separation in New Zealand were achieved by primary legislation.[21] However, both instances occurred more than 20 years ago and the approaches taken were highly specific to the situations in those sectors at the time. Accordingly, I do not attach any particular weight to this and focus below on the background to the Act and relevant amendments.

*Electricity Industry Act 2010*

19. As noted above, the Act was passed in 2010 following a Ministerial Review in 2009 which was initiated in response to concerns about the performance of the electricity market, specifically, security of supply and rising prices.[22] Among other things, the Review identified weaknesses in competition in the retail market and that some generators had market power in dry years. It made a number of recommendations, including replacement of the Electricity Commission with the Authority, with a narrower focus on promoting competition for the long-term benefit of consumers.[23]

20. The Electricity Industry Bill (which became the Act) largely implemented the recommendations of the Review. As well as establishing the Authority it also introduced the Code. The Explanatory Note to the Bill explained that the key difference between the Code and the Electricity Governance Rules (**EGR**s) which preceded it was that the Code, unlike the EGRs, would not require the approval of the Minister before coming into force. The Note commented that: "*This change is consistent with increasing the independence of the Authority. Involving the Minister in approving the rules invites lobbying from parties that have been unsuccessful in the rule-making process and increases uncertainty for investors. It is also unrealistic to expect the Minister to be accountable for the rules, which are detailed and technical and extend to over 1400 pages*."[24] This suggests that Parliament fully intended the Authority to have wide rule-making powers, to enable it to address the competition issues in the market the Review had identified.

21. My review of the available materials from the 49th Parliamentary term (2008-2011) and the passage of the Electricity Industry Bill identifies little further comment on the intended scope of the Code or the specific issue of corporate separation. To the extent that comments were made on those issues during various readings of the Bill and in Committee, those related (at a high level) to the purpose of the Authority and to the separation of the distribution and retailer functions.[25]

[21] Separation of electricity distribution from generation and retail was achieved via the Electricity Industry Reform Act 1988 and structural separation in telecommunications was achieved in 2011 via amendments to the Telecommunications Act 2001.
[22] Explanatory Note to Electricity Industry Bill.
[23] Chronology of New Zealand Electricity Reform, Energy Markets Policy, Ministry of Business, Innovation and Employment, August 2015.
[24] Explanatory Note to Electricity Industry Bill, Industry Participation Code.
[25] *See*, for example, 49th Parliament, Electricity Industry Bill — Second Reading, 20 July 2010, Hansard volume 665, Page 12473, Hon Gerry Brownlee (Minister of Energy and Resources) ("*Second, a set of significant amendments made by the select committee concerns the rules that are designed to head off the risk of anti-competitive behaviour by lines businesses if and when they ever get back into retailing.* ***The amendments raised several thresholds for application of those rules, such as for when corporate separation is required and for the amount of generation directly connected to the grid that lines companies can own.*** *These changes improve the balance between encouraging lines companies to provide competitive retail generation services and making sure we retain an open, competitive market.*") (emphasis added)

*Electricity Industry Amendment Act 2022*

22. In April 2018 the Minister of Energy and Resources commissioned an independent review into the electricity market. This review was prompted by rising electricity prices for residential consumers, in the face of stable pricing for commercial and industrial customers. The review considered competition in the wholesale electricity market, with the final report (**Electricity Price Review**) being published in May 2019.[26]

23. The Electricity Price Review identified a concern with the wholesale contract market and recommended measures to strengthen competition, including that the Authority require vertically integrated companies to report separately on the financial performance of their retail and generation/wholesale operations. It did not recommend forcible separation at that stage but recorded that if the package of measures in the report did not adequately strengthen wholesale competition, then operational separation should be considered.[27]

24. Another of the recommendations of the Electricity Price Review was that the Government should give the Authority more power to regulate network access and should "*remove rules in Part 3 of the Act that define (narrowly in today's terms) what distributors and retailers are and can do, and delegate to the Electricity Authority the development of regulations to replace them*".[28] A footnote to that passage notes that "*Existing measures in Part 3 of the Electricity Industry Act 2010 include corporate separation, ownership separation, management separation and non-discrimination rules for distributors involved in generating and retailing electric*ity."[29]

25. The Electricity Industry Amendment Act 2022 (**Amendment Act**) followed the 2019 Electricity Price Review. The Amendment Act made changes to (amongst other things) how responsibility for the Code is allocated under the Act – for example, to increase the role of the Minister and to give the Authority oversight of existing corporate separation and arm's length rules. I identify the amendments and where relevant, the associated legislative history below.

26. First, the Amendment Act reintroduced and expanded the possible matters on which the Minister can intervene to amend the Code as if he or she were the Authority.[30] The matters related to competition in the wholesale market. For example, the standard terms on which distributors offer retailers access, requiring retailers to provide information to the Authority to benefit consumers in comparing and switching retailers, requiring industry participants to provide information to the Authority to enable improvements in the performance of the wholesale market etc.[31]

27. In particular, the Amendment Act expressly permitted the Minister to amend the Code to require some or all gentailers to release information "*about the profitability of their retailing activities*."[32] In effect, this information disclosure is a form of accounting separation, since generation and retailing activities would need to be accounted for separately. This shows that Parliament considered this form of regulatory separation might be used to address competition

[26] Electricity Price Review Final Report, 21 May 2019.
[27] Electricity Price Review, p 45. Given the Price Review refers to operational separation as anticipating measures further than disclosure, and interacting at arm's length, it appears that the "operational separation" referred to is broadly similar to corporate separation as referred to in the Options Paper.
[28] Electricity Price Review, p 56.
[29] Electricity Price Review, footnote 167.
[30] This amendment was carried out by introducing a new section 44B (to replace former section 43).
[31] Act, s44B.
[32] Act, s44B(2)(g).

issues in the retail market (as the Electricity Price Review had recommended) and that this could be achieved via the Code.

28. The Hansard records for this amendment show that the Minister's greater power was heavily criticised as an overreach, and usurpation of the Authority, which was argued to be better placed to amend the Code.[33] The fact that the Minister's power to intervene is time-limited and will expire on 1 September 2025 confirms that this was only intended to be a backstop measure.[34] However, it nevertheless indicates that Parliament continued to take the view that relatively intrusive requirements on industry participants could and should be imposed via changes to the Code, rather than requiring legislation.

29. Secondly, the Amendment Act made changes to the existing separation rules for generation and retail functions. Prior to the Amendment Act the structural separation of distribution from generation and retail functions, and corporate separation and arm's length rules where distributors were involved in either or both generation and retail activities were provided in Part 3 of the Act.[35]

30. The Amendment Act made the following changes:

    a) moved the corporate separation and arm's length rules provisions to the Code;[36]

    b) retained in a new section of the Act the structural separation of distributors from generation and retail, at the same threshold;

    c) amended section 32 to allow the Authority to impose obligations on non-industry participants "*for the purpose of restricting relationships between two classes of industry participants*";[37] and

    d) confirmed that where corporate separation or arm's length rules apply, the Commerce Act will treat the bodies corporate as separate, even if they have a common owner.[38]

31. On any view, these amendments provided for the Authority to have greater direct responsibility for regulatory separation activities, again, consistent with the recommendations of the Electricity Price Review. The corporate separation provisions (albeit for distributors as against generators/retailers) are now expressly within the Authority's responsibility to monitor, enforce and investigate via the Code. Again, this indicates that Parliament was comfortable with this type of regulation sitting within the Code and being subject to the Authority's power to amend the Code rather than remaining within the Act itself.

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[33] *See*, 53rd Parliament, Electricity Industry Amendment Bill – Third Reading, 25 August 2022, Hansard volume 762, Hon Priyanca Radhakrishnan ("*Another focus point of debate on this bill has been the time-limited backstop power given to the Minister of Energy and Resources through this bill. The concern is that this power will give any Minister of Energy and Resources unrestricted ability to act as if they were the Electricity Authority. This is not the case. The bill grants the Minister power to amend the code for a small number of specified matters only if satisfactory progress has not been made on these matters.*"). This included Select Committee submissions from the Authority itself which recommended the provision be removed, as it operates as an independent Crown entity.

[34] *See*, 53rd Parliament, Electricity Industry Amendment Bill – Third Reading, 25 August 2022, Hansard volume 762, Hon Priyanca Radhakrishnan; quote as above at n 30. The previous National government that introduced the Act had included a similar provision in the original Act, for which time had run out.

[35] Act, s72 (as it was prior to the amendments in September 2022).

[36] Code, Part 6 and Part 6A.

[37] Act, s32(3).

[38] Act, s44D.

32. I have not located any commentary within the legislative record to suggest that these amendments were specifically intended to facilitate further anticipated corporate separation. However, consistent with the views expressed in the Electricity Price Review, referred to in paragraph 24 above, the Parliamentary records do identify that moving regulatory separation provisions to the Code was intended to give the Authority the ability to make flexible and responsive regulation in response to emerging technologies.[39] It is difficult to see why this would not have been intended to encompass corporate separation of gentailers' generation and retail businesses, particularly as the potential need for such a measure was expressly flagged in the Electricity Price Review.

33. Finally, for completeness, while competition issues in the electricity market could, to some extent, be addressed by the Commerce Commission using its powers under the Commerce Act 1986, the Commission does not have the power to impose regulatory separation. Further, the Commission declined to investigate complaints by the IERs in view of the measures being considered by the Electricity Competition Taskforce (and now being considered by the Authority).[40]

**Decisions on the Authority's code-making power**

34. Despite several Court decisions since the Act's inception, there has been relatively limited judicial discussion of the extent of the Authority's code-making power. A number of cases refer to the Code but do not specifically address its scope.[41] The case which provides the best guidance for current purposes (and which will be binding on any High Court judge considering the same issues at first instance) is the Court of Appeal's decision in *Vector Limited v Electricity Authority* (***Vector***).[42]

35. *Vector* concerned an application for judicial review of a proposal by the Authority to prescribe in the Code standard terms for "*use-of-system*" agreements (**UoSA**s) between distributors and retailers of electricity and, in particular, to prohibit individually negotiated terms within them. Vector challenged the proposal, arguing that the Authority had no power to interfere with freedom of contract, or alternatively, that the proposal fell outside the matters the Authority could prescribe.

36. At first instance, the High Court confirmed the Authority had the power to do as it proposed. Indeed, Simon France J recorded the Authority's "*very broad power*" to carry out its objectives via the Code.[43] Vector appealed, seeking declarations challenging the Authority's proposed amendments.

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[39] *See*, 53rd Parliament, Electricity Industry Amendment Bill – Third Reading, 25 August 2022, Hansard volume 762, Hon Priyanca Radhakrishnan: "*The bill will move some provisions from Part 3 of the Act into the code. It will give the authority jurisdiction to develop proportionate and targeted rules to address any competition-related problems arising from the involvement of distributors or Transpower in other contestable markets, if they emerge.* ***It is more appropriate that these statutory provisions are in the code because the rapidly evolving electricity system requires more flexible and responsive regulation than would be the case if the rules remained in primary legislation***." (emphasis added)

[40] Commerce Commission letter to independent electricity retailers and gentailers regarding complaints under section 36 of the Commerce Act dated 12 December 2024.

[41] *See,* for example*, Trustpower Ltd (formerly Bay Energy) v Electricity Authority* [2016] NZHC 2914 (judicial review relating to a consultation process carried out by the Authority); *Manawa Energy Limited v Electricity Authority* [2022] NZHC 1444 (judicial review relating to the Authority's decision to replace the transmission pricing methodology guidelines in 2020); *Buller Electricity Limited v Electricity Authority* [2024] NZHC 706 (judicial review challenging decisions of the Authority and Transpower).

[42] *Vector Limited v Electricity Authority* [2018] NZCA 543.

[43] *Vector Limited v Electricity Authority* [2017] NZHC 1774 at [33].

37. On appeal, President Kós framed the Court's inquiry as "*not so much the capacity of the Authority to impose standard terms in distribution agreements via the Code. This it clearly can do… Rather, the present issue really concerns the power of the Authority to* prevent *parties negotiating* other *terms.*"[44] That is, the Court was required to determine whether Parliament intended the statutory power it conferred on the Authority under section 32(1) to extend so far as to authorise a requirement for complete standardisation.[45]

38. The Court of Appeal upheld the High Court's finding that the Authority had "*made its case*" for greater standardisation of UoSAs, but concluded that the Authority had failed to demonstrate the need for complete standardisation.[46] It declared unlawful the proposed amendment which prohibited additional terms or the inclusion of other matters in a default UoSA.

39. Some aspects of the decision in *Vector* are confined to the circumstances of that case. However, four points are instructive for present purposes:

  a) First, the Court noted that the "*very generalised power*" contained at section 32(1) to incorporate "*any provisions*" within the Code was not conferred in "*unqualified terms*" or "*unlimited*".[47] Instead, both the objects of the Act and in section 32 inform the possible amendments to the Code.[48]

  b) Secondly, the Court identified that policy and legislative history prior to the Act may be indicative of legislative intent for the specific proposed amendment. Some legislative history was examined but little weight was accorded to it.[49]

  c) Thirdly, the Court accepted the Authority's competition-related justifications for the proposed Code change to allow for standardized UoSAs.[50] That is, that UoSAs lower retail market entry and expansion barriers, reduce the cost of doing business and reduce potential for UoSAs to stifle competition and innovation.[51] The Court noted that "*little contrary argument was advanced*" by the appellants to oppose these justifications.[52]

  d) Fourthly, and most importantly, the Court addressed what the threshold of "*necessary or desirable*" to achieve one or more of the specific objects of section 32 requires. The Court held that where the exercise of the power is "*extensive*", the words "*or desirable*" did not set a lower standard than the word "*necessary*."[53] That is, the greater the intervention or the greater the impact of a proposed measure, then the higher the threshold the Authority will need to meet to demonstrate the measure is necessary or desirable. No further comment on the interpretation of "*necessary*" was proffered.

[44] *Vector Limited v Electricity Authority* [2018] NZCA 543 at [37].
[45] Ibid, at [38].
[46] Ibid, at [52].
[47] Ibid, at [40], [42].
[48] Kós P's decision referred to the Supreme Court's observations in *Unison Networks Ltd v Commerce Commission* [2007] NZSC 74, [2008] 1 NZLR 42, that "*A statutory power is subject to limits even if it is conferred in unqualified terms". Parliament must have intended that a broadly framed discretion should always be exercised to promote the policy and objects of the Act*."
[49] Ibid, at [41].
[50] Ibid, at [43], [48], [49].
[51] Ibid, at [43].
[52] Ibid, at [43].
[53] Ibid, at [52].

40. In my view, *Vector* supports the argument that the Authority has the power to impose corporate separation of the kind described in the Options Paper via the Code.[54] However, it also makes clear that, before it can do so, the Authority will need to be satisfied that corporate separation is justified by reference to the objectives of the Act and at least one of the objectives in section 32 ***and***, given the high level of intervention involved, that it is *necessary* to achieve one or more those objectives. This aspect is discussed more fully below.

**The threshold for the Authority's exercise of its code-making powers**

41. Notwithstanding my view that the Authority can impose corporate separation via the Code, the Act identifies that can only occur if the proposed term is consistent with the Authority's objectives ***and*** "*necessary or desirable*" to promote one or more of the objectives in section 32(1). The Court of Appeal's decision in *Vector* confines that further: where the intervention is extensive, desirable will mean necessary. Therefore, before the Authority could impose corporate separation it would need to be reasonably satisfied that the measure is necessary to address the competition risks identified in the Options Paper.

42. Further, in the event of an application for judicial review of a decision by the Authority to introduce corporate separation, there would need to be sufficient evidence to satisfy the Court on the balance of probabilities that it was necessary.

43. Therefore, the lawfulness of any decision by the Authority to impose corporate separation will depend on the strength of the evidence to support this being a necessary measure. The quality or adequacy of evidence is a matter on which both the Authority and the Courts have commented. In *Vector,* the Court held that the "*necessity*" for the proposed clauses in the UoSAs was never demonstrated to the Court's satisfaction.[55] Equally, in various consultation documents, the Authority confirmed that evidence in support of particular outcomes is crucial to its decision making – especially where the parties making submissions had the "*best access to relevant information*."[56]

44. As a higher impact intervention affecting property rights, it is strongly arguable that corporate separation can only be necessary if alternative, softer intervention measures are not likely to be effective. Therefore, to establish that corporate separation is necessary, the evidence must demonstrate that less impactful interventions (such as non-discrimination obligations or negotiate-arbitrate regulation) would not sufficiently resolve the identified problem (or would not resolve it in a sufficiently effective or timely manner).

45. This does not mean the Authority would need to test Options 1, 2 or 3 before implementing Option 4. But, in my view, there would need to be evidence to satisfy the Authority (and, in the event of an application for judicial review, the Court) that:

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[54] Note that the consequence of *Vector* was (in the end) dealt with by Parliament amending the Act to prescribe quality and information standards in distribution agreements. But that despite that, *Vector* is still good law and binding authority on the High Court.

[55] *Vector Limited v Electricity Authority* [2018] NZCA 543 at [52].

[56] Electricity Authority "Reviewing risk management options for electricity retailers – update paper following submissions", 27 February 2025. At [2.3], that paper records that submitters put forward a range of views, but failed to present further data or specific evidence in support: "*While submitters put forward a range of views for and against these findings, parties that disagreed with the Authority's competition concerns did not present further data or specific evidence to support those views, despite having the best access to relevant information. Given the lack of evidence provided to disprove or reduce the Authority's competition concerns, we consider it is appropriate to take steps to address these concerns to promote competition in, and the efficient operation of, the electricity industry for the long-term benefit of consumers*.").

a) The status quo is not delivering satisfactory levels of competition, reliable supply and/or efficiency in the electricity industry such that intervention is necessary to promote one or more of those objectives; and

b) The alternative, less instrusive options would not adequately promote the desired objective(s), whether because they are not likely to be effective (or sufficiently effective) to address the identified issue or because their effectiveness is uncertain and the timeframe to establish whether they are likely to be effective is too long to justify, having regard to the harm that may occur in the meantime.

46. Lastly, if the Authority forms the view it is or may be appropriate to impose corporate separation on gentailers, it would be necessary for it to follow the Act's prescribed process to make that part of the Code. Section 39 provides that the Authority must publicise a draft of the proposed amendment, prepare and publicise a regulatory statement, and consult on the proposed amendment and the regulatory statement.[57] After receiving the evidence and submissions from industry participants, the Authority must satisfied that the amendment is necessary.

47. This consultation process mitigates against the risk of the Authority's ultimate decision being susceptible to a successful judicial review. A thorough process of consultation, combined with quality evidence, makes the likelihood of the Court finding an error in the final decision less likely.

48. Alternatively, the Authority can amend the Code without first going through the consultation process if it considers it necessary or desirable in the public interest that the proposed amendment be made urgently.[58] However, a decision by the Authority to amend the Code urgently could itself be challenged by judicial review. In light of *Vector*, it is likely the Authority would need to consider it was *necessary* to act urgently rather than simply being desirable.

Yours sincerely

[redacted]

Jenny Cooper KC

[57] Act, s39; *Trustpower Ltd (formerly Bay Energy) v Electricity Authority* [2016] NZHC 2914.
[58] Act, s40.

# ANNEX C: Report by Link Economics (Public version)

linkeconomics.com

# Electricity retailing – adjusting the tilt of the playing field

**Prepared for Electric Kiwi, Octopus Energy, Pulse Energy and 2degrees**

**By Emma Ihaia and David de Boer**

**PUBLIC VERSION**

7 May, 2025

# Contents

# Definitions

| | |
|---|---|
| **DSF** | Demand-Side Flexibility |
| **EDM** | Elimination of Double Marginalisation |
| **GW** | Gigawatt |
| **GWh** | Gigawatt hour |
| **HHI** | Herfindahl-Hirschman Index |
| **ICP** | Installation Control Point |
| **ITP** | Internal Transfer Pricing |
| **kWh** | Kilowatt hour |
| **MDAG** | Market Development Advisory Group |
| **MW** | Megawatt |
| **MWh** | Megawatt hour |
| **OTC** | Over-the-Counter |
| **PEF** | Pricing Equivalence Framework |
| **TOU** | Time-of-Use |

# Executive Summary

1. In this report, we find retail electricity competition to be in a dire state. In a context where spot prices have risen over time and have become more volatile, access to risk-management tools (hedges) has become an essential input for retail competition. The large vertically integrated gentailers have an implicit hedge against high spot prices by controlling 95% of flexible generation. Without sufficient access to risk-management tools on the same terms that gentailers supply their own downstream operations, independent retailers face the very real prospect of a margin squeeze and market foreclosure. The resulting retail market structure is that of an oligopoly with a competitive fringe that does not have the ability to compete aggressively.

2. The impact on competition of the lack of non-discriminatory access to shaped hedges is evident from the exit of numerous independent retailers in recent years, a reduction in the trader switching rate, a levelling off in the market share of independent retailers after a period of growth, an increase in retail market concentration for some customer segments, and periods where independent retailers have suspended customer acquisition activities.

3. If competition continues to be hobbled through the lack of access to essential inputs on non-discriminatory terms, the consequences of severely weakened competition from independent retailers will include a lack of innovation, including in pricing. Innovation is likely to be particularly important in the context of the energy transition and achieving efficiency through reducing peak demand, both in terms of avoided generation investment and also transmission and distribution network investment deferral, with the potential to save consumers hundreds of millions of dollars per year.

4. The Authority has recognised the importance of hedge contracts to the financial viability of new and independent retailers and generators. It has identified a range of regulatory options, and has focussed on Option 2, which requires adherence to non-discrimination principles.

5. If the Authority continues to favour Option 2, then we would suggest that it includes a price squeeze test requirement (rather than simply a prohibition of cross-subsidies) and that it also consider how to incorporate assurance/audit requirements, with clear and meaningful consequences for non-compliance. However, even then, it does not appear to us that this strengthened form of Option 2 will be sufficient to enable effective retail competition, given the difficulties in monitoring and detecting non-compliance, and the fact that by the time the Authority is aware of non-compliance it will likely to be too late – the damage to competition will already have occurred. As a result, we consider that some form of separation, such as operational or corporate separation, would be necessary.

6. We have not taken a definitive view on whether structural separation is necessary, as a full assessment of the costs and benefits of structural separation is beyond the scope of this report. However, we do make the following observations:

   a. When evaluating the efficiencies of vertical integration, what is of primary relevance to the Authority's analysis of the appropriate regulatory remedies is not the private benefits of vertical integration – that is, benefits that accrue to the gentailer – but whether there are true efficiencies relative to what would be otherwise achieved and whether public benefits will result (which depend on whether the efficiencies will be passed on to consumers).

b. While there are implementation costs associated with separation, including the costs business disruption, these are likely be substantially less than those incurred in the context of telecommunications, because vertical separation in the context of electricity does not require the separation of physical assets.

c. Structural separation that was either regulator-mandated (BT) or encouraged/incentivised by government (Telecom NZ), appears to have paved the way for voluntary separation, by demonstrating the benefits of separation, including that the combined market capitalisation of the separated firms can be higher that of the integrated firm.

d. Benefits of structural separation can include the ability to improve strategic and management focus on what are two very different types of businesses (infrastructure vs retailing activities such as marketing). Structural separation can also have the effect of improving access to capital – while some investors (for example, superannuation funds) are looking for long-term physical assets that have a reasonably low-risk, other types of investors are looking for higher-risk investments such as retailing.

e. Experience from the initial operational separation of Telecom in New Zealand is that it became apparent quite quickly in the process that some of the compliance monitoring measures were not effective. This experience suggests to us that rather than starting at lower end with softer regulatory interventions and then moving to more intrusive remedies (as the Authority proposes), we should learn from other experience and implement more effective regulatory measures from the outset.

# 1 Introduction

7. The Electricity Authority (the Authority) has published an options paper on “Level Playing Field measures” (the Options Paper).[1] Electric Kiwi, Octopus Energy, Pulse Energy and 2degrees have engaged us to:

   a. comment on the types of competitive harm that arise through discriminatory practices by gentailers (as vertically integrated firms with market power over an essential input) and the effects these have on retail outcomes,

   b. provide a view on the relevance or otherwise of the efficiency benefits of vertical integration listed in paragraph 3.17 and commentary on separation in the telecommunications sector,

   c. examine the practical implementation of non-discrimination obligations, including how the principles should be applied and how adherence to the obligations should be monitored, drawing on experience from other jurisdictions and from the telecommunications sector, and to

   d. provide a view on the effectiveness of Option 2 in addressing the types of competitive harm at issue and whether additional options should be considered.

8. We have prepared this report drawing on our experience as competition and regulatory economists, including applied experience in the telecommunications sector across several countries of developing and implementing operational separation regimes, developing internal compliance testing and processes for vertically integrated firms, and advising the vertically integrated firms and the Commerce Commission on the implementation of structural separation. We attach a short description of our relevant experience in this regard.

# 2 The effects of gentailer vertical integration on retail market outcomes

## *2.1 The need for access to an essential input*

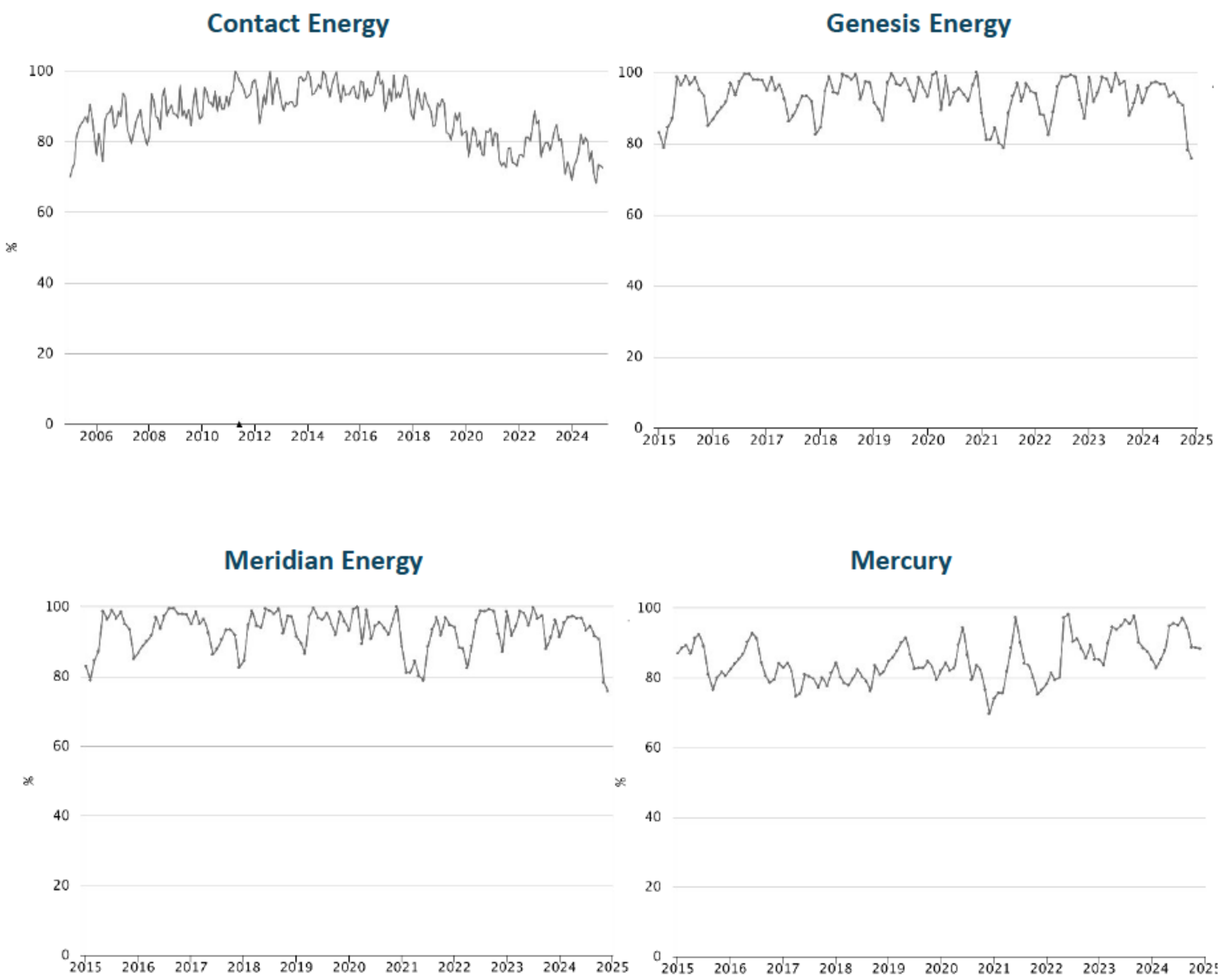
9. While the wholesale market provides access to wholesale electricity, the volatility that can occur in spot prices due to periods of high demand combined with generation shortages, as well as the increase in spot prices relative to cost of generation[2] means that an independent retailer faces fundamentally different risks and costs than gentailers. Gentailers know that even if their retailing arm effectively faces losses during periods of high spot prices, their generation arm reaps off-setting benefits. While gentailers hold an implicit hedge, independent retailers must either seek contractual shaped hedges to manage the risk of high spot prices, or have very deep pockets and take on the risk of wholesale market volatility.

[1] Electricity Authority (27 February 2025), “Level Playing Field measures Options paper.”

[2] As observed by the Authority in para 3.41 of the Options paper: “there is also an ongoing gap between the forward curve derived from ASX hedge prices and the cost of new generation build, as shown in Figure 4 below. The gap is significant and has endured for many years.”

10. The bulk of flexible generation is held by the gentailers, which produce 85% of overall electricity and 95% of flexible generation,[3] with high levels of matching between each gentailer's energy sales and purchases (see Figure 1 below). This means that there is scarce access to the long-term shaped hedge contracts needed by independent retailers, and that the independent retailers need to seek access to hedge contracts from their vertically integrated rivals. While the ASX provides standardised baseload short-term contracts, Over-the-Counter (OTC) Contracts are a means for load-profiled hedges and contracts with longer terms to be negotiated. A standardised super-peak hedge OTC contract (the standardised flexibility product), which was designed by an industry working group in conjunction with the Authority was announced in December 2024. However, the provision of this product is not mandated.

***Figure 1: Matched sales and purchases of gentailers***



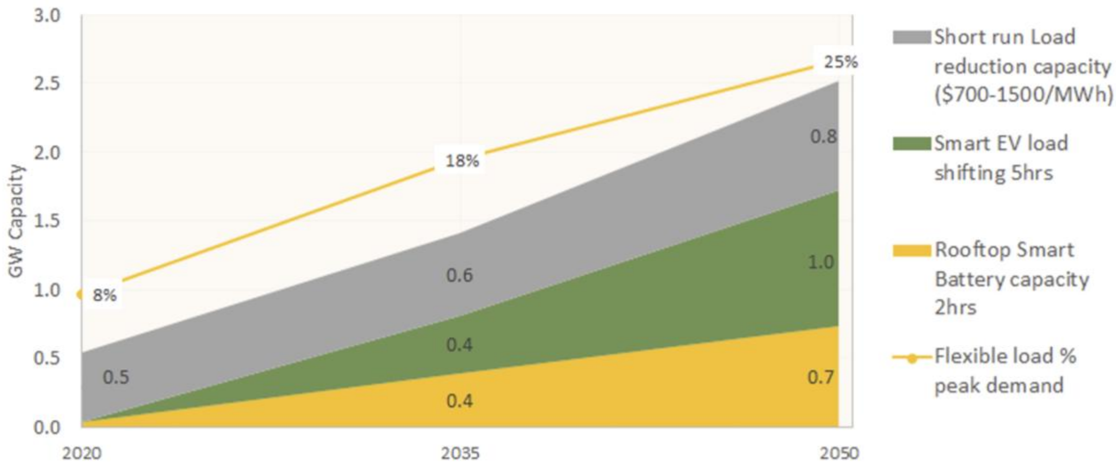

Source: Electricity EMI, Vertical Integration Trends

11. Other options for independent retailers to manage risk could include self-supply of generation or demand-side flexibility (DSF). However, neither of these options appear to be a viable way of adequately addressing the risks faced:

[3] Commerce Commission (5 February 2025), Statement of Issues Contact Energy Limited / Manawa Energy Limited, para 240.3.

a. The option for independent retailers to self-supply through building flexible generation is not realistic given: (i) that it requires different set of specialised skills, (ii) that it appeals to a different set of investors (as is discussed in more detail in section 3.2), (iii) a lack of appropriate sites for large-scale hydro-generation, and (iv) the energy transition away from fossil fuels. In any case, the large upfront costs as well the extended timescales needed to build generation mean that self-supply, even if it was possible, would create a significant barrier to entry through self-supply of flexible generation.[4]

b. While use of DSF, where consumers either shift their load over time or reduce their total demand, is one way to reduce exposure to high spot prices, it does so by providing customers with a different grade of service. In any case, it seems unlikely that the scale of available DSF would be sufficient to make a material difference to the spot-price risk faced by independent retailers. Figure 4 from MDAG's Issues Paper estimated that DSF was approximately 8% of peak demand in 2020, and its reference case showed that increasing over time. However, in the early years, almost all of the modelled DSF is load curtailment in response to high spot prices (the grey area in the MDAG chart below), rather than load shifting and would presumably mainly be associated with large commercial and industrial connections rather than residential customers. Rooftop solar with battery currently has less than half a percent penetration, so does not provide a sizeable option.[5] Although independent retailers may be more likely to attract customers with EVs or Rooftop solar + batteries with innovative pricing, the volume of customers of that type are very small.




12. As a result, access to long-term OTC hedge products is essential in order to be able to compete effectively in the retail market. Inadequate access to these products (either through limited supply or supply at a price that is higher than gentailers self-supply) severely constrains retailers' ability to compete in a context of volatile spot prices, and has the effect of constraining independent retailers' capacity.

[4] This barrier is heightened by the need for investment in diverse generation assets.
[5] The Authority's EMI Installed distributed generation trend data shows that that update of solar + battery was 0.456% of residential ICPs as at 31 March 2025.

### 2.2 *Ability of vertically integrate firms to discriminate in favour of their downstream operations*

13. Vertical integration provides the strategic advantage of being able to prioritise service provision to downstream operations and to effectively provide preferential access terms as compared with external wholesale customers.

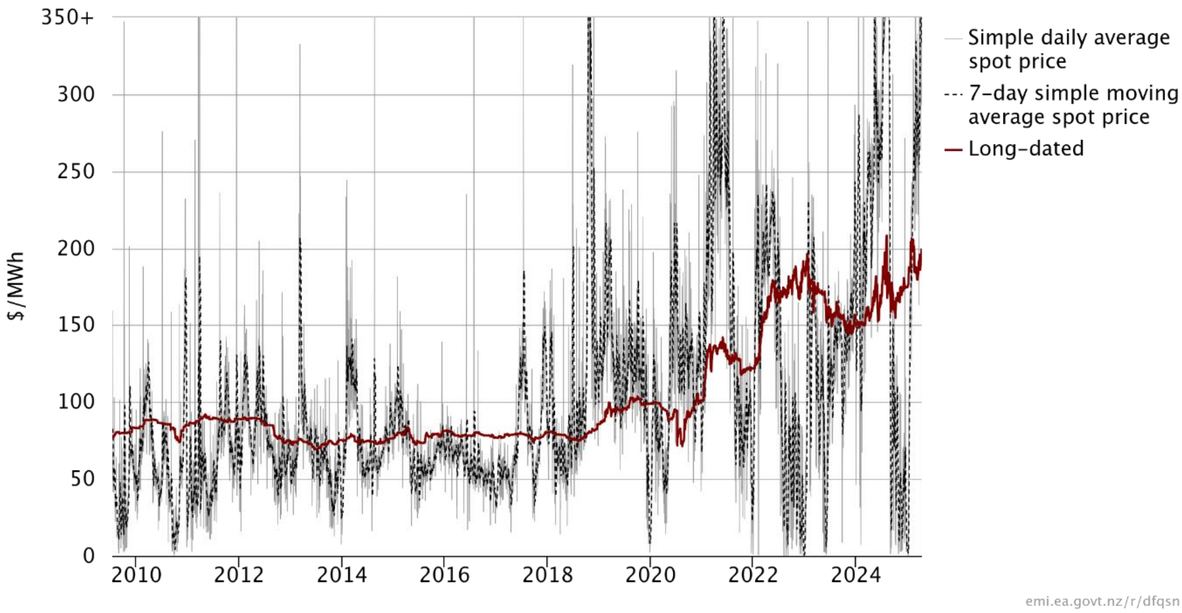
14. The prioritisation of the gentailers' own downstream arms and the resulting lack of depth and liquidity for OTC shaped hedge contracts seems evident from the Authority's finding that: "Over a third of the time retailers receive only one offer in response to requests for shaped hedges."[6] This outcome is consistent with the expected incentives of vertically integrated firms.

15. [**Confidential**

]

16. With limited access to OTC shaped contracts on terms that are dictated by their vertically integrated rivals, retailers have faced squeezed margins during periods of high wholesale prices, which have been common over recent years. Comparing retail pricing for residential customers with ASX forward prices shows that baseload prices have been above the level of the retail price for a significant proportion of the past three years (see Figure 3Figure 3 below). As the Authority has noted, OTC super-peak hedge contracts *"trade at a substantial unquantified premium over ASX baseload prices adjusted for shape",*[7] which implies that margins of independent retailers are even more squeezed than is evident from the comparison in Figure 3Figure 3.

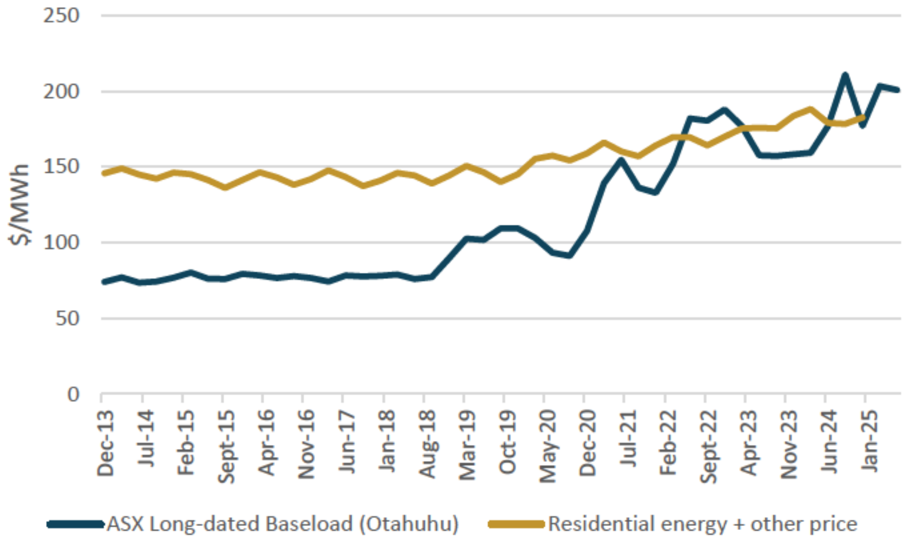
***Figure 2: Forward price curves and spot prices (Otahuhu)***




Source: Electricity Authority EMI

[6] Options Paper, para 3.39(d).
[7] Electricity Authority (27 February 2025), Reviewing risk management options for electricity retailers - Update paper following submissions, para 2.1.

***Figure 3: Residential energy + other price compared with ASX long-dated baseload***




Source: MBIE Sales-based electricity costs, Report for December 2024. Electricity Authority EMI Forward price curves.

Note: We have used the Energy and other component of prices, which we have adjusted to remove GST.

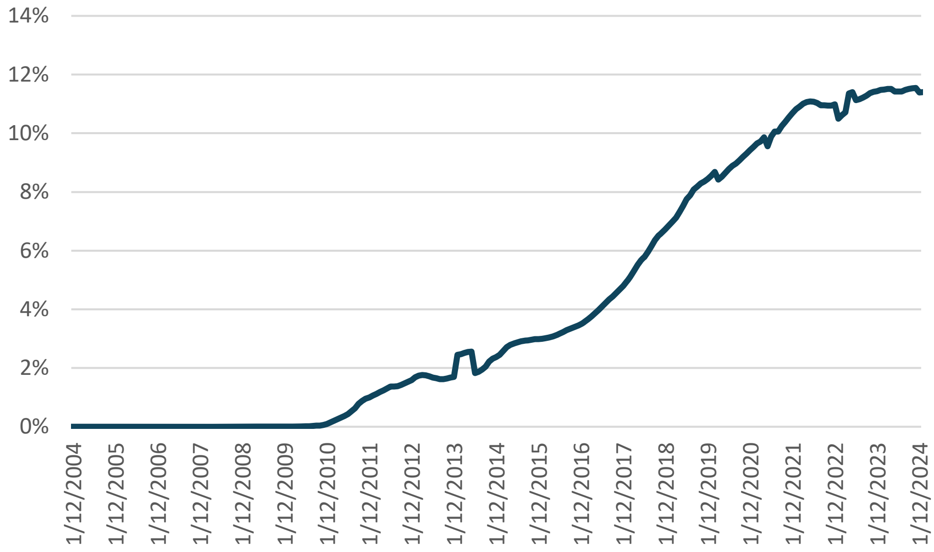
17. The retail prices used in the above chart are extracted from MBIE's sales-based electricity costs, which are effectively a weighted average across all retailers.

## *2.3 Competition effects of inadequate access and margin squeeze*

18. The access problems discussed above lead to competition problems of foreclosure through a price squeeze, refusal to supply (explicitly or constructively), and raising rivals' costs. Even if wholesale prices in a given year turn out not to be so high as to result in a price squeeze, independent retailers are still disincentivised from competing aggressively as doing so means that they go into following years with a larger customer base and consequently a greater exposure to high wholesale prices. This outcome is evident from the withdrawal of independent retailers from PowerSwitch or not accepting customers, as has been the case.

19. It is apparent from a review of data on retail market outcomes that the nature of competition has changed over time, with a period of sustained growth in the share of ICPs held by independent retailers from 2011 through 2021. The independent retailers' share levelled off from 2021, coinciding with a sustained period of higher and more volatile wholesale prices (as is evident from Figure 4Figure 2).

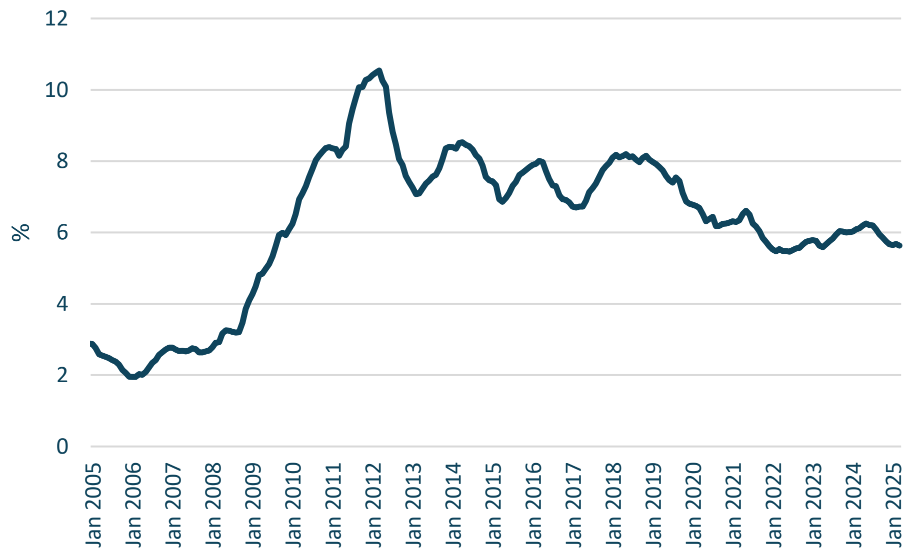
***Figure 4: Share of ICPs over time held by independent retailers***




Note: Excludes Contact, Genesis, KCE, Mercury, Meridian and Nova

20. The trader switching rate has been subdued in recent years (as can be seen from Figure 5Figure 5) indicating competition has become less intense during this period, which is consistent with independent retailers having less capacity to take on the risk associated with growing their customer base.

***Figure 5: Trader switching rate (12-month rolling)***

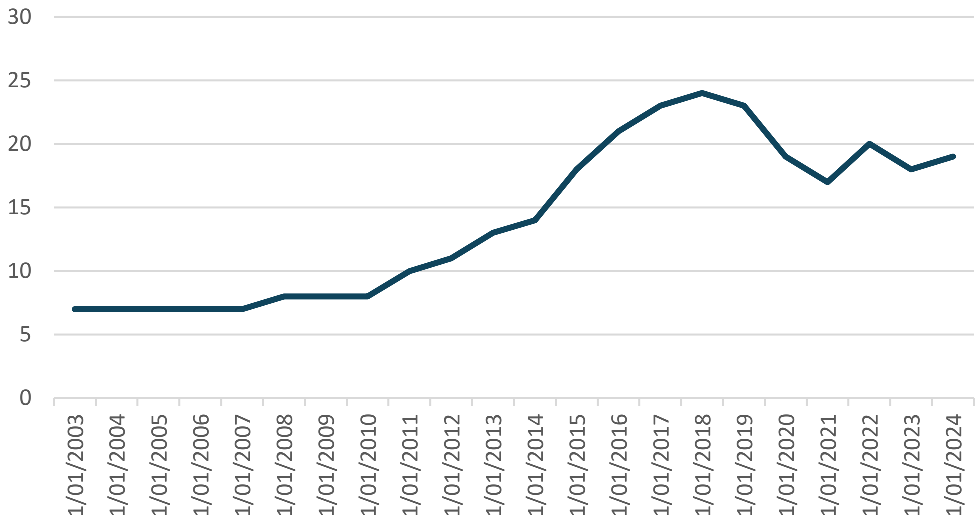



Source: Electricity Authority EMI

21. The number of retailers has also reduced. Of the 24 retail parents that each served more than 100 connections at the end of 2018, 12 remain in operation (soon to be 11 with the pending

exit of Prime Energy), with only 5 of these being independent retailers that do not own generation.[8]

***Figure 6: Number of retailers with more than 100 ICPs***

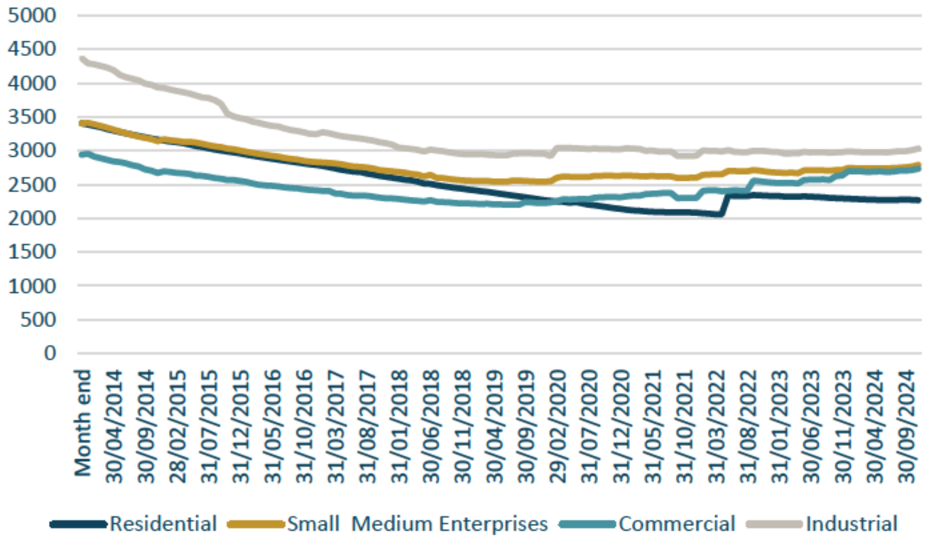



22. The result is that market concentration, after declining until 2021 has levelled off, though in some customer segments it has increased in recent years. The Authority publishes a data series of the Herfindahl-Hirschman Index (HHI), which is a concentration measure calculated as the sum of the squares of the market shares of each market participant. The Authority's measure of HHI is based on ICP shares (for parent companies) and currently sits at 2219, which is between the HHI for a four player and five player market, where all firms have an equal market share.

23. Typically revenue market shares are a better measure of the relative positions of rivals – entrants will often win a greater proportion of low-value customers than high-value customers, meaning that an entrant's customer share will be significantly higher than its revenue share. However, the information to calculate the revenue-based shares and HHI is not readily available. Disaggregating the ICP-based HHI by customer segment shows: (1) the HHI is considerably higher for business customer segments than for residential, and (2) while the HHI has levelled off for residential, SME and industrial, it has been increasing for Commercial.

[8] The remaining independent retailers are 2degrees, Electric Kiwi, Flick Electric, Plus Energy and Paua to the People.

*Figure 7: HHI by customer segment*




Source: Electricity Authority EMI data

24. The higher concentration of business market segments (highest for industrials where it is around 3000) is consistent with independent retailers effectively being capacity constrained. In other words, if they acquire large customers that proportionately increases their exposure to high wholesale prices.

25. The limited ability/incentive for independent retailers to expand has culminated in some putting a pause on customer acquisition at times of particularly high wholesale prices, on multiple occasions. It is unexpected in competitive markets to see entrants intentionally ceasing customer acquisition, but this has happened multiple times in recent years.

## 2.4 Benefits that are being foregone

26. As is apparent from the above discussion, the retail market structure is that of an oligopoly with a competitive fringe. However, the lack of access to risk management tools means that fringe effectively has limited capacity and is not able to compete aggressively, given the lack of availability of essential products at pricing that would enable them to confidently expand their market share. This leads to a number of competition benefits, and flow-on benefits, that are being foregone – these could be thought of as costs of vertical integration. In addition, vertical integration of firms that own the bulk of flexible generation has the implication of potentially restricting investment by independent generators.

### Innovation

27. The loss of benefits resulting from suppressed competition includes innovation. Innovation is likely to be particularly important in the context of the energy transition and achieving efficiency. Smaller players have in the past been more nimble in being able to offer innovative pricing and were leaders in offering time-based pricing options. For example, Electric Kiwi introduced the hour of power and more recently it has offered "Shift and Save" which incentivises customers to shift load off-peak. Time-based pricing by retailers enables price signals to be passed to customers about congestion on networks at peak times and times of

generation shortages and also provides variety and choice for customers. Other areas of innovation including billing and customer service delivery.

28. Following competition through innovation by a number of smaller market participants, some gentailers have moved to offer pricing innovation, whether through the use of apps, or time-based pricing, though often through sub-brands which have the effect of limiting the effects of competition to the segment of customers who are most engaged and least affected by customer inertia. The Authority's recent consultation paper on Time-of-Use (TOU) pricing highlighted the lack of wide availability and uptake of time-of-use pricing from gentailers and this has prompted the Authority to consider regulation to compel gentailers to offer TOU options. Stronger retail competition and non-discrimination measures may compel gentailers to offer TOU pricing more widely to avoid the need for this type of retail regulation.

29. The lack of TOU price offerings likely reflects that gentailers have much weaker incentives to drive DSF than independent retailers do.

### *Efficient price signals and demand-side flexibility*

30. A flow-on effect of the innovative pricing that has been pioneered by independent retailers is the very large efficiencies that can be achieved through reducing peak demand, both in terms of avoided generation investment and also transmission and distribution network investment deferral.

31. MDAG highlighted the scale of the savings in generation system costs that can be avoided with DSF:[9]

> *Reduced system costs as DSF can – at least partly – fulfil the role of a peaking plant, potentially at lower cost to the system. For example, if an additional 5-6% of system load was responsive (as per the enhanced demand flexibility case) that would save around $120 to $170 million per year in generation system costs (i.e. excludes any additional savings from reduced network costs). This is a gross benefit and the net benefit would be lower because the costs for demand-side parties to be responsive (foregone usage and any capital costs) would need to be deducted. This estimate appears to be broadly comparable with a cost benefit study by Sapere, which estimated the economic surplus of distributed energy resources over 30 years at $6.9 billion in present value terms, or roughly $230m per year. These estimates provide an indication of the size of the prize that could be available if additional DSF can be unlocked; (Footnotes omitted)*

### *Price competition*

32. Due to not having adequate non-discriminatory access to shaped hedges, independent retailers are not able to exert the competitive pressure on retail prices that they otherwise would. Effective regulatory intervention would ensure that the independent retailers are able to access hedge contracts and prices on the same terms that the retail operations of gentailers can, rather than requiring gentailers to increase retail prices.

33. The foregone benefits of price competition would have a different nature across customer segments. For residential customers, inflated prices lead to some contraction in electricity

[9] MDAG (18 January 2022), Price discovery under 100% renewable electricity supply – Issues discussion paper, p. 88.

usage and loss of consumer surplus as well as the flow-on effects from energy poverty, including health implications of insufficient heating.

34. Studies typically show that the price-elasticity of demand for business customers is high relative to residential customers, with some types of industrial customers being particularly price sensitive. As a result, prices that are above the competitive level will result in a contraction in demand which has multiplier effects on the economy.

***Support for independent generation investment***

35. It is clear that substantial investment in generation is required to address the demand growth that is expected to arise through decarbonisation. As is described by the Authority, access to flexible generation "is also important to industrials (for financial risk management), and for parties (including retailers and larger end users) buying PPAs that support independent generators."[10]

# 3 Efficiencies of vertical integration

36. The Authority notes that vertical integration may generate efficiencies through synergies or cost savings. It then provides a list of examples of benefits that could arise from gentailer vertical integration. We have been asked to provide comment on the relevance or otherwise of those examples. We note that we have not attempted to quantify the efficiencies of vertical integration and do not take a view on whether or not structural separation is justified. We have discussed some examples of where structural separation has been implemented.

## *3.1 Public benefits vs private benefits*

37. As a general comment, we note that what is of primary relevance to the Authority's analysis of the appropriate regulatory remedies is not the private benefits of vertical integration – that is, benefits that accrue to the gentailer – but whether there are true efficiencies relative to what would be otherwise achieved and whether public benefits will result (which depend on whether the efficiencies will be passed on to consumers).

## *3.2 Comments on the Authority's list of examples of potential vertical integration benefits*

**Risk management**

38. The first potential benefit listed by the Authority is risk management through an internal hedge, limiting the retail business' exposure to spot price risk, and providing more certain downstream demand for the generation business.

39. As noted above, what is relevant to the Authority's decision on the appropriate regulatory remedies is not whether the vertical integration provides private benefits. The risk management example appears to be a strategic competitive benefit to the vertically integrated firm rather than an efficiency, to the detriment of competition and consumer outcomes.

40. The Authority notes that one element of the risk management benefit is that "Gentailers can limit their exposure to spot price risk by maintaining an approximate balance between their

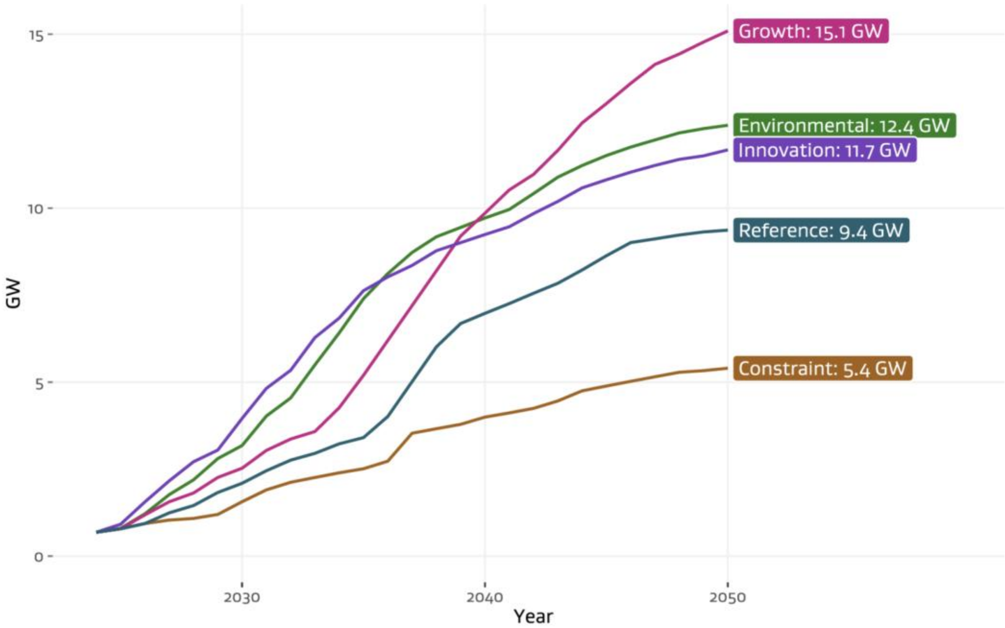
[10] Options Paper, para 1.3.

own generation output and the total electricity demand of their retail customers (internal hedge)."[11] This would seem to imply that vertical integration limits gentailers' incentives to invest in further generation, which would be harmful to NZ's prospects of achieving the generation needed to accommodate the growth in electricity demand that will come from decarbonisation, and that vertical integration would not support vibrant retail competition if the gentailer has the incentive to only build sufficient generation to support the electricity demand of its retail arm.

**Generation financing costs**

41. The second potential benefit listed is reduced financing costs of generation, on the basis that the risk profile of a gentailer can support lower cost access to finance than may be achievable by an independent generator. It is not clear to us that this potential benefit is valid where there is strong demand for new generation, which is the current situation and is likely to be the case for the foreseeable future, as modelled, for example by MBIE in its July 2024 Electricity Demand and Generation Scenarios (EDGS) – see Figure 8 below. In the presence of sustained demand for new generation build, the risk management benefit of having certain downstream demand for the generation business would seem to be severely diminished as compared with what it may have been in the past.

***Figure 8: New Generation Build Required as estimated by MBIE***




Source: MBIE (July 2024) Electricity Demand and Generation Scenarios: Results summary, Figure 23.

[11] Options Paper, para 3.17(a)

### Transaction costs

42. Vertical integration could avoid transactions costs associated with explicit contracts for hedges, depending on what measures regulation imposes on the vertically integrated firms. There is then a question of how significant these transaction cost savings are. Structural separation examples, including the recent Nova announcement as well as telecommunication sector examples suggest that these are not prohibitive.

43. The avoided transactions costs must be set against the additional costs of regulation and Commerce Act compliance needed to ensure non-discrimination in a vertically integrated context. The relevant costs include those that are incurred by vertically integrated gentailers and by regulators, as well as costs incurred by companies seeking access. As we discuss below in section 4, the costs of regulatory compliance that are incurred by vertically integrated firms are one reason given by telecommunications companies for taking the step to structurally separate.

### Coordination of investment

44. It is not clear to us how coordination between investment at different levels of the supply chain is relevant in the context of assessing vertical integration between electricity generation and retail.

### Economies of scope

45. Retailing and generation require quite distinct skills – one involves infrastructure build and asset management and the other focuses on retail function such as sales and marketing, customer acquisition, and billing and customer relationship management. The overlap in skills would seem to lie in wholesale trading capability. Aside from wholesale energy knowledge and trading would be economies of scope associated with corporate overheads. As for transaction costs, this is a question of how large these cost savings are and whether they are passed on to consumers.

### Double-marginalisation

46. Elimination of double-marginalisation (EDM) is listed by the Authority as another potential benefit of vertical integration. However, to draw this conclusion first requires assessment of whether the assumptions behind EDM hold. EDM is based on an assumption of a monopoly (and monopoly pricing) for each of the upstream and downstream products with fixed proportions between wholesale and retail,[12] which does not fit the scenario of the gentailers. While EDM has in the past been taken into account in merger analysis, in more recent years the limitations of the model on which EDM is based have been recognised.

### Financial robustness

47. The impact of vertical separation vs integration will vary according to the specific situation of the firm. We note that while the Authority has suggested that vertical integration may improve financial robustness, financial sustainability has been used in practice as a reason why a number of firms have chosen to pursue separation (see the discussion below in section 4). Reasons for this include: access to capital through sale of one part of the business, the ability to improve strategic and management focus on what are two very different types of

[12] See, for example, the discussion in: John Kwoka and Margaret Slade (2020), "Second Thoughts on Double Marginalization" *Antitrust* Vol. 34 No.2 Spring 2020.

businesses (infrastructure vs retailing activities such as marketing), and cheaper access to capital. As McKinsey & Co describes in an article that identifies the separation vs integration trade-offs for vertically integrated telecommunication companies and their investors:

> *By operating independently, financing options for the NetCo improve considerably. Since it primarily invests in infrastructure, the NetCo can attract long-term investors who are interested in buying into a physical asset. Similarly, the ServCo's investment profile is better suited to investors who are looking for higher risk-adjusted returns. As a result, the multiples for the two entities recalibrate in a way that increases their combined valuation.*[13]

48. The telecommunications situation discussed by McKinsey & Co seems directly analogous to gentailers. While some investors (for example, superannuation funds) are looking for long-term physical assets that have a low-return and low-risk profile, other types of investors are looking for higher-risk investments such as retailing.

**Other factors**

49. Other factors relevant to assessing the trade-offs between vertical integration and separation including separation costs and the impact of intrusive regulatory measures on investment incentives.

50. Costs of the implementation of structural separation, including business disruption, can be significant, however separation of electricity generation from retailing would likely be substantially simpler and lower cost than it has been for telecommunications where separation has been successfully implemented. In particular, unlike separation of telecommunications network companies into upstream and downstream companies, there are no shared physical assets that need to be separated, or product ordering systems that need to be duplicated in the separation of electricity retailing from generation. The key synergies between electricity retailing and generation relate to risk management.

51. With regard to the effect on investment incentives of intrusive regulatory measures such as forced separation, in some circumstances this could have a chilling effect on investment. However, equally, if market power and discriminatory practices over access are not adequately addressed then investment can also be held back. In the case at hand, very large investments are required to deliver the capacity needed to address the expected growth in demand. By levelling the playing field for retailers, structural separation of gentailers would likely support investment in generation by independent generators.

# 4 Experience from separation measures in other jurisdictions and sectors

52. As noted above, the decision on whether structural separation is justified is circumstance-specific. However, the idea of separation is not new – it has been contemplated and implemented all over the world, in some cases by government or regulatory mandate and in other cases voluntarily based on commercial reasons.

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[13] McKinsey & Co (22 January, 2020), "Can telcos create more value by breaking up?" https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/can-telcos-create-more-value-by-breaking-up

53. The Authority details numerous case studies in Appendix D2 of the Options Paper, which includes the functional and structural separation of Telecom NZ, the separation of ECNZ and a number of regulatory measures including virtual separation of electricity generation in other jurisdictions. We note that the example of Telecom NZ is one where structural separation led to the two separated firms having a significantly larger combined market capitalisation than the previous integrated firm had.

54. Other relevant examples of structural separation and relevant asset sales include:

    a. Telecom Italia (TIM): In 2024, after many years of contemplating structural separation Telecom Italia sold its fixed telecommunications "NetCo" and established a master services agreement to cover the relationship between TIM and NetCo. The sale enabled TIM to cut debt and achieve a financially sustainable situation.[14]

    b. Telstra: Operational separation was implemented to address concerns that Telstra was providing priority to downstream units. These concerns were analogous to those contemplated by the Authority. In the case of Telstra, these included, for example, complaints about space allocations in exchanges/street cabinets, as well as margin squeezes on broadband prices. A detailed operational separation was put in place, including equivalence of inputs requirements and an imputation testing regime. The operational separation regime was later superseded by the decision that the government-owned company NBNCo would build a high-speed broadband network and would be a wholesale-only supplier of broadband services.

    c. The sale of mobile towers by numerous international telecommunications companies, including in NZ and Australia. For example, 2degrees sold its mobile tower assets to Connexa,[15] Spark sold its towers to CDPQ[16], Vodafone NZ (now One) sold its mobile towers to a group of investors[17] and Telstra sold a 49% share in its mobile towers business (InfraCo Towers) to a consortium of superannuation funds.[18]

    d. The recent announcement by Nova to separate its retail business from its generation.[19]

55. Can separation case studies provide useful insights across sectors? A cost–benefit assessment of separation vs regulation is likely to be heavily influenced by the specific features of the both the country and the sector under analysis. Another word of caution is that the regulatory objectives of separation vary across sectors.

[14] Fierce Network (2 August 2024), "Telecom Italia shifts to new era after NetCo sale" https://www.fierce-network.com/modernization/telecom-italia-looks-future-after-netco-sale
[15] Australia New Zealand Infrastructure Pipeline (December 2022), "2Degrees Mobile Tower Assets Sale" https://infrastructurepipeline.org/project/2degrees-mobile-tower-assets-sale#:~:text=2degrees%20Mobile%20has%20entered%20into,mobile%20towers%20across%20the%20country.
[16] Business Desk Markets (28 Feb 2025), "Spark completes $311m sale of mobile towers to CDPQ" https://businessdesk.co.nz/article/markets/spark-completes-311m-sale-of-mobile-towers-to-cdpq#:~:text=Spark%20has%20completed%20the%20sale,Canada's%20Ontario%20Teachers'%20Pension%20Plan.
[17] RNZ (18 July 2022), Vodafone agrees to $1.7b sales of mobile phone towers" https://www.rnz.co.nz/news/business/471133/vodafone-agrees-to-1-point-7b-sale-of-mobile-phone-towers
[18] Telstra (01 September 2021), "Telstra finalises $2.8 billion InfraCo Towers sale"https://www.telstra.com.au/aboutus/media/media-releases/telstra-finalises-infraco-towers-sale
[19] Newsroom (11 April 2025), "Nova Energy chief quits as firm splits generation and retail arms" https://newsroom.co.nz/2025/04/11/nova-energy-chief-quits-as-firm-splits-generation-and-retail-arms/

56. Of note is that differences in the nature of value chains should be recognised when drawing implications from other sectors. For example, electricity and water are far more 'homogeneous' products than telecommunications, and the effect on the industry of continuous technological change is less problematic in these sectors. Telecommunications separation also required separation of physical assets, adding further substantial cost.

57. While the specific features of both the country and the sector under analysis will mean that evidence from other jurisdictions on structural separation will not be fully transferable from one sector to another, a number of transferrable learnings can be identified.

58. Firstly, a lesson from the telecommunications sector is that at the time structural separation was being considered the benefits of separation relative to the size of the efficiencies of vertical integration were understated by many observers and by the vertically integrated firms themselves. A cautious approach was taken to separation benefits that could not be concretely quantified. Over time, there has been a shift from a pure focus on productive efficiencies to dynamic efficiencies and flow-on economic benefits of increased competition, as the latter have become more apparent. This shift in thinking can be observed, for example, in the various OECD papers on structural separation that have been published over time.[20] (In a 2024 report "Revamping competition in New Zealand", the OECD suggested that if the voluntary code of conduct did not sufficiently address competition concerns then this might call for vertical separation of electricity generators and retailers.[21]) In the context of electricity, there are new technologies to be harnessed on the demand-side, which are potentially highly relevant to the dynamic efficiencies that arise from stronger retail competition.

59. Numerous other studies were published which leaned towards the view that telecommunications companies would not be better off with structural separation, citing transactions costs, incentives to invest and other efficiencies. In reality, structural separation in the telecommunications sector, in combination with economic and behavioural regulation, has been very successful, both for the economy and for the separated firms. As mentioned above, Chorus and Spark were valued more separated than they were as an integrated firm.

60. Secondly, structural separation that was either regulator-mandated (BT) or encouraged/incentivised by government (Telecom NZ), appears to have paved the way for voluntary separation, such as the structural separation of Telecom Italia mentioned above as well as the separation of other telcos in the EU, including in Denmark and the Czech republic.[22]

61. Thirdly, experience from the initial operational separation of Telecom in New Zealand is that it became apparent quite quickly in the process that some of the compliance monitoring measures were not effective. This experience suggests to us that rather than starting at lower end with softer regulatory interventions and then moving to more intrusive remedies (as the Authority proposes), we should learn from other experience and implement more effective regulatory measures from the outset.

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[20] For example, the 3 November 2003 OECD Digital Economy Paper on "The Benefits and Costs of Structural Separation of the Local Loop", as compared with a 2016 report which reviewed established examples of structural separation in electricity, natural gas, rail and telecommunications, and identified more than seven other sectors for which structural separation could be relevant. See OECD (2016), Structural separation in regulated industries Report on implementing the OECD Recommendation.

[21] Dennery, C. (2024), "Revamping competition in New Zealand", OECD Economics Department Working Papers, No. 1817, OECD Publishing, Paris, p23. https://doi.org/10.1787/8bbbad04-en

[22] McKinsey & Co (2020),

# 5 Practical implementation of regulatory remedies

62. While the Principles/Rules in the Options Paper are necessarily set out at a high level at this stage of the process to give an indication of the form that non-discrimination principles could take, we discuss the proposed remedies in the context of some broad practical criteria.

## *5.1 The Authority's proposal – Option 2*

63. The Authority has identified a set of four options ranging from accounting separation with enhanced Internal Transfer Pricing (ITP) through to corporate separation with arms' length rules. From these options it has proposed to adopt Option 2 which imposes a prohibition on discrimination and a possible prohibition on cross-subsidisation.

64. Within Option 2, the Authority proposes a 3-step process of escalating interventions for implementing of non-discrimination. Step 1 would add principles-based non-discrimination requirements to the already-introduced voluntary standardised super-peak hedge contract. Step 2 would involve the regulation of the standardised super-peak contract as well as detailed non-discrimination requirements, and Step 3 would require that all Gentailer-supplied hedge contracts must be traded through a regulated market on equal terms for all buyers.

## *5.2 How do regulatory rules need to look to be effective*

65. A starting point is to consider the characteristics are good regulation. We identify the following questions to help test the proposals identified by the Authority:

    a. Does the intervention adequately address the specific market power issues (price squeezes and access to hedge contracts)?

    b. Does the option include incentives for the Gentailer to provide equal access? What are the consequences of non-compliance?

    c. Will the Authority be able to monitor/observe market behaviour in near real-time and thus detect and respond to non-compliance?

    d. Does the option allow the independent retailers to monitor and respond to discrimination in real-time or will they still be reliant on Gentailer contract offers (do they have any power in the process)?

## *5.3 Option 2 evaluation – how well will this deal with the issues at hand*

66. The problem for the Authority is that the Gentailers have advantages that the regulatory option needs to overcome (transparency of information and level of control). The success of Option 2 relies on the Authority regulating transparency of the Gentailers' compliance with the non-discrimination undertakings. This will be neither simple nor easy and involves difficult trade-offs, as well as significant data collection and monitoring resources by the Authority.

67. An Option 2 type of behavioural approach has several drawbacks. Firstly, it does not eliminate the incentive and opportunity to continue to engage in anti-competitive behaviour. Behavioural rules can try to limit the opportunity, but most rules can be subject to evasion. Secondly, it can be difficult for the Authority (and the downstream entity) to identify if a rule has been violated. Thirdly, behavioural rules can require long-term monitoring of compliance,

which can be a difficult and costly process, involving significant data collection and monitoring resources.

68. The draft non-discrimination principles (Rules) set out in Appendix B of the Authority's Options Paper attempt to address these more obvious drawbacks of Option 2. The Rules are written using the word 'must', compelling the Gentailer to follow them. While this appears to be a good start, it is then up to the Gentailer to voluntarily reveal any rule-breaking behaviour and report to their board and to the Authority.

69. The difficulty with this approach is that these rules may not address the market power that the Authority has identified. In addition, it is unclear how the director certification of the Gentailer's compliance with the Rules will work without some sort of assurance regime and in the absence of any obvious penalties for non-compliance or making a mis-leading declaration. While we appreciate that the Authority may not yet have examined what penalties and consequences would result from non-compliance, these consequences/penalties are a crucial component of the regulatory intervention and need to be clear to give strong incentives to comply.

70. The ability to monitor is crucial and difficult. A problem with monitoring is not seeing issues until it is too late. As discussed above, experience from the telecommunications sector is that some measures are not effective and so rather than starting at lower end and moving up, it is important to learn from other experience and implement more effective measures from the outset.

### *5.4 Imputation tests or replicability tests are the regulatory standard for addressing non-discrimination*

71. Regulators who are concerned about discriminatory practices by firms with market power and margin squeezes typically apply either imputation tests or replicability tests. These tests have the effect of prohibiting cross-subsidies, while also assisting in both assessing whether the principle of non-discrimination in pricing is being adhered to and helping to avoid a substantial lessening of competition.

72. As part of the pricing equivalence framework that Telstra was subject to under operational separation requirements, Telstra was required to prepare imputation tests where revenue was compared with the sum of retailing costs and wholesale charges. The Telstra example provides a useful case study of how imputation tests have been used to assess whether non-discrimination has been adhered to and the assurance process for assessing compliance.

73. Under the operational separation requirements, Telstra was required to publish a Pricing Equivalence Framework (PEF) to describe how pricing equivalence would apply.[23] The PEF had the aim of providing public assurance that Telstra was acting legitimately in the pricing of eligible services supplied to customers of a retail business unit, when compared with the prices at which Telstra provided to wholesale customers. It also provided increased certainty to Telstra that it was not breaching the telco-specific conduct regime that applied under Part XIB of the Trade Practices Act (now the Competition and Consumer Act).

[23] For information on the Pricing Equivalence Framework, see https://www.accc.gov.au/system/files/Price%20Equivalence%20Framework.pdf

74. Under the PEF, Telstra was required to provide to the ACCC the PEF Imputation Test results for each material price change proposal no later than four business days after customers were advised of the price change. Telstra was also required to provide to the Minister and ACCC an Annual Compliance Report, which included a summary of: Telstra's performance in meeting all of its obligations under the Operational Separation Plan (OSP), including in relation to the PEF, any areas of non-compliance with the operational separation requirements and action taken to address the noncompliance including in relation to the PEF, and action taken by Telstra to address any systemic problems in relation to its obligations under the operational separation plan.

75. An independent external audit and report was required on the extent to which Telstra complied with the Operational Separation Plan during each financial year, which included compliance with the PEF Strategy. This Audit Report was to be provided to the Minister and the ACCC within 120 days of the end of each financial year. Telstra was also required to produce a quarterly report for public release on its website containing information about each material price change proposal that has been notified to the ACCC.

76. Although the ACCC did not have direct enforcement powers in relation to the OSP and the PEF, it was required to report any breaches of the plan to the Minister. In addition, the ACCC retained the ability to issue Competition Notices under the telco-specific conduct regime that applied under s151 of Part XIB of the Trade Practices Act, now the Competition and Consumer Act. This regime enabled it to quickly respond to instances of anti-competitive conduct in the telecommunications industry. In other words, if the results of the imputation tests provided under the PEF raised concerns, the ACCC had the option to investigate the possibility of a price squeeze and issue a Competition Notice if it had reason to believe that Telstra had engaged in anti-competitive conduct. Failure to cease anti-competitive conduct in response to a Competition Notice could result in substantial fines of up to A$10 million plus A$1 million per day for each day that the contravention continued, stepping up to A$3 million per day if the contravention continued for more than 21 days.[24]

## 5.5 Other options

77. Operational/functional separation where the retail and generation arms trade at arms' length seems an obvious option to contemplate. It is difficult to see how the principles of option 2 can be fully applied without some form of separation. Functional separation provides the operational safeguards to ensure that the principles are being adhered to. Non-discrimination measures have often been implemented as part of operational/functional separation (for example in both the cases of Telecom NZ and Telstra).

## 5.6 Evaluating the options

78. A key consideration is how well each of the options ensure access to essential inputs on terms that do not result in a price squeeze. The only option that will entirely level the playing field between the retail arms of gentailers and independent retailers is structural separation – the

[24] For information about the telco-specific conduct regime and competition notices see ACCC (August 2018), Telecommunications Competition Notice Guidelines, available at: https://www.accc.gov.au/system/files/ACCC%20Telecommunications%20Competition%20Notice%20Guidelines%20-%20August%202018.pdf

other options adjust the tilt of the playing field. However, there is a trade-off between the benefits (including these competition effects) and the costs of structural separation.

79. We have noted that access regulation of a vertically integrated operator does not necessarily remove the ability, much less the incentive, of the vertically integrated incumbent to discriminate. In particular, the latter has proved difficult for regulators to monitor. For example, in the telecoms sector prior to the application of separation measures, margin squeeze cases were common, while potentially even more severe foreclosure occurred as a result of discrimination in non-price terms.

80. The Authority commented in its Options Paper that the ITP/RGM regime was not useful in providing transparency over possible Gentailer price discrimination behaviour.[25] We agree with the Authority on this point and consider it likely that the Option 2 non-discrimination undertakings will suffer the same fate as has ITP/RGM.

81. To attempt to make Option 2 successful some assurance (audit) requirements are needed, rather than non-discrimination principles that rely on voluntary disclosure. Even then it is unclear that this will be sufficient to address the difficulties with Option 2.

82. We note that in considering the costs of the relevant options, it is important to consider the correct counterfactual. The Authority is proposing to address the access issues through regulatory intervention. However, in the event that the outcome does not adequately prevent a substantial lessening of competition by firms with substantial market power, competition law continues to be relevant. In other words, the relevant counterfactual to regulation is the internal compliance regime needed to ensure compliance with the Commerce Act. In practice, this involves vertically integrated firms ensuring they have internal checks to ensure that they are providing access to contracts needed to avoid a substantial lessening of competition, and the use of internal imputation testing compliance processes.

[25] Options Paper, para 3.44

## About the authors

**Emma Ihaia**

Emma Ihaia specialises in competition analysis and regulatory economics, with 25 years of experience in this field. Emma has been retained as an expert in the context of regulatory investigations and consultations, and has prepared competition assessments for merger clearances, authorisations, and market studies.

Non-discrimination and price squeezes in the presence of vertical integration have been a specialty area for Emma. She advised both Telstra and Telecom Italia on methodologies for testing for non-discrimination and assisted them with the associated internal compliance programmes. She also advised Telstra through the process of developing operational separation measures, focussing particularly on the imputation tests that Telstra was required to publish to demonstrate price equivalence between internal and external wholesale pricing.

Emma has previously worked for several international economics consultancies and established Link Economics in 2012. She has also held roles in management and governance at New Zealand electricity distribution networks.

Emma is the deputy chair of the advisory board of the Competition Law and Policy Institute of New Zealand (CLPINZ). She is also a member of the Law and Economics Association of New Zealand (LEANZ), the Association of Competition Economists (ACE) and the Institute of Directors. Emma holds a Master of the Arts (First Class Honours) in Economics from the University of Auckland where her thesis modelled the strategic pricing of monopolistic networks.

**David de Boer**

David has a focus on regulatory economics and the application of regulatory systems in the real world. David has advised on regulatory determinations and on the establishment and periodic review of regulatory regimes. He has also undertaken market reviews, advised on mergers, and has published research on regulation and market performance.

David has a professional career that spans both economic consulting and the management of regulated entities. David has worked on the design and implementation of the regulatory regimes across multiple sectors. He spent several years as a senior consultant at the New Zealand Institute of Economic Research (NZIER). David is experienced in implementing structural market change to improve consumer outcomes – he advised the Commerce Commission on regulatory matters with the separation of Telecom into Chorus and Spark and advised Crown Fibre Holdings (now Crown Infrastructure Partners Limited) on the establishment of the Local Fibre Entities.

David has recently worked with both Wellington Water and DIA on the design and implementation of regulation of the water sector. Prior to that David was the principal advisor on regulation and network economics at Electricity Networks Aotearoa (ENA).

David holds an MCA (Economics) and an MBA (Finance & Strategy) from Victoria University.

## Disclaimer

Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented in this report, Link Economics Ltd accepts no liability for any actions taken based on the report's contents.

# ANNEX D: Matthews Law letter dated 7 August 2024

Matthews Law
COMPETITION · REGULATION · POLICY · STRATEGY

Level 33, Vero Centre
48 Shortland St
Auckland 1010

7 August 2024

Electricity Authority
WELLINGTON
**Attn:** Anna Kominik, Chair and
Sarah Gillies, Chief Executive
**By email only**
**Copies**: NZCC & MBIE

Dear Anna and Sarah

**INDEPENDENT ELECTRICITY RETAILERS – REQUEST FOR URGENT ACTION IN WHOLESALE ELECTRICITY MARKET AND CORPORATE SEPARATION**

1. As you are aware, we are supporting independent electricity retailers (**IERs**), 2degrees, Electric Kiwi, Flick Electric and Octopus Energy, to advocate for action to be taken to address competition issues in the electricity industry.

2. Further to our letter dated 22 July 2024, we remain concerned about the approach taken by the Electricity Authority (**EA**) to the concerns raised by a number of parties and industry participants. The current segmented workstreams of the EA are not an effective way to promote competition in the electricity industry and are not delivering the best outcomes for consumers. The EA's incremental approach and bias towards the status quo risks overlooking changes that are necessary or desirable to ensure that New Zealand consumers have a reliable supply of electricity at the most efficient prices.

3. We set out in this letter why the EA needs to take a long-term view of the industry and urgently implement changes to the Electricity Industry Participation Code (**Code**) to ensure that the settings are correct to ensure that the long term objectives are met and that competition is working effectively for the benefit of consumers in New Zealand.

4. The Electricity Industry Act 2010 (**Act**)[1] states:

   *(1) The main objective of the Authority is to* ***promote competition*** *in, reliable supply by, and the efficient operation of, the electricity industry* ***for the long-term benefit of consumers****.*

5. Without swift action, competition at the retail and wholesale levels in New Zealand's electricity sector is likely to continue to wither due to the unavailability of hedging products capable of supporting successful new entry or expansion of existing competitors. Less than effective competition to deliver new sources of electricity will increase the cost and reduce the prospects of New Zealand achieving net zero by 2050.

6. Neither wholesale or retail electricity markets are functioning in a workably competitive manner, which has been documented in both the EPR[2] and MDAG[3] reports**.** Many of the issues have been caused by the vertical integration of the four gentailers. Evidence of this (as detailed by our clients in their complaints to the Commerce Commission) includes:

[1] s 4 (Purpose) Electricity Industry Act 2010
[2] Electricity Price Review Final Report, p.2.
[3] MDAG Final recommendations Report, p.12 –13.

a. There is not sufficient investment in additional generation expected given anticipated demand[4] and the incumbent gentailers do not have incentives to expand generation to keep pace with demand.

b. There is not sufficient liquidity in the market for risk management tools (both on the ASX and in the OTC market). This has a number of effects, including:

   i. Disincentivising independent generators from building new generation assets or entering the generation market.

   ii. IERs being forced to limit the growth of their customer base, and the market share of the IERs starting to stagnate or decline.

c. Barriers to entry for generation are high.

d. Wholesale prices have increased rapidly and are well above the long run marginal cost of generation.

e. Retail prices are below wholesale prices.

f. The gentailers have reported high or record profitability for their wholesale businesses and losses for their retail businesses.[5]

g. IERs are unable to expand or compete in the way you would expect to see in a workably competitive market.

7. Conversely, the value of IERs has been recognised in both the EPR and MDAG reports and there is no evidence that IERs are not equally efficient.

8. While the EA has undertaken a number of different projects and workstreams (or these are underway) none of these comprehensively consider the systemic issues identified by the Commerce Commission, or the impact on new generation, retail competition or the interests of consumers, and there is no sense of urgency. For example, the wholesale market review did not consider the interplay with the retail market, and a number of the facts and/or assumptions upon which the EA's conclusions are based have not been borne out.

9. The EA has the power to amend the Code where the amendments are "*consistent with the objectives of the [EA] and are* ***necessary or desirable to promote … competition*** *in the electricity industry*", reliable supply to consumers, efficient operation of the electricity industry. [6]

10. In our view, it is both necessary and desirable for the EA to take urgent action to address the underlying issues of vertical integration and market design if the New Zealand electricity industry is to meet expected increased demand, support the transition to decarbonisation,

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[4] Total generation capacity only increased by 0.31% between 2021 and 2022 despite "record electricity generation from both wind and geothermal" and above average hydro inflows due to a wet winter, see p.14 of MBIE Energy in New Zealand 23. energy-in-new-zealand-2023.pdf (mbie.govt.nz) In terms of actual generation in 2022, New Zealand generated 0.77% less electricity than in 2019 (p.15).

[5] See for example, for the 6 months ended 31 December 2023: Meridian Condensed Interim Financial Statements 2024 shows an EBITDAF of $-43mil for retail and $534mil for wholesale respectively; Genesis Interim Report 2024 shows an EBITDAF of $-34.8mil for retail and $245.9mil for wholesale respectively; Mercury Interim Report 2024 shows an EBITDAF of $-20mil for retail and $454mil for wholesale respectively; and Contact 2024 Interim Financial Statements shows an EBITDAF of $-1mil for retail and $383mil for wholesale respectively.

[6] Electricity Industry Act 2010, ss 32 and 38.

encourage retail innovation and ensure long term reliability and affordable electricity for consumers.

11. Different competitive models (e.g. independent retailers and generators) can be expected to lead to increased output (supply of electricity and hedges) (productive competition); enhanced dynamic competition and greater innovation than a counterfactual of four vertically integrated players with similar market designs and incentives (resulting in coordinated effects).

12. The most efficient way to address the issues is to amend the Code to require that:

    a. the generation and retail arms of the four incumbent gentailers (Contact, Genesis, Mercury and Meridian) are operated as separate companies as defined in Part 6A of the Electricity Industry Participation Code 2010 (**Code**)(**Corporate Separation**) (We note that this is a form of operational separation and does not require separate ownership. The ultimate shareholders of each entity do not need to change); and

    b. arms-length and non-discrimination rules apply, so that the gentailers cannot give preference to their retail companies and each company has separate management.

13. Part 6A and Schedule 6A of the Electricity Industry Participation Code 2010 (**Code**) has both corporate separation and arms-length rules that apply to separate distribution businesses from generation and retail businesses and these could easily be amended to apply to separate generation and retail businesses.

14. Requiring corporate separation (where the gentailers must operate their generation and retail businesses as separate companies), together with arms-length and non-discrimination rules, will encourage both investment in new generation by independent generators, and increased competition by IERs and will ensure that there is a liquid hedge market.

15. Our clients are therefore requesting an urgent Code change. It is necessary and desirable in the public interest for the Code amendments to be made urgently, given the significant nature of the issues and the likely long term impact on consumers and the reliable and affordable supply of electricity if no action is taken and competition continues to wither.

16. This letter contains the following appendices, which provide more detail on the arguments supporting the above propositions:

    a. Appendix 1: The policy case for intervention

    b. Appendix 2: Current market design prevents workable and effective competition

    c. Appendix 3: EPR and MDAG conclusions about the state of the market

    d. Appendix 4: EA's power to amend the Code

    e. Appendix 5: Why corporate separation and arm's length rules is the preferred solution.

    f. Appendix 6: Code Amendment Request Form

17. Our clients have engaged HoustonKemp, a respected economics consultancy. We have relied on their opinions and economic analysis in preparing this letter, and in particular in relation to the policy case for intervention set out in Appendix 1.

18. As set out in our letter dated 22 July 2024 (to which we have not had a substantive reply) and in correspondence between Electric Kiwi and the EA, we request an urgent meeting with the full EA board.

19. We cannot stress enough the urgency of the situation. The lack of investment in additional generation assets is becoming increasingly critical and IERs will continue to exit the market. We therefore urge the EA to act as swiftly as possible.

Yours faithfully
**MATTHEWS LAW**

[redacted]

**Andrew Matthews / Alicia Murray**
Partners

[redacted]

# Appendix 1: The policy case for intervention

20. This appendix sets out the policy case for the EA to intervene in the electricity industry to increase the availability of hedging contracts that are capable of mitigating the financial risks associated with variable renewable energy sources.

21. Electricity demand across New Zealand is expected to grow steadily over time, consistent with the transformational electrification of residential, commercial and industrial energy needs that will be required to meet New Zealand's commitment to net zero emissions by 2050.[7]

22. New electricity generation in New Zealand is projected to be delivered predominantly by variable renewable energy sources, ie, wind and solar. The electricity output from these sources is neither predictable nor controllable, so that production cannot readily be targeted towards periods of high prices. By consequence, the output of such forms of generation are of inherently lower value than those forms that are relatively more predictable and controllable.

23. As with all investors, those committing capital to variable renewable energy sources seek to manage the relevant risks so as to improve the certainty of returns, to the extent possible. Renewal energy generation investors may achieve this by entering offtake arrangements with electricity retailers that provide price commitments, such that the retailer takes on some or all the generators' wholesale pricing risk.

24. The nature of the electricity retailing function means that the only retailers that will take on these risks are those who themselves can mitigate or offset them. Such retailers either own, or have access to contracts that are backed by, generation sources that are predictable and controllable, such as thermal generators or hydroelectric facilities. The development of demand side management arrangements and the related capability of consumers to adjust their immediate energy demand is unlikely to be a sufficiently close substitute to obviate the underlying, substantial requirement for risk management backed by predictable and controllable forms of electricity generation. Access to the inherently higher value, risk mitigation properties offered by such dispatchable generation sources is therefore essential for the successful integration of variable renewable generation sources into the electricity system.

25. This presents a challenge for the future development of New Zealand's electricity system because:

    a. dispatchable sources of renewable generation are almost entirely owned by the four incumbent gentailers and there are substantial barriers to the entry of such sources in the future; and

    b. access to contracts that share some of the valuable, risk mitigation properties offered by dispatchable sources of generation are not widely available – the only type of hedging contracts that are widely available in New Zealand are base contracts, which do not encapsulate these risk mitigation properties.

26. It follows from these observations that, without greater access to hedging contracts that share the risk mitigation properties of dispatchable generation, the financeability of new variable

[7] For example, the technical annex to the Climate Change Commission's draft advice on New Zealand's fourth emissions budget (dated April 2024) indicates that annual electricity demand across New Zealand is expected to rise from 39.43 TWh in 2022 to 63.57 TWh in 2050, an increase of 61 per cent. See Climate Change Commission, *'EB4-08-Electricity-market-modelling-datasets-for-draft-EB4-advice.xlsx'*, worksheet 'Demand', cells B10:B38.

renewable energy sources will typically require that they be developed by, or enter into offtake arrangements with, one or more of the four incumbent gentailers.

27. If sustained over time, this situation is likely to result in a withering of competition for the development of new generation capacity to be delivered when needed and at least cost. In particular, the four incumbent gentailers:

    a. do not face strong incentives to undertake or support an expansion of New Zealand's electricity generation capacity because this would be expected to reduce the profitability and so the value of their existing generation plant; and

    b. may be expected to delay or not proceed with generation projects that would otherwise be on New Zealand's least cost development path, thereby resulting in a path of generation development that is more costly and so giving rise to higher wholesale prices than would otherwise be the case.

28. These circumstances will in turn be expected to affect competition in the retail sector, with New Zealand's electricity consumers paying more for electricity than might otherwise be the case, both as a result of a higher cost generation development path – giving rise to higher wholesale costs – and higher wholesale margins (because retail competition will also be compromised).

29. This policy case relies upon a number of propositions, some of which will need to be tested against evidence. However, it is consistent with well-understood economic principles and with recent conditions and activity in the electricity industry, including:

    a. the gentailers obtaining resource consents for renewable generation but not building the renewable generation assets

    b. the high current level of wholesale spot market prices;

    c. the lack of availability of hedge products (both in relation to ASX-traded and OTC products); and

    d. the exit of IERs from the electricity industry.

## Appendix 2: Current market design prevents workable and effective competition

### *Vertical efficiencies should not be presumed*

30. The EA often presumes the efficiencies (benefits) of vertical integration as a starting point without giving proper weight to its potential countervailing inefficiencies (negatives). For example, vertical integration can:

    a. hinder competition in one or all related markets;

    b. thin contracts markets, exposing non-integrated retailers to wholesale price volatility, which in turn deters entry / expansion;

    c. increase risk of foreclosure;

    d. cause the vertically integrated firm to underinvest in the development of infrastructure;

    e. allow the vertically integrated firm to exercise market power by raising prices (eg through withholding capacity);

    f. create information asymmetries which create further barriers to entry and reduces confidence in the market; and

    g. cause a chronic lack of liquidity.

31. The efficiencies that can be derived by the gentailers from vertical integration seem almost entirely financial or risk management based, rather than productive efficiencies, and we urge the EA to properly consider the competitive effects and optimal market design without placing undue weight on unquantified and ill-defined vertical efficiencies.

### *Competition is not working well in the electricity industry*

32. There are a number of interconnected issues that stem from the vertical integration of the incumbent gentailers and the current market design which prevent workable and effective competition as set out below.

33. **Gentailers inherited assets and built matching retail books:** Electricity deregulation led to ECNZ's generation being split. While local lines (**EDB**) businesses were structurally separated, and no longer permitted to retail, the four legacy generation businesses were permitted to enter retailing, and now hold most retail customers formerly held by the EDBs. They account for about 86% of generation and 84% of retail, so are largely hedged.

34. **Inherited (legacy) SMP:** As noted, incumbents' generation is largely "inherited" hydroelectric generation. These four large generators, with significant hydro generation assets, dominate supply. Following comprehensive investigation and analysis, based on quantitative evidence

from Prof Wolak, the Commerce Commission (**NZCC**) found that all four have substantial market power (**SMP**).[8] Subsequent reports reach similar views.[9]

35. **High entry barriers exacerbated by vertical integration:** Generation is characterised by high entry barriers, exacerbated by vertical integration. Incumbents even argue new entrants should vertically integrate when that was not how their businesses evolved. Vertical integration leads to competition concerns where vertically integrated entities have market power at one or more functional levels. Those problems are exacerbated in highly concentrated oligopolistic markets where all the main players are vertically integrated. (Here any efficiencies seem almost entirely risk management, rather than productive, which would not be necessary with liquid markets).

36. **Market liquidity issues:** There is a spot market, but no matching liquidity in risk management tools (hedges). In a workably competitive market, we expect liquidity, for the benefit of both sides of the market. Indeed, that is common overseas.

37. **Disincentives to expand generation**: Incumbents have no incentives to expand output given their internal hedge (balanced supply and demand) and this would reduce returns and expose them to the need to find additional demand. Indeed, they have incentives to "spill" hydro and engage in other profit-maximizing conduct, to the detriment of consumers. Potential new generators face (among other barriers) the considerable obstacle of customers for such large projected supply. Without a liquid [hedge] market this is a considerable risk.

38. **Disincentives to enter / expand in retail:** Equally market design and conduct means that "equally efficient" IERs are unable to compete – it is alleged that even using their own accounting methodologies (and ITP), which is lower than the average wholesale cost available to IERs, the retail businesses of the four gentailers are loss-making. This is reflected in the financial statements of the gentailers which all show negative EBITDAF values for their retail businesses.[10]

39. **EPR recommendations not fully implemented and/or have not delivered, regardless change is needed with the move to electrification:** In 2019 the EPR made several recommendations that sought to address the market structural issues. However, those recommendations have not been fully implemented and/or the anticipated effects have not happened. For example, only base-load hedge products have been listed on the ASX (with limited liquidity and high transaction costs) and there has been limited OTC hedge product availability. More recently MDAG has reinforced the need for proper functioning wholesale [hedge] markets given the anticipated increase in demand (c.50%) and initiatives around supply. Its recommendations recognised the need for shaped peak products.

### *Breaches of the Commerce Act*

40. In addition, it has been accepted or acknowledged (including by the EA) that the four gentailers have market power.[11]

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[8] In its 22 May 2009 Investigation Report the Commerce Commission concluded: *"The Commission's investigation has led the Commission to the view that the four main generators – Contact Energy Limited (Contact), Genesis Power Limited (Genesis), Meridian Energy Limited (Meridian) and Mighty River Power Limited (Mighty River Power) - have a **substantial degree of market power in the wholesale electricity market**."* This was peer-reviewed by Von der Fehr.
[9] Similar views were reached by Oliver Browne, Stephen Poletti & David Young (2012): *Simulating market power in the New Zealand electricity market,* New Zealand Economic Papers, DOI:10.1080/00779954.2011.649566
[10] See above n 5 for each gentailer's financial statements.
[11] See above n 8; and Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system – Decision Paper (May 2023), Executive Summary (p.i).

41. It also appears that the four gentailers have been/are engaging in textbook incumbent conduct found in the NZCC's Misuse of Market Power Guidelines (and similarly in most competition regulators) which undermines the effective operation of the wholesale electricity market:

    a. Actual / constructive refusal to supply (eg shaped hedge products);

    b. Price (margin) squeeze / Predation;

    c. Lack of investment by gentailers in renewable or other generation (see also Policy reasons for intervention); and

    d. Gentailer spilling or restricting peak demand.

42. The IERs have provided detail on these issues to the Commerce Commission in their complaints, which were made in mid-2023.

43. The Commerce Commission has acknowledged that there are issues within the electricity industry that need to be addressed urgently, and it was on this basis that the Commission chose to refer the issues back to the EA, as the specialist industry regulator.

### *Independent electricity retailers unable to expand*

44. The market conditions, including the misuse of market power by the gentailers, have limited the IERs' ability to expand:

    a. Seven new retail brands launched during the past five years and obtained in excess of 100 customers. However only two of these new entrants (Octopus and For Our Good) have managed to grow to some scale with over 1,000 customers, and they remain sub-scale with less than 10,000 customers each as at June 2024.

    b. Over the same five year period, fifteen retail brands with over 100 customers ceased operations or were acquired by a vertically integrated retailer while under financial distress.

45. This is ultimately detrimental for consumers because it results in less innovation (for example the gentailers have been slow to adopt or implement demand response technology), and the independents are not able to grow their customer base and expand the use of this because of the lack of available hedge products.

### *Conclusion*

46. The current market design and the entrenched market power of the gentailers will (and in some cases already is) constraining generation capacity and increasing the price that New Zealand consumer pay for electricity. This will only get worse if we continue with the status quo.

47. Our clients' concerns and the urgency of the situation cannot be understated. The EA's current Risk Management Review will not address the underlying issues. A process commencing over 7 months ago[12], based on earlier NZCC reviews[13] (and with ongoing NZCC support) with a very limited scope, assumptions that assume the problem away, little obvious progress to date and

[12] While the RMR started 7 months ago, these issues have been raised with and identified by the EA for many years (including in a number of other projects) and the NZCC already begun considering these specific issues (including market definition and market power analysis) in the wholesale electricity industry since 2022 (based on OIA request 23.224).
[13] As above n 12, the NZCC began considering these issues since 2022.

no defined timeframes for next steps lacks the urgency, efficiency and expertise expected of an expert industry regulatory body.

# Appendix 3: EPR and MDAG conclusions about the state of the market

48. There have been a number of reports, working groups, EA projects and commentary about the issues in the wholesale and retail electricity markets. For the purpose of this letter, there are two key reports that provide context and support for the IERs' position that urgent structural change is now necessary:

   a. Electricity Price Review (**EPR**) Final Report[14] dated 21 May 2019; and

   b. MDAG: Price discovery in a renewables-based electricity system – Final Recommendations Paper[15] dated 11 December 2023.

## EPR

49. The EPR report made a number of conclusions and recommendations, including in relation to the wholesale market. The recommendations included disclosure obligations on the gentailers regarding their internal transfer prices and gross margins, and mandatory market making obligations.

50. While some of these recommendations have been implemented to various degrees, the implementation of the recommendations has not achieved the desired outcomes (for example, the recommended market making obligations were implemented only in relation to baseload contracts, and not peak and cap products).

51. The EPR report identifies a number of problems in the wholesale market, consistent with the ongoing concerns expressed by the IERs. These problems continue to persist in the market.

52. Regarding separation of generation and retail businesses, the EPR noted:

> *P.41: "We do not favour the option of forcibly separating the generating and retailing activities of vertically integrated businesses. We consider the benefits of vertical integration outweigh the costs, even after the costs of promoting competition in a vertically integrated industry are included…. However, the benefits of allowing vertical integration should be shared more widely – hence our recommendation for mandatory market-making."*

53. However, it is also noted:

> *"If our recommendations do not result in the intended improvements, more far-reaching measures may be needed, such as options we did not favour."*[16]

54. The EPR report was released 5 years ago. Despite the implementation of some of the EPR's recommendations, the lack of competition in the wholesale market has only increased, mandatory market-making provisions have not resulted in any meaningful change, and the benefits of vertical integration have not been shared more widely. It is clear that the intended

[14] Electricity Price Review: Final Report (mbie.govt.nz): See *Section D: Reinforcing wholesale market competition* (pp41-)
[15] Appendix_A2_-_Final_recommendations_report.pdf (ea.govt.nz)
[16] (fn 7 in EPR Report): See our options paper for these options, which included retail price caps, splitting vertically integrated companies and requiring small distributors to amalgamate.

improvements have not resulted and therefore, it is time to revisit the more "far-reaching measures", such as structural separation.

## MDAG

55. In the MDAG report, the group noted that the key pillars of a well functioning wholesale electricity market are:

    a. Accurate pricing;

    b. Tools to manage risk;

    c. Competition; and

    d. Public confidence.

56. It is clear from the report that they do not consider that the electricity markets are currently functioning well, and the transition to renewable sources will only increase the market power of the gentailers and slow our progress towards decarbonisation. Relevant statements include:

    > *6.18 "our system will be more sensitive to the weather…Spot prices will become more volatile… we do need to make sure participants have access to the necessary tools to manage and mitigate increased spot price volatility."*
    >
    > *7.26 "A thinning of competition for flexibility products could tear at the fabric of the broader market. That is because flexibility products provide a critical bridge to integrate intermittent supply into products suitable for retail consumers. Put simply, weaker competition for flexibility products could also undermine competition in the retail and new investment markets."*
    >
    > *7.27 "Our view is that the risk of declining competition for longer-duration flexibility contracts must be proactively managed – rather than adopting a 'wait and see' approach."*

57. The report made a total of 31 recommendations including:

    a. A requirement for hedge market transparency;

    b. Market making obligations for flexibility products;

    c. Development of a competition dashboard.

58. MDAG recognised the need for flexibility (hedge products):[17]

    > *"Flexibility products are becoming increasingly important as the system shifts to renewable generation sources but there is no market-making in this type of contract."*

59. There has not been any urgency in implementing the MDAG recommendations and the risks identified by MDAG are already playing out, including the decline in retail competition and a lack of investment in new generation. Many of the issues identified by MDAG are the same as

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[17] MDAG: Price discovery in a renewables-based electricity system – Final Recommendations Paper dated 11 December 2023, recommendation 24

those identified in the EPR and the EA cannot afford to wait a further 5 years before taking action.

# Appendix 4: EA's power to amend the Code

60. The purpose of the Electricity Industry Act 2010 (**Act**)[18] is to provide *"…a framework for the regulation of the electricity industry"* and the EA has the following objectives:

> *(2) The main objective of the Authority is to **promote competition** in, reliable supply by, and the efficient operation of, the electricity industry **for the long-term benefit of consumers**.*
>
> *(3) The additional objective of the Authority is to protect the interests of domestic consumers and small business consumers in relation to the supply of electricity to those consumers.*
>
> *(4) The additional objective applies only to the Authority's activities in relation to the dealings of industry participants with domestic consumers and small business consumers.*

61. The EA has the power to amend the Code where the amendments are "*consistent with the objectives of the [EA] and are **necessary or desirable to promote … competition** in the electricity industry*", reliable supply to consumers, efficient operation of the electricity industry.

62. The High Court has noted that the EA's powers are broad and should not be interpreted narrowly. The overall goal is the long-term benefit of consumers and the Act provides a framework for the regulation of the "electricity industry" as a whole.[19]

### *Workable and effective competition*

63. We note that the Commerce Act defines competition as "workable or effective competition". The High Court has noted:

> *...workable competition means a market framework in which the presence of other participants (or the existence of potential new entrants) is sufficient to ensure that each participant is constrained to act efficiently and in its planning to take account of those other participants or likely entrants as unknown quantities. **To that end there must be an opportunity for each participant or new entrant to achieve an equal footing with the efficient participants in the market by having equivalent access to the means of entry, sources of supply, outlets for product, information, expertise and finance.** This is not to say that particular instances of the items on that list must be available to all. That would be impossible. For example, a particular customer is not at any one time freely available to all suppliers. Workable competition exists when there is an opportunity for sufficient influences to exist in any market, which must be taken into account by each participant and which constrain its behaviour.*[20]

64. In a market study context, the Commerce Commission has considered "commonly understood indicators of whether competition is working well or not", which include:

    a. Profitability;

    b. Price outcomes (i.e. Prices charged to consumers);

    c. Extent of investment / innovation;

    d. Quality, range, services offered to consumers; and

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[18] s 4 (Purpose) Electricity Industry Act 2010
[19] *Manawa Energy Ltd v Electricity Authority* [2022] NZHC 1444 at [61], [69]
[20] Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd [1987] 2 NZLR 647 (HC) at 671; and Fisher & Paykel Ltd v Commerce Commission [1990] 2 NZLR 731 (HC) at 757-758.
Misuse of Market Power Guidelines at [15].

e. Market features – industry structure and infrastructure, conditions of entry / expansion, behaviour of market participants.

65. Taking into account these factors, neither electricity generation (or wholesale) market or the retail electricity market are functioning in a workably competitive manner:

| | WHOLESALE MARKET | RETAIL MARKET |
|---|---|---|
| **Profitability** | High or record profits in gentailers' wholesale business<br><br>Wholesale prices have increased rapidly and are widely acknowledged to be well above the LRMC of generation | Losses in gentailers retail business<br><br>IERs in financial distress either exiting the market or acquired by gentailers |
| **Price outcomes (i.e. prices charged to consumers)** | Wholesale prices above retail prices | Wholesale prices above retail prices |
| **Extent of investment/innovation** | No significant investment in generation<br><br>No incentives to invest<br><br>No meaningful increase in generation capacity in the last 5 years<br><br>Independent generators disincentivised from entry | Slow uptake by gentailers of demand response technology<br><br>IERs unable to obtain scale, despite innovative offerings |
| **Quality, range, services offered to consumers** | | The lack of available hedge products has lead the IERs to limit the growth of their customer base, and the market share of the independents has stagnated or decreased, reducing customer choice<br><br>Low and declining switching rates |
| **Market features** | High barriers to entry<br><br>No liquid market for risk management tools | High level of market exit and the current trading environment suggests no further new entry/expansion |

### *Wholesale market review*

66. The EA, in its decision paper in May 2023 on the wholesale market review, concluded that:[21]

[21] Electricity Authority, *Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system*, Decision Paper, May 23, p.i.

*structural reform options are currently not justified by the available evidence; these would be costly and may not be efficient, effective, or timely. By increasing uncertainty, they are also likely to stymie much needed investment in generation.*

67. However, there is no discussion in this paper on why structural reform would be costly or inefficient. There are also efficiencies that arising from imposing regulatory measures to try and address the issues, particularly where there are information asymmetries. It can therefore be more efficient to require corporate separation:

    a. The OECD acknowledged that "[f]*or legislators and sector regulators, structural separation offers a more durable resolution in cases of persistent market failure*."[22]

    b. Corporate separation has resulted in "*structurally more competitive markets and stronger competition*" across various jurisdictions and there has not been obvious examples where separation resulted in harm to competition in the market.[23]

    c. The EA's continued efforts to manage the wholesale electricity market through detailed and complex regulation on a project-by-project basis will be expensive, difficult to implement, administratively burdensome and nevertheless, may not be effective.[24]

    d. Economic evidence from the EC supports greater degrees of separation (ie full ownership unbundling) as the "most effective means" to ensure choice for consumers and encourage investment.[25]

68. This review was also limited in scope of the wholesale market, and did not consider the impact on the retail market or on New Zealand consumers.

69. In any event, a number of the facts and/or assumptions upon which the EA's conclusion is based have not been borne out:

    a. The paper notes that average spot prices are trending down and that over time, it is anticipated that investment in new renewable generation will bring prices back down to the cost of new supply.[26] However, average spot prices are in fact trending upwards and have climbed significantly since January 2023, reaching $363.49/MWh in July 2024.[27]

    b. The EA noted that the current conduct-based measures plus entry by new supply would mitigate the exercise of market power.[28] However, there has not been significant entry by new supply[29] and the conduct measures have not had the desired effect. In fact, the

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[22] OECD *Report on Experiences with Structural Separation* (2011) at p.11.

[23] Kwoka and Valletti (2021) "Unscrambling the eggs: breaking up consummated mergers and dominant firms." *Industrial and Corporate Change, 30*(5), 1286-1306 at 4.4 (p.1299).

[24] OECD *Structural separation in regulated industries - Report on implementing the OECD Recommendation* (2016), at p.9; see also European Commission, Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and Electricity sectors (Final Report) COM(2006) 851 (**EC Art 17 Inquiry into European gas and Electricity sectors Final Report**) at 55.

[25] EC Art 17 Inquiry into European gas and Electricity sectors Final Report at 55.

[26] Electricity Authority, *Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system*, Decision Paper, May 23, p.ii.

[27] Demand-weighted average monthly prices, see Electricity Authority - EMI (market statistics and tools) (ea.govt.nz).

[28] Electricity Authority, *Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system*, Decision Paper, May 23,p.iii.

[29] Total generation capacity has only increased by 0.31% between 2021 and 2022, despite "record electricity generation from both wind and geothermal" and above average hydro inflows due to a wet winter , see p.14 of MBIE Energy in New Zealand 23. In terms of actual generation in 2022, New Zealand generated 0.77% less electricity than in 2019 (p.15).

exercise of market power issues has continued to worsen, as demonstrated by the IERs' complaints to the Commerce Commission.

c. Enabling more responsive demand was another measure thought to constrain the exercise of market power.[30] However, gentailers have been slow to adopt demand response technology, and independent retailers have been unable to grow their customer base and offer innovative demand response products because of the lack of available hedge products.

d. The EA asserted that it had "heard and acted on stakeholder concerns about internal transfer pricing".[31] However, it is clear that the ITP disclosure requirements are meaningless, with the gentailers stating that the ITP is not used to set their retail pricing and is an artificial construct. Until there is corporate separation of the retail and generation businesses, there will not be proper transparency.

### *Other EA workstreams*

70. While the EA has undertaken a number of different projects and workstreams (or these are underway) none of these comprehensively consider the systemic issues identified by the Commerce Commission, or the impact on new generation, retail competition or the interests of consumers, and there is no sense of urgency.

71. The segmented approach by the EA risks overlooking gaps in the analysis, and creates a bias towards the status quo. The EA appears to be favouring sunk costs in inherited investments over the innovation and efficiencies that are created by independent parties. There has been no evidence or analysis of the vertical efficiencies or why the status quo should be preferred.

72. Recent work streams have been limited in scope and made assumptions that are questionable. For example:

a. **MDAG Price discovery in a highly renewable system** work did not consider the interplay of the wholesale market with retail competition.

b. **Risk Management Review:** The Project Initiation Document (PID) narrowly defines the scope and contains key assumptions that are incorrect (which assume away the issues). The IERs have also been told that after 6 months the EA is still working on market definition, it will take almost a year for a report to be issued, which will "define the problem" for consultation but will not include any proposed solutions.

c. **ITP and retail margin disclosure:** There have been significant delays by the EA in making the ITP and retail margin disclosure available (the FY22/23 data was only published by the EA in June 2024 and there is no indication as to when the FY 23/24 data will be published). The ITPs are clearly stated by the gentailers to be accounting/disclosure tools only and not used to set their retail prices e.g. Meridian states "*Meridian views its ITP as an accounting mechanism primarily used in external report to provide a guide on the relative performance of the wholesale and retail segments of the business… Meridian's ITP is not used to price mass marked retail customers*".[32]

[30] Electricity Authority, *Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system*, Decision Paper, May 23, p.iv.
[31] Electricity Authority, *Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system*, Decision Paper, May 23, p.iv.
[32] ITP benchmarks | Tableau Public.

d. **Internal transfer price post implementation review** These are disclosure rules only, the EA implemented them poorly and is now finally conducting a post implementation review. When they were recommended they were intended to provide more transparency so that regulatory action could be taken if excessive profits or a margin squeeze eventuated, there has been no mention of either of these as part of the review.

e. **Trading Conduct Monitoring:** The EA's monitoring of trading conduct only relates to trading conduct in the spot market and does not mention recent moves in the futures market.

### *Code Change is necessary or desirable*

73. In our view (for the reasons set out above), it is both necessary and desirable for the EA to take urgent action to address the underlying issues of vertical integration and market design to ensure New Zealand's electricity industry is able to meet the expected increased demand, support the transition to decarbonisation, encourage retail innovation and ensure long term reliability and affordable prices for consumers.

74. The EA's powers are broader than those of the Commerce Commission, and they are not constrained by market definition. In order to make changes to the Code, the EA only needs to be satisfied that the changes are necessary or desirable to promote the aims in s 15 of the Act.

75. To meet this test, you only need to be satisfied that the changes will improve the level of competition in a market and the outcomes for consumers.

76. Corporate separation and arms'-length rules would promote competition in the electricity industry for the long-term benefit of consumers by:

a. Creating incentives for generation business to expand capacity.

b. Creating a liquid market for hedge products (particularly OITC products).

c. Ensuring all electricity retailers can compete on a level playing field.

d. Removing information asymmetries.

77. There is already a framework which the EA could adopt, which contains the necessary corporate separation provisions and arms-length rules in Part 6A and Schedule 6A.1 of the Code. With relatively simple amendments to Part 6A of the Code the EA the EA could require corporate separation of the generation and retail businesses of the gentailers.

78. The relevant provisions include:

***Clause 6A.3 Corporate separation and arm's-length rules applying to distributors and connected generators and connected retailers.***

*(1) Every participant and specified person who carries on the business of distribution must carry on that business in a different company from the company that carries on the business of a connected generator or a connected retailer.*

(2) *The following persons must comply, and ensure that the person's businesses comply, with the arm's-length rules:*

a. *every distributor in respect of which there is a connected generator or a connected retailer, and any other participant involved in that distributor:*

b. *a connected generator in respect of the distributor, and any other participant involved in the connected generator:*

c. *a connected retailer in respect of the distributor, and any other participant involved in the connected retailer:*

d. *a specified person who is involved in the distributor, and either a connected generator or a connected retailer in respect of the distributor.*

79. A similar section could be added to apply to generators and retailers, for example

***New Clause: Corporate separation and arm's-length rules applying to generators and connected retailers.***

*(3) Every participant and specified person who carries on the business of generation must carry on that business in a different company from the company that carries on the business of a connected retailer.*

(4) *The following persons must comply, and ensure that the person's businesses comply, with the arm's-length rules:*

a. *every generator in respect of which there is a connected retailer, and any other participant involved in that distributor:*

*b. a connected retailer in respect of the generator, and any other participant involved in the connected retailer:*

*c. a specified person who is involved in the generator, and a connected retailer.*

80. Amendments would also be required to clause 1 of Schedule 6A (which talks about the objectives of the arms-length rules).

81. The arm's-length rules in clause 3 of Schedule 6A would not need any amendments and contain broad rules about not preferring the interests of the separate business and not discriminating in favour of the separate business.

82. Attached at Appendix 6 is a Code Change Amendment Form setting out our client's request for these Code amendments.

### *Urgency*

83. It is necessary and desirable in the public interest for the proposed Code amendments to be made urgently, given the significant nature of the issues and the likely long term impact on consumers and the reliable and affordable supply of electricity if no action is taken and competition continues to wither.

# Appendix 5: Why corporate separation and arm's length rules is the preferred solution

### *Electricity Price Review recommendations*

84. In 2019, the EPR noted:

> *If our recommendations do not result in the intended improvements, more far-reaching measures may be needed, such as options we did not favour.[33]"*

85. The EPR report was released 5 years ago. Despite the implementation of some of the EPR's recommendations, the lack of competition in the wholesale market has only increased. It is clear that the intended improvements have not resulted and therefore, it is time to revisit the more "far-reaching measures", such as corporate separation.

### *Separation options*

86. Economic literature talks about different levels of separation as set out by Cave:[34]

    a. Ownership separation (in whole or part)

    b. Legal separation (separate legal entities under the same ownership)

    c. Business separation with separate governance arrangements

    d. Business separation with localised incentives

    e. Business separation

    f. Virtual separation

    g. Creation of a wholesale division

    h. Accounting separation.

87. Corporate separation, as defined in Part 6A of the Code, is the same as option (b) above.

88. Corporate separation and arms'-length rules would promote of improve competition in the electricity industry for the long-term benefit of consumers by:

    a. Creating incentives for generation business to expand capacity.

    b. Creating a liquid market for hedge products (particularly OTC products).

    c. Ensuring all electricity retailers can compete on a level playing field.

    d. Removing information asymmetries.

[33] (fn 7 in EPR Report): See our options paper for these options, which included retail price caps, splitting vertically integrated companies and requiring small distributors to amalgamate.
[34] Martin Cave, *Six Degrees of Separation: Operational Separation as a Remedy in European Telecommunication Regulation*, Communications & Strategies, no 64, 4th quarter 2006, p.89.

89. We have considered whether some lesser form of separation would achieve the desired objectives, but we do not believe that anything less than corporate separation would resolve the current significant challenges in electricity markets because:

a. The gentailers will continue to have incentives to limit additional generation capacity to match their retail books.

b. With anything less than corporate separation, there remains a lack of transparency and information asymmetries which will require regulation to resolve.

c. Disclosure obligations imposed by the EA, for example in relation to ITP and retail gross margin have not achieved the stated purpose. This is for a number of reasons including the refusal by the gentailers to engage constructively (e.g. the fact that the ITP is prepared only for disclosure purposes and not used by the gentailers to set their retail prices, the fact that the retail gross margin data disclosed does not relate to or match up with reported profits in the gentailers' annual reports, the delays by the EA in publishing the information).

d. Other forms of regulatory oversight impose significant cost and inefficiencies and are less effective.

# Appendix 6: Code Amendment Request Form

## Request to amend the Electricity Industry Participation Code 2010

This form is to request:

☒ an amendment to an existing clause or clauses in the Electricity Industry Participation Code 2010 (Code)

☐ the removal of an existing clause or clauses in the Code

☒ a new clause or clauses in the Code

Please refer to the Code amendment request guidelines [insert link] when completing this form. The Guidelines contain more information about requesting a Code amendment and the Authority's process when it receives a request.

Please complete all relevant sections of this form, with as much information as you can. The more information you include in your request, the better we will understand and be able to assess your request. If there is not enough room in this form, you can attach more pages.

Email completed forms to info@ea.govt.nz.

### Proposer

| | |
|---|---|
| Name: | Electric Kiwi, Flick Electric, Octopus Energy and 2degrees<br>Please contact Andy Matthews or Alicia Murray of Matthews Law with any questions. |
| Date: | 6 August 2024 |
| Organisation: | Electric Kiwi, Flick Electric, Octopus Energy and 2degrees |
| Position in organisation: | Please contact Andy Matthews or Alicia Murray (Partners) of Matthews Law with any questions. |
| Telephone: | [redacted] |
| Email address: | [redacted] |

## Section 1: Information to include for all requests

Complete this section for all Code amendment requests.

### The proposal

| | |
|---|---|
| **1. Objective of the proposal**<br>What do you want the proposal to achieve?<br>Provide supporting information on the problem or issue the proposal seeks to resolve | Without swift action, competition at the retail and wholesale levels in New Zealand's electricity sector is likely to continue to wither due to the unavailability of hedging products capable of supporting successful new entry or expansion of existing competitors. Less than effective competition to deliver new sources of electricity will increase the cost and reduce the prospects of New Zealand achieving net zero by 2050.<br><br>Neither wholesale nor retail electricity markets are functioning in a workably competitive manner. Many of the issues have been caused by the vertical integration of the four gentailers.<br><br>It is both necessary and desirable for the EA to take urgent action to address the underlying issues of vertical integration and market design if the New Zealand electricity industry is to meet expected increased demand, support the transition to decarbonisation, encourage retail innovation and ensure long term reliability and affordable electricity for consumers.<br><br>For more detail, please see our letter to the Electricity Authority dated 6 August 2024 (**Letter**).<br><br>The most efficient way to address the underlying issues is to amend the Code to require:<br>1) the generation and retail arms of the 4 incumbent gentailers (Contact, Genesis, Mercury and Meridian) are operated as separate companies (**Corporate Separation**); and<br>2) arms-length and non-discrimination rules apply, so that the gentailers cannot give preference to their retail companies and each company has separate management. |

| | |
|---|---|
| **2. Category of request**<br>State whether you think the request is minor, medium or complex, and why (applying the criteria in the Guidelines [insert link]).<br>For minor requests, specify whether you think the nature of the amendment is technical and non-controversial. | The request is **complex** as the proposal requires Corporate Separation and arms-length and non-discrimination rules/obligations being imposed on the 4 incumbent gentailers – which may involve changes to the market and participants' systems.<br><br>We believe this is a necessary policy change by the EA due to:<br>• Increasing electricity demand / electrification;<br>• New Zealand's commitment to net zero emissions by 2050;<br>• Investors requiring firming of the risk presented by new renewable generation (non-dispatchable) through dispatchable generation (which is almost entirely owned by the gentailers);<br>• the situation likely resulting in withering of competition for the development of new generation capacity as needed and for least cost; and<br>• these circumstances will in turn affect competition in retail electricity markets – consumers (both present and future) will pay more for electricity than what could be possible. |
| **3. Clause(s) to which the proposal relates**<br>If the proposal relates to existing Code clause(s), state the full clause reference/s here.<br>If the proposal relates to a new clause, state where you think this would best fit in the Code. | The current Part 6A and Schedule 6A of Code has both corporate separation and arms-length rules that apply to separate distribution business from generation and retail businesses, which could easily be amended to apply to the separation of the 4 incumbent gentailers' generation and retail businesses.<br><br>See also [77]–[80] of the Letter for further details. |

<table>
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**4. Description of the proposed amendment**

Describe the Code amendments you are proposing (or attach a draft of the proposed Code amendment when submitting this form).

Note: if you are providing draft wording of the proposed Code amendment, see the Code drafting manual for guidance.

</td>
<td>

Simple amendments to Part 6A and Schedule 6A of Code would be necessary to repurpose the provision to apply to the separation of generation and retail businesses.

A similar section to clause 6A.3 could be added to apply to generators and retailers, for example:

***New Clause: Corporate separation and arm's-length rules applying to generators and connected retailers.***

(5) *Every participant and specified person who carries on the business of generation must carry on that business in a different company from the company that carries on the business of a connected retailer.*

(6) *The following persons must comply, and ensure that the person's businesses comply, with the arm's-length rules:*

a. *every generator in respect of which there is a connected retailer, and any other participant involved in that distributor:*

b. *a connected retailer in respect of the generator, and any other participant involved in the connected retailer:*

c. *a specified person who is involved in the generator, and a connected retailer.*

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**5. How the proposal supports the Authority's main objective**

Identify how your proposal would support the Authority's main objective of promoting competition in, reliable supply by, and/or efficient operation of the electricity industry for the long-term benefit of consumers.

If the proposal is not expected to impact a limb of the main objective, use "No impact on this limb"

See section 15(1) of the Act

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**Competition:**

This proposal promotes competition by:

- incentivising the entry or expansion of independent generators
- ensuring all electricity retailers can compete on a level playing field thus promoting entry/expansion (noting the current market conditions causing exit / acquisitions of independent retailers by gentailers);
- removing information asymmetries that hide the exercise of market power and/or discrimination by the gentailers.

**Reliability:**

This proposal promotes reliable supply by:

- creating incentives for generation business to expand capacity; and
- creating a liquid market for hedge products (particularly OTC products).

**Efficiency:**

This proposal promotes efficient operation by:

- reducing the EA's administration and compliance costs of regulation.

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| | |
|---|---|
| | See Appendix 1 of the Letter which outlines the policy case for the proposal.<br>See also Appendix 2 of the Letter which expands on the current state of competition as well as breaches of the Commerce Act by the gentailers which the proposal seeks to address. |
| **6. Application of the Authority's additional objective**<br>Identify whether your proposal relates to the dealings of industry participants with domestic consumers and small business consumers.<br>If it does, identify how your proposal will protect the interests of domestic and small business consumers in relation to the supply of electricity to those consumers.<br>See sections 15(2)-(3) of the Act | The proposal does not specifically relate to the dealings of industry participants with domestic or small business consumers. However, we consider that this amendment would positively impact domestic or small business consumers more generally. |
| **7. How the proposal complies with section 32 of the Act**<br>The Code may only contain provisions which are necessary or desirable to promote specific matters listed in section 32(1) of the Act which are:<br>a) competition in the electricity industry<br>b) the reliable supply of electricity to consumers<br>c) the efficient operation of the electricity industry<br>d) the protection of the interests of domestic consumers and small business consumers in relation to the supply of electricity to those consumers<br>e) the performance by the Authority of its functions<br>f) any other matter specifically referred to in the Act as a matter for inclusion in the Code.<br>Identify which of the section 32(1) matters listed in the adjacent column your proposal relates to. | It is both necessary and desirable for the EA to take urgent action to address the underlying issues of vertical integration and market design to ensure New Zealand's electricity industry is able to meet the expected increased demand, support the transition to decarbonisation, encourage retail innovation and ensure long term reliability and affordable prices for consumers.<br>Corporate separation and arms'-length rules would promote competition in the electricity industry for the long-term benefit of consumers by:<br>• Creating incentives for generation businesses to expand capacity.<br>• Creating a liquid market for hedge products (particularly OTC products).<br>• Ensuring all electricity retailers can compete on a level playing field.<br>• Removing information asymmetries.<br>See Appendix 4 of the Letter which sets out the basis for the proposed Code change. |
| **8. Affected parties**<br>Who is likely to be substantially affected by the proposal? | This proposal would substantially affect a number of industry participants, in particular the proposal directly impacts the 4 incumbent gentailers, requiring them to operate their generation and retail business as separate |

| | |
|---|---|
| Thei could include other participants (such as generators, distributors metering equipment providers, intermittent generation owners), consumers, market operation service providers. | legal entities and comply with the arms length rules in schedule 6A.<br>The proposal will also significantly impact both independent generators and independent retailers and improve competition within the electricity industry.<br>Therefore, the proposal would have a positive impact on New Zealand consumers. |
| **9. Urgency**<br>Identify whether you consider your proposal to be urgent (providing supporting rationale).<br>Section 40 of the Act | Yes, the proposal is urgent.<br><br>It is necessary and desirable in the public interest for the Code amendments to be made urgently, given the significant nature of the issues and the likely long term impact on consumers and the reliable and affordable supply of electricity if no action is taken and competition continues to wither. |
| **10. Support for the proposal**<br>Do you consider there is widespread support for your proposal among the people likely to be affected? If so, provide supporting rationale. | This proposal has significant support from a number of industry participants.<br>In addition, the problems that this proposal seeks to address have been identified through a number of independent reviews, including the Electricity Price Review (EPR) in 2019, Wholesale Market Review and the Market Development Advisory Group (MDAG) report in 2023.<br><br>Please see the Letter for further details. |
| **11. Prior consultation**<br>Do you consider there has been adequate prior consultation on the proposal so that all relevant views have been considered? If so, provide supporting rationale. | The underlying issues have been raised but not properly addressed in a number of EA workstreams (Wholesale Market Review, MDAG recommendations, ITP and retail margin disclosure, and currently the Risk Management Review) and by independent advisory bodies (EPR and MDAG).<br><br>See also Appendix 3 of the Letter for discussion on EPR / MDAG recommendations. |
| **12. Other relevant information**<br>Is there any other relevant information you would like the Authority to consider? | As discussed above, we refer to our 6 August 2024 Letter to the Electricity Authority. |

## Section 2: Standard Code amendment requests

This section should be completed for all standard Code amendment requests. A request will be treated as a standard Code amendment request unless the Authority is satisfied that one of the following applies:

- the nature of the amendment is technical and non-controversial (question 2)
- the proposed amendment should be made urgently (question 9)
- there is widespread support for the amendment among the people likely to be affected by it (question 10), or

- there has been adequate prior consultation so that all relevant views have been considered (question 11).

You do not need to complete this section of the form if any of these apply. However, if the Authority does not agree with your assessment and decides to treat the request as a standard Code amendment request, we may come back to you and ask you to complete this section.

Provide a summary of the costs and benefits in the table below. Benefits can be qualitative and/or quantitative.

## Costs and benefits of the proposal

| | |
|---|---|
| **13. Costs of the proposal**<br>Identify the expected costs of the proposal, including:<br>• your assessment of the direct cost to develop and implement the proposed Code amendment, and<br>• the consequential costs as a result of the amendments. | We do not believe the costs for the EA will be significant, given the consultation for this Code change will overlap with many of the EA's existing workstreams, including the Risk Management Review, the ITP post implementation review, the work on the MDAG recommendations. In fact, there will likely be efficiencies from drawing all these strands together in a coherent single project.<br>If the Code change is implemented, there will be costs for the 4 incumbent gentailers to separate their generation and retail businesses, but these costs will be a one-off and there will not be on-going costs. |
| **14. Benefits of the proposal**<br>Identify the expected benefits of the proposal | There are many benefits to the proposal including:<br>• Creating incentives for generation businesses to expand capacity.<br>• Creating a liquid market for hedge products (particularly OTC products).<br>• Ensuring all electricity retailers can compete on a level playing field.<br>• Removing information asymmetries.<br>The proposal will also ultimately reduce ongoing costs and workstreams for the EA, requiring less intervention, monitoring and regulation. |
| **15. Net benefit of the proposal**<br>State whether you consider the proposal has a positive net benefit, and why. | For the reasons above and set out in our Letter, we consider the proposal would have a significant net positive benefit. |

## Assessment of alternative options

| | Alternative means of achieving proposal's objective *(repeat column as necessary)* | |
|---|---|---|
| | Alternative 1 | Alternative 2 |
| **16. Describe alternative option** Include a brief description of any alternative means identified of achieving your objective | Status Quo – ie allowing the 4 incumbent gentailers to continue operating generation and retail businesses, which results in those gentailers exercising their market power and engaging in anti-competitive conduct to the detriment of NZ consumers and the reliability and supply of electricity. | Disclosure rules or other forms of regulatory intervention or operational separation.<br><br>See Appendix 5 of the Letter for further detail. |
| **17. Identify extent to which the alternative would achieve your objective** | The Status Quo would not achieve our objectives as noted in [45] of the Letter, the current market design and the entrenched market power of the gentailers will constrain (and likely is constraining) generation capacity and ultimate increase prices to the detriment of consumers.<br><br>See also [31] – [40] of the Letter which outline the current issues with the state of competition under the Status Quo. | Anything less than corporate separation would not resolve the current significant challenges in electricity markets. |
| **18. Affected parties** Who is likely to be substantially affected by the alternative? | Independent Electricity Retailers (IERs) who are currently forced to exit and/or limit the growth of their customer base. The market share of the IERs is continuing to stagnate or decline.<br><br>Independent Generators who are disincentivised to build new generation assets unless they are able to obtain arrangements with gentailers. | Independent Electricity Retailers (IERs) who are currently forced to exit and/or limit the growth of their customer base. The market share of the IERs is continuing to stagnate or decline.<br><br>Independent Generators who are disincentivised to build new generation assets unless they are able to obtain arrangements with gentailers. |

| | Alternative means of achieving proposal's objective<br>***(repeat column as necessary)*** | |
|---|---|---|
| **19. Expected costs and benefits**<br>Please include direct costs to develop the alternative and consequential costs and benefits to all affected parties | Ineffective workstreams that do not address the underlying issues will continue to compound, causing administrative and financial burden on the EA for the foreseeable future until adequate measures are taken (which by that point may be too late, further emphasising the urgency of the situation). | Ineffective workstreams that do not address the underlying issues will continue to compound, causing administrative and financial burden on the EA for the foreseeable future until adequate measures are taken (which by that point may be too late, further emphasising the urgency of the situation). |
| **20. Why do you prefer the proposal over this alternative?** | Any lesser options would not resolve the current issues as:<br>• The gentailers will continue to have incentives to limit generation capacity to the extent that it matches their retail books;<br>• Anything less than corporate separation would lead to issues of transparency and informational asymmetries which make monitoring/regulating substantial use of market power and discrimination difficult.<br>• Disclosure obligations imposed may not achieve the desired/stated purpose (eg ITP and retail gross margin disclosures are considered meaningless).<br>• Effectiveness of lesser measures are questionable.<br>See Appendix 5 of the Letter | Any lesser options would not resolve the current issues as:<br>• The gentailers will continue to have incentives to limit generation capacity to the extent that it matches their retail books;<br>• Anything less than corporate separation would lead to issues of transparency and informational asymmetries which make monitoring/regulating substantial use of market power and discrimination difficult.<br>• Disclosure obligations imposed may not achieve the desired/stated purpose (eg ITP and retail gross margin disclosures are considered meaningless).<br>• Effectiveness of lesser measures are questionable.<br>See Appendix 5 of the Letter |

# ANNEX E: The IERs submission on Risk Management Review Issues Paper, dated 20 December 2024

# Submission on *Reviewing risk management options for electricity retailers – issues paper* on behalf of the Independent Electricity Retailers (IERs) namely, 2degrees, Electric Kiwi, Flick Electric and Octopus Energy

**Matthews Law provides this submission on behalf of the IERs.**

**20 December 2024**

20 December 2024
Sarah Gillies
Chief Executive
Electricity Authority
Wellington

By email: rmr@ea.govt.nz

**Copies**: EA, NZCC & MBIE

## Reviewing risk management options for electricity retailers – issues paper[1] (IP)

### Executive Summary

**Introduction**

1. We, the independent electricity retailers (namely, 2degrees, Electric Kiwi, Flick Electric and Octopus Energy together, the **IERs**), appreciate this opportunity to give important feedback, which is critical to the EA meeting its statutory obligation, namely *"to **promote competition** in, reliable **supply** by, and the efficient operation of, the electricity industry for the long-term benefit of **consumers**"*.[2]

2. It is good to see recognition (albeit qualified) that "*It would support retail competition in the short to medium term… To deepen and increase the liquidity of OTC hedges, and increase price transparency for shaped products*". We **agree** that "*medium-size (and some smaller) non-integrated retailers contributes to innovation in a significant way, and likely in a greater proportion to their market share*"[3] although we have concerns with the EA's approach.

3. However, the **framing** of, and thinking behind, the RMR (whether by accident or design) **ignores critical factual and legal context, leading to flawed conclusions**, which are not consistent with orthodox approaches or international best practice.[4] The incorrect framing **means the wrong questions are asked**, creating a high likelihood of incorrect and incomplete conclusions being reached, which has proven to be the case. This default to the status quo is reinforced by an inconsistent approach to the evidence.

4. This approach will not lead to supply (generation) increasing to meet the estimated 50-80% forecasted increase in demand. It risks losing the price and non-price (innovation, quality, service etc) leadership of independents.

**Whether by accident or design, the RMR is badly framed**

5. The Executive Summary says that the EA "*... commenced a risk management review in December 2023 to test whether the availability of over-the-counter (OTC) risk management 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."*

[1] Reviewing_risk_management_options_for_electricity_retailers__issues_paper.pdf
[2] Electricity Industry Act 2010 No 116 (as at 23 December 2023), Public Act 15 Objectives of Authority – New Zealand Legislation
s 15 (Objectives of Authority)
[3] IP, Chapter 2, para 4.18
[4] We raised framing concerns and assumptions at the outset in relation to the PID for the RMR in our 10 April 2024 letter to the EA through Matthews Law.

6. By **design** this framing **deliberately excludes *"generators and traders"*** (ie the supply-side of hedge markets). Also by design, it **incorrectly assumes** hedges are just *"risk management products"* substitutable for others and there are *"other options"*, **wrongly implying they are economic substitutes**.

7. This approach is **inconsistent with the EA's own statements** about the markets on its website:[5]

> *The **hedge market is the electricity futures market**. **Generators and traders** can enter financial hedge contracts with other participants to manage the risk of future price movements in the spot market.*
>
> *The hedge market is a **key part of the wholesale marke**t. It provides t**ransparent and robust forward price signals** and **enables participants to manage their exposure to the spot market.***
>
> *If a party purchases a contract that reduces their financial risk, this is called hedging. If a party sells a contract that increases their financial risk, this is known as speculating.*
>
> *There are the following three key markets in the New Zealand hedge market:*
>
> ***1. Futures and options exchange (currently ASX only)***
>
> ***2. Over-the-counter (OTC) market***
>
> ***3. Financial transmission rights (FTR) market***

**Effects of this framing**

8. The EA could and should have undertaken the inquiry consistent with its statement on its website. The EA did not pay sufficient heed when advised that the PID was highly flawed.[6]

9. When we contrast these approaches (IP framing and the EA's website) with the way our legitimate concerns were largely dismissed,[7] this indicates that considerable effort was made to **avoid starting in the logical (and correct) place, and instead deliberately re-framing the inquiry quite differently, in a way designed to understate the problems and consequently the solutions**.

10. Comparing the RMR framing with the EA's own statements, it is even clearer the RMR framing:

    a. Has a "contextual vacuum" notably excluding the vertical supply chain (esp generation).

    b. In doing so, it fails to direct the inquiry to promoting electricity competition and supply.

    c. Starts with the wrong premise, incorrectly broadening the market horizontally and incorrectly equating an **input for supply[8]** with demand-side management, an approach which is not consistent with regulatory best practice and is flawed economics.

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[5] Hedge market | Electricity Authority

[6] We raised framing concerns and assumptions at the outset in relation to the PID for the RMR in our 10 April 2024 letter to the EA through Matthews Law.

[7] We were told that the RMR was taking a long period as you were taking a precise approach to market definition. That statement turned out to be false as the IP confirms. But the bad framing has led to conclusions which are bad economics - mixing supply and demand, treating complements as substitutes, and (which seems to be partially admitted) the approach is an example of the Cellophane fallacy, by not considering market power when considering substitution.

[8]Again inconsistently ( this time within its own IP) the EA recognised hedges **are an input:** *"While not the focus of this review, we acknowledge that risk management is also an important **input** for large industrials."* Footnote 1, page 2, Executive Summary of the IP. (As an aside it is poor formatting to have each chapter start with new numbering, making it challenging and time-consuming to cross-reference and comment on the IP. A 'barrier to submitting".)

11. This approach **favours the status quo and is consistent with confirmation bias**, an impression reinforced by:

    a. No consideration of what workable or effective hedge markets would look like.

    b. Statements in favour of the status quo which do not appear substantiated / evidenced.

    c. Conversely an undermining or rejection of evidence indicating change is needed.

12. Relatedly, the approach to the ITP is perplexing and again seems to favour the status quo (ie gentailers). It was recommended by the EPR to provide transparency given incentives by the gentailers to exercise market power. The EA failed to design an ITP framework that adequately addressed the recommendation by the EPR. Yet it is now rejected as a "distraction" (for gentailers) rather than the proper approach, namely considering how to address this regulatory failure.

13. We briefly expand on the context & framing and the risks of favouring the status quo **below**.

**Context & Framing**

14. The IP ignores (and even 'waters down') past findings and context of NZ electricity markets.

15. Generation is characterised by high barriers to entry, vertical integration and an oligopoly of parties with "*substantial market power*" (namely, the big 4 gentailers: Contact, Genesis, Mercury and Meridian, herein the **incumbent gentailers**[9]).[10]

16. The RMR ignores:

    a. the likelihood that workably competitive electricity / generation markets would have liquid hedge markets (*cf* the EA's website as quoted in paragraph 6 above);

    b. orthodox economic theory which recognises that NZ's market structure impacts the ability and incentives to engage in anticompetitive conduct; and

    c. given these clear risks this is the reason International best practice (OECD) recognises and recommends structural separation (*ex ante*) as best practice.

17. As a related concept by equating a vertical input to retailing (hedges) with the downstream retail activity (demand side management, ie restricting output / moving output to another time) the IP confuses the role of retailers, and its own role, by trying to specify how retailers should compete (picking winners).

    a. It sets up an incorrect logic that retailers are responsible for managing risk for their customers, and therefore should be responsible for their own risk management. It frames this around demand-side management. This approach is incorrect, seeking to turn retailer buy-side (and generator sell-side) issues into a retail supply side response. The IERs cannot be expected to be responsible for failings of the market - that is the EAs responsibility.

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[9] We note that there are other gentailers (eg Nova) who are vertically integrated, however, we have not considered them as part of the big 4 gentailers as they do not have market power in the electricity industry (noting the historical context of inherited generation assets).

[10] In its May 2009 Investigation Report the Commerce Commission concluded that all 4 gentailers have a "*substantial degree of market power in the wholesale electricity market*", at para ii. There is no evidence to suggest that market conditions have substantively changed since, given the gentailers "inherited" ECNZ's legacy generation and still maintain control c.86% of total generation.

b. It is self-serving and circular logic: the inquiry should be solely about hedge markets, liquidity and availability. **The absence of these markets is due, in large part to the regulatory design, which the EA is responsible for.** (This may explain the EA's apparent unwillingness to fully and properly scrutinise the issues in an orthodox manner.) **Parties seeking liquid hedge markets should not be blamed for the lack of competitive upstream markets.**

c. We agree that demand-side management is important. But that is a different issue and the EA's approach suggests competing by supplying less or shifting supply. That is already part of how retailers compete, as the IP notes.

d. It should be up to the market to determine which retailers are "*winners*" and they should choose what they offer to customers. If they fail to offer a retail offering which insufficiently manages risks, then customers will not choose them.

e. Above all retailers need the **conditions for competition** – the **input** - to compete on a level playing field (in supplying the output) which is the essence of competition law.[11] As do generators.

**Risks of favouring status quo**

18. The IP (and thus the EA) risks confirmation bias by assuming that a level of workable and effective competition exists and/or that there is an efficient market structure. This approach should not automatically be the starting point. Particularly noting the context of numerous studies which suggest otherwise (which the IP seems to dismiss, undermine or ignore).

19. Conversely, the IP states, without supporting evidence, that *"Gentailers have an efficient hedge against … volatility"*[12]*.* However, this statement does not consider whether such efficiency is on balance procompetitive and best for consumers. It confuses an internal private benefit with the public benefit of competitive markets.

20. This approach is in stark contrast with the approach of Ofgem & CMA[13] which found that while vertical integration can offer benefits, it also reduces competition in the market.

**Summary**

21. Fundamentally the RMR **ignores context** - the legal objectives and factual background. As the IP notes "*context matters*".[14] Market analysis cannot ignore the supply chain.

22. The RMR's **framing is, by design, wrong**, meaning the IP proceeds **on a faulty premise** that hedging is just one way of mitigating risk rather than a critical input. In doing so it incorrectly treats other risk management options as good economic substitutes, which they are not. This design understates the gentailers' market power. It also leads to a fundamental flaw, namely equating demand-side management with a supply-side input.[15]

23. This framing and approach **favours the status quo and is consistent with confirmation bias,** and risks conveying an impression of regulatory capture by incumbents. Despite framing that narrows the scope of issues, the RMR has still identified evidence (or at least a high risk) of

[11] *Telecom v Clear* (1994) 6 TCLR 138
[12] Heading 7 of Ch 3.
[13] Ofgem & CMA in *State of the Market Assessment* (March 2014) at 1.36–1.39.
[14] IP, Executive Summary, p.3
[15] Inconsistently in footnote 1 of the Executive Summary the EA notes that *"While not the focus … we acknowledge that risk management is also an important **input** for large industrials."*

persistent low levels of contracting / refusals to supply which calls for (following best practice) intervention to ensure non discriminatory access.

24. There appears to have been a long-standing **focus on productive efficiency**) **at the expense of promoting competition and supply** (quantity), while effectively ignoring the harms of vertical integration. Even if this is not accepted **we urge the EA to recognise that significant changes are required to increase generation supply (output) and maintain competitive markets throughout the supply chain.** This requires asking the right questions and applying the right legal test, which the RMR does not do..

25. We expand on these points below.

## Structure of Submission

26. Our submission is structured as follows:

A. **Context & Framing**

1. Market conditions
   i. Demand is exponentially growing but supply is not at pace
   ii. Current market conditions are not workably competitive
   iii. Disincentives to expand generation
2. Legal & regulatory framework
3. Competition & Economics
4. Framing – wrong questions lead to the wrong answers
   i. Narrow premise with self serving question
   ii. Supply chain
   iii. Demand response as a substitute
   iv. Characterisation of retailers' obligation

B. **Risks of favouring the status quo**

1. The EA sets its own evidentiary burden of proof too high
2. Separation should not be treated as a backup option / disproportionate intervention
3. Recognising vertical integration as a substitute for hedges biases the status quo
4. Assumptions & inconsistencies
   i. EA is inconsistent on its view of vertical integration as a 'substitute'
   ii. Vertical integration can often be harmful
   iii. Demand response as a substitute
5. Timeframes / EPR Recommendations

C. **Benchmarks / Factual Points**

D. **ITP**

## A. Context & Framing

27. The IP fails to consider the broader factual and legal context of the electricity industry when framing the issues in the hedge market.

28. By not considering the broader context of current market conditions and the legal framework, the IP does not ask the right questions at the outset. This leads to the IP asking the wrong questions which risks the EA coming to incomplete conclusions for the RMR.

29. The appropriate starting point & benchmark which the IP should be asking is:

    a. What would workably or effective competition in hedge markets look like?; and

    b. Whether the current market structure facilitates workable or effective competition.

30. The EA appears to be considering what workable or effective competition looks like *within* the framework of current market conditions / design, when it should be considering whether the current market conditions / design *itself* is workably competitive.

31. By framing the RMR in this way, the EA narrows the scope of the IP to exclude the broader supply chain (especially generation) and fails to conceptualise hedges as essential inputs (cf the IP currently considers hedges as part of broader "*risk management options*").

### 1. Market conditions

**i. Demand is exponentially growing but supply is not at pace**

32. Electrification is leading to rapid increase in demand – Forecast demand growth by 2050: **c.50%** (MDAG) **to 81**%(MBIE).

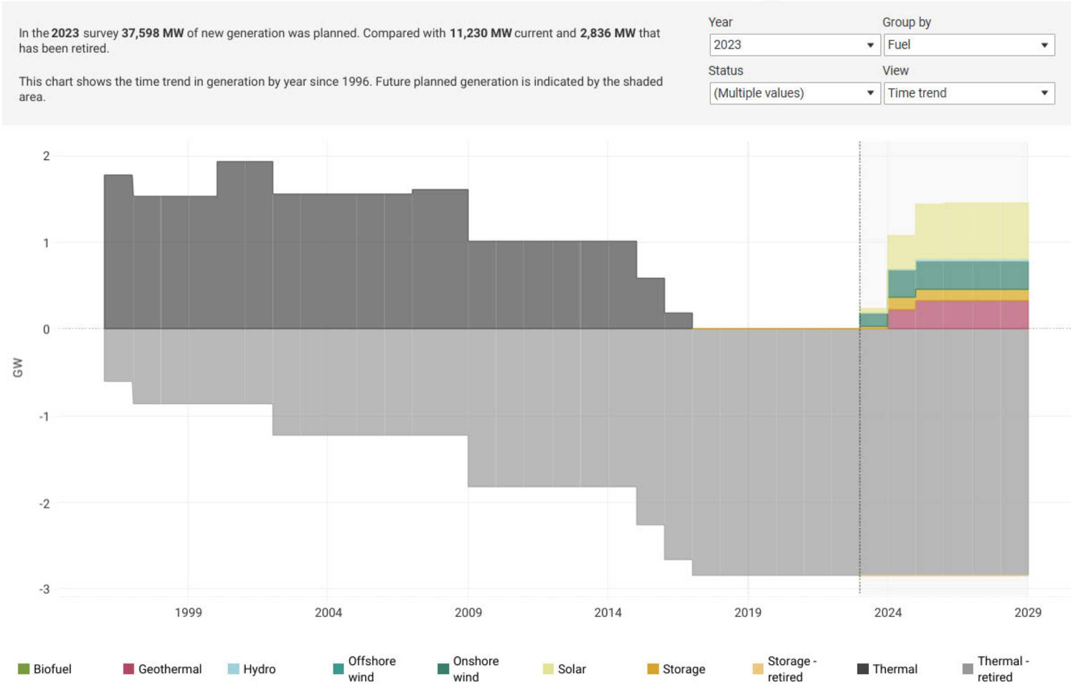
33. The Sapere Report confirms the importance of reliability of generation supply / input within the broader context of the rapid demand growth:

    a. "…key concerns for security and **reliability** occur because of the potential speed of **demand growth** and whether **generation**, transmission, and distribution **can respond appropriately, quickly enough**."[16]

34. Despite the growing concern in relation to reliable supply, generation supply (and also hedges) has largely stagnated with no material increase and current *committed*[17] generation investment pipelines are expected to largely replace non-renewable generation that is winding down.

***Figure 1*: EA's Investment pipeline - A summary of generation and responses to the 2023 investment survey**

[16] Review of potential security, reliability, and resilience concerns arising from future scenarios for the electricity industry – Report for the Electricity Authority (29 June 2021) at p.iv.
[17] Following Concept Consulting's Generation investment survey 2022 definition: "P*rojects classified by Transpower as"in delivery"are treated as"committed"projects for our purposes*".




*Source: Electricity Authority's dashboard of* [Investment pipeline | Tableau Public]

a. We note that while the *actively pursued*[18] pipeline may have appeared to grow from previous years, there is an inherent uncertainty that a potential investment goes ahead. Hence we do not necessarily agree with the EA's view that the forecasted generation investment pipeline has seen an uplift. Announced projects do not constitute *committed* generation. Regardless, it is wrong to compare these figures with the status quo. The benchmark (counterfactual) are markets under workable and effective competition. It is also important to be alive to strategic announcements and even preliminary work on projects. There are analogies to land banking in grocery which can crowd out other players entering / expanding even when the land is not used. Announcements can also be a strategic barrier to entry where investment announcements have been identified as 'strategic barriers to entry' to deter other investors from entering (by signalling growth of an incumbent competitor).

35. There are potentially other contributors to scarcity. The EA only briefly acknowledges the scarcity of supply (up and down the supply chain at both generation and contract levels) but does not consider the effects of scarcity when reaching its views:[19]

a. "*On the supply side,* ***there is increasing scarcity of capacity available to under-write shaped contracts****. As more intermittent generation enters the market, this means a greater proportion of generation requires firming to meet electricity demand*.
…
*A decrease in supply and an increase in demand for electricity means that* ***risk management is becoming more expensive.*** *This is reflected in an increase in the cost of electricity (ie, spot purchases and hedging costs)*".

b. It is concerning that the EA instead uses scarcity as part of its justification for the incumbent gentailers' position to not recently offer OTC contracts without considering

[18] Following Concept Consulting's Generation investment survey 2022 definition: "*Projects classified by Transpower as in the "investigation" or "concept assessment" stages are treated as "actively pursued"projects for our purposes*".
[19] IP, Ch 3, para 6.2 and 6.5.

the broader context of why the scarcity exists (which the incumbent gentailers maintain to their benefit).

The lack of:

c. a meaningful increase in generation supply;

d. a shaky investment pipeline (in light of demand growth); and

e. the lack of weight to supply scarcity issues in the IP

show that the EA is not acknowledging the signals of market power at play.

36. It is also incorrect to ascribe scarcity to other reasons without considering what would occur under workable or effective competition (ie with better regulatory structure). We appreciate it is confronting for the EA given its role but it is even more important to recognise these issues which were within its control and responsibility. Even if the EA thinks it got it right in the past, it must acknowledge the status quo will not deliver the competition & supply needed.

**ii. Current market conditions are not workably competitive**

37. Neither wholesale or retail electricity markets are functioning in a workably competitive manner, which has been documented in both the EPR[20] and MDAG[21] reports:

a. There is not sufficient investment in additional generation expected given anticipated demand[22] and the incumbent gentailers do not have incentives to expand generation to keep pace with demand. As a result there is declining security of supply.

b. There is not sufficient liquidity in hedge markets (both on the ASX and in the OTC market). This has a number of effects, including:

- Disincentivising independent generators from building new generation assets or entering the generation market.

- IERs being forced to limit the growth of their customer base, and the market share of the IERs is stagnating or declining.

c. Barriers to entry for generation are high.

d. Wholesale prices have increased rapidly since 2018 and remained well above the long run marginal cost of generation.

e. Retail prices are below wholesale prices.

f. The incumbent gentailers have reported high or record profitability for their wholesale businesses and losses for their retail businesses.[23]

[20] Electricity Price Review Final Report, p.2.
[21] MDAG Final recommendations Report, p.12 –13.
[22] See comments re generation and supply capacity, investment pipeline at para 34.
[23] See for example, for the 6 months ended 31 December 2023: Meridian Condensed Interim Financial Statements 2024 shows an EBITDAF of $-43mil for retail and $534mil for wholesale respectively; Genesis Interim Report 2024 shows an EBITDAF of $-34.8mil for retail and $245.9mil for wholesale respectively; Mercury Interim Report 2024 shows an EBITDAF of $-20mil for retail and $454mil for wholesale respectively; and Contact 2024 Interim Financial Statements shows an EBITDAF of $-1mil for retail and $383mil for wholesale respectively.

g. IERs are unable to expand or compete in the way you would expect to see under a workable or effective competition.

See **Annex B** for further details on the EPR and MDAG conclusions on the market structures / conditions (Appendix 3 from the IERs 7 August 2024 letter to the EA).

**iii. Disincentives to expand generation**

38. Despite the need for growth in the reliable supply of electricity (and hedge contracts), incumbents are disincentivised to expand output (or in other words, financially incentivised to limit supply to keep markets tight and inflate scarcity) at the rate we would expect to see in a workable or effective state of competition given their internal hedge (to balance supply and demand). Increasing supply would reduce returns and expose them to the need to find additional demand (total generation remaining stagnant at *Figure 1* above shows this in effect).

a. This is evident in the incumbent gentailers' use of capital to consolidate rather than expand. Mercury Energy bought independent generator Tilt Renewables, Contact Energy is currently seeking clearance to acquire Manawa Energy.

b. This incentive to limit supply and maintain scarcity was also identified as a real risk by Concept (coined as "*cannibalization*") in their *Generation investment survey 2022* prepared for the EA:

> "*it is unclear whether major suppliers' investment pace is being tempered by cannibalization concerns*
> *…*
> *Such concerns can arise due to the depressing impact a new project may have on revenue from existing generation in an incumbent developer's portfolio.* ***If a cannibalization effect applies, an incumbent supplier can be better off by delaying or foregoing investment, even though the project is economic in its own right.***
>
> *If competitive pressures in the investment arena are sufficiently strong, the cannibalization concern will not arise. This is because any incumbent generator that delays its own investment will risk ceding the opportunity to a competitor (another incumbent or a new entrant).*"[24]

## 2. Legal / Regulatory Framework

39. The IP does not frame the RMR correctly from an appropriate legal starting point. We set out the legal and regulatory framework below.

40. The EA's main objective is "*to* ***promote*** ***competition*** *in,* ***reliable supply*** *by, and the efficient operation of, the electricity industry* ***for the long-term benefit of consumers****.*"

41. The Commerce Act 1986 defines "competition" as "*workable or effective competition*".[25]

42. The High Court expands that "workable and effective competition" means:

"*a market framework in which the presence of other participants (or the existence of potential new entrants) is sufficient to ensure that each participant is constrained to act efficiently and in its planning to take account of those other participants or likely entrants as unknown quantities.* ***To that end there must be an opportunity for each participant or new entrant to achieve an***

[24] Concept Consulting *Generation investment survey 2022* prepared for the EA, at p.23.
[25] section 3(1).

***equal footing with the efficient participants in the market by having <u>equivalent access</u> to the means of entry, sources of supply, outlets for product, information, expertise and finance***."[26]

43. This idea of equivalent access was affirmed by the Privy Council in *Telecom v Clear* applying Kahn's "principle of comparative parity" (**non-discrimination**):

"*in considering whether competition would be deterred by* [the incumbent's] *charges, what is pertinent is not the absolute level of those charges but whether* [the incumbent] *is charging* [access seeker] *more for the service it provides to* [access seeker] *than it charges its own customers for the same component of its own services*."[27]

44. The Sapere Report confirms the importance of reliability of generation supply / input within the broader context of the rapid demand growth (in line with the EA's objective of reliable supply):

" …key concerns for security and **reliability** occur because of the potential speed of **demand growth** and whether **generation**, transmission, and distribution **can respond appropriately, quickly enough**."[28]

45. The importance of competitive hedge markets as described is explicitly acknowledged in s 130 of the Electricity Industry Act 2010 (**EIA**) which provides specific Commerce Act authorisation *"for the purpose of developing and operating an active market for trading financial hedge contracts for electricity."*

## 3. Competition & Economics

### Substantial Market Power (SMP)

46. The Commerce Commission (**NZCC**) in its May 2009 Investigation Report found all 4 incumbent gentailers have a "***substantial degree of market power*** *in the wholesale electricity market*".[29]

47. The EA seeks to undermine[30] this finding by suggesting that (1) the NZCC's report is 15 years old; (2) the SMP concerned only the spot market and (3) regulation and monitoring has since improved. It is difficult to accept without clear evidence that such market conditions have changed.[31]

48. The EA overstates the impact of Trading Conduct Rule changes which again is inconsistent with when the EA previously acknowledged their limitations. We consider that a finding of SMP in the spot market would translate to SMP in hedge markets. This is because the two markets are interdependent and as the EA acknowledges, the incumbent gentailers are the dominant suppliers of hedge contracts (as they have almost all dispatchable generation to supply at peak times) with which all industry participants must trade with to manage price volatility risk in the spot market.[32]

49. The EA takes the extraordinary approach of rejecting or undermining evidence and also applying an excessively high evidential burden. It goes to great efforts to undermine that evidence by suggesting it is not conclusive enough. The EA seems to reject good evidence that does not suit its narrative of maintaining the status quo and 'doubles down' on this approach by suggesting

[26] *Fisher & Paykel v CC* [1990] 2 NZLR 731 (HC) at 757-8.
[27] (1994) 6 TCLR 138
[28] Review of potential security, reliability, and resilience concerns arising from future scenarios for the electricity industry – Report for the Electricity Authority (29 June 2021) at p.iv.
[29] NZCC May 2009 Investigation Report, at para ii.
[30] IP at Chapter 7, para 5.13.
[31] There is no evidence to suggest that market conditions have substantively changed since, given the gentailers "inherited" ECNZ's legacy generation and still maintain control c.86% of total generation.
[32] See IP, at Chapter 4 para 5.38 - 5.49.

that there may be other reasons to explain any increased prices and scarcity issues. Indeed, even in its own 2021 review of the wholesale market competition[33] the EA accepted that gentailers may have been exercising market power.[34]

50. The difficulty / inability to find conclusive evidence of the exercise of market power is a common issue with vertical integration and why it is considered regulatory best practice to separate vertically integrated parties to address the real risk of such exercise of market power and bring about the needed transparency for regulators to closely monitor markets.

51. The EA's modelling suggests that different products are substitutes but this proceeds on the predetermined view that hedges are substitutes with other risk management options (incorrect framing of the review). The EA compares these options (which are not substitutes) under current market conditions which is not under workable or effective competition conditions and therefore, falls foul of the cellophane fallacy.

## 4. Framing – wrong questions lead to the wrong answers

**i. Narrow premise with self serving question**

52. In the absence of the broader factual and legal context, the IP Executive Summary reads: "The Electricity Authority Te Mana Hiko commenced a risk management review in December 2023 to test whether the availability of over-the-counter (OTC) risk management 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."

53. This framing narrows the scope of the review by viewing hedging as just one way of mitigating risk and not as an essential input to manage the price volatility of the spot market as a retailer that sells to consumers at a FPVV.

54. This narrow scope of viewing hedges as part of broader risk management options is inconsistent with the EA's definition of the **hedge market** (which affirms the view that hedge markets should be viewed separately as a key input of the wholesale market):

> "*The hedge market is the electricity futures **market**. **Generators** and traders can enter financial hedge contracts with other participants to manage the risk of future price movements in the spot market. The hedge market is a **key part of the wholesale market.** It **provides transparent and robust forward price signals** and enables participants to manage their exposure to the spot market*."[35]

55. This raises a number of issues in the IP, in particular the EA:

    a. should have started by considering what workable and effective competition would look like in hedge markets (and in related interdependent markets which are affected by shared market designs).

    b. should have considered upstream supply and the assessor for that (competition agencies realise the interdependencies but this framing assumes them away).

[33] Review of wholesale market competition | Our projects | Electricity Authority
[34] Promoting competition in the wholesale electricity market in the transition toward a renewables-based electricity system – Decision Paper (May 2023), p.i.
[35] Hedge market | Electricity Authority

c. should note a corollary of starting with the SMP (rather than rewriting past conclusions about SMP to question this) would be to recognise that SMP and the supplier risk management products[36]

d. has made a fundamental failure to recognise incumbents incentives not to supply – this should be assumed

e. *"in the context of other risk management options"* starts with the presumption that there are good substitutes and/or those should fall within the same markets

**ii. Supply chain**

56. Significantly it does not fully consider the interdependencies of a vertically integrated supply chain, most notably the significance of liquid markets for generation – this has the effect of understating the importance of a vibrant hedge market.

57. This is reflected above in our views at *1. Market Conditions iii. the disincentives to expand generation*.

**iii. Demand response as a substitute**

58. The IP suggests demand response management is a substitute to super-peak hedges (notwithstanding that demand-side management cannot be, as a matter of economic principle, considered a substitute for a supply-side input). Greater adoption or utilisation of demand response while complementary to reducing exposure to the price volatility of peak time, does not increase the liquidity of the hedge market.

59. Further, it is a flaw to model (as in the IP) demand response as a flat line demand as we know this is not achievable and would still require retailers to 'restrict' customers on electricity use at peak hours (ie the service offering provided by such demand responses are a 'lesser' offering to many customers). Retailers should be able to compete on a like for like basis, but they should not be forced to cease or limit supply to be able to maintain their businesses.

**iv. Characterisation of retailers' obligation**

60. Adopts a circular logic that says that retailers are responsible for managing risk for their customers therefore they are responsible for managing risk. In a workably competitive market there would be hedges (ie we would expect risk management would naturally occur if freely available). This is part of how retailers compete and something for the market to determine (as to whether it is a suitable approach).

61. The IP also contradicts itself by suggesting retail tariffs as substitutes to super-peak hedges as a 'risk' management option (retail tariffs inherently pass on the risk to customers to a certain degree).

## B. Risks of favouring the status quo

62. The IP by examining the state of competition *within* the current market structure / conditions without considering whether there is a more workable or effective market design risks confirmation bias (favouring the status quo of maintaining the incumbent gentailers as market makers who predominantly control the majority of the generation and retail sectors of electricity).

[36] We do note the IP does however acknowledge the need to "buy" these from generators.

63. We note that this potential bias to the status quo is evident in the EA's choice of adopting language such as "*non-integrated retailers*".

### 1. EA sets its own evidentiary burden too high

64. The EA market monitoring program has limitations and it is broadly accepted that detecting the exercise of market power can be challenging. The EA uses the absence of conclusive evidence of any exercise of market power (as was the case in its assessment of the wholesale market) by the gentailers as evidence that market power is not being exercised. Hence any and all options that have considered separation measures in the past have never been adopted because it cannot satisfy its own burden of proof to engage in such measures.

### 2. Separation should not be treated as a backup option / disproportionate intervention

65. The IP (and past EA work projects and the Energy Competition Task Force work programmes) describes separation measures as 'back up options' and considers it a drastic measure to take despite finding evidence of issues with accessing hedge contracts with incumbent gentailers engaging in self preferencing for supply and price.

66. Viewing separation measures as a last resort ignores the current self-preferencing behaviour, and the factual background behind why the EPR did not immediately recommend separation back in 2018 (which we note was 8 years ago with no material positive change in market conditions since those findings):

> "*An effective contract market is critical to mitigating the potential adverse effects of vertical integration and short-term generator market power. Our view is reinforced by the recent review in the United Kingdom, which concluded vertical integration was not adversely affecting competition, in part **because the contract market had sufficient liquidity** "for independent firms to hedge their exposure to wholesale market risk in a similar way to vertically integrated firms*."[37]

67. It is puzzling to see the EA acknowledges the risk that vertical integration presents when SMP is present yet accepts such risks clearly present in the industry:

> "*vertical integration presents particular risks when substantial market power is present in upstream markets due to the incentive to leverage that substantial market power into downstream markets that are otherwise competitive*".[38]

68. If the EA were to correctly adopt the NZCC's conclusive findings of incumbent gentailer SMP then it must recognise its own finding that vertical integration presents a real risk of damaging competition in wholesale and retail electricity markets.

69. If the EA were to adopt a risk-preventative approach, it follows that separation measures are necessary and desirable given the current market conditions. This would align the EA with the orthodox approach taken by forward looking regulators to vertically separate incumbents in a number of jurisdictions across a variety of industries (especially in utilities).

**Orthodox approach to vertical integration (when there are risks of misuse)**

70. International best practice suggests that the orthodox approach to vertical integration where there are risks of misuse of market power (often these vertically integrated firms inherit their

[37] P.43 of Electricity Price Review First Report for discussion (30 August 2018).
[38] At Chapter 7, para 3.10.

size from historical break ups and/or privatisation of government monopolies) is to vertically separate.

71. The **OECD** unequivocally states that the *"…principal benefits of vertical separation* [ie corporate / ownership] *when compared with access regulation are: separation limits the need for regulation that is difficult and costly to devise and implement, and may be only partly effective; it improves information; and it eliminates the risk of cross-subsidies by the incumbent from its non-competitive to its competitive segments"*.[39]

72. Structural separation has been successfully used in numerous industries globally, including:

a. **UK electricity:** The UK electricity sector was subject to vertical separation at the time of privatisation under the Electricity Act 1989. The wholesale and retails arms of vertically integrated companies are operationally and managerially separated, and in principle, trade with the wholesale and retail arms of independent companies in the same manner with which they trade with their own subsidiaries (ie non-discrimination); other examples in UK include airports (BAA-horizontal) and BT.

b. **Australia telco (Telstra):** Government used a 2-pronged strategy: (1) through a government driven national broadband network (NBN) to provide wholesale network to support retail competition; and (2) functional separation of Telstra's wholesale and retail operations on a voluntary basis (this was subject to a backdrop of 'forced' separation should Telstra fail to propose adequate separation undertakings[40])

c. **EU** (unbundling provisions of Gas & Electricity Directives): Separation has been common in the electricity sector, where Member States must comply with the requirements of the European Commission's energy markets liberalisation programme;

d. **US:** Standard Oil (1911); American Tobacco Trust; Paramount movies / theatres (1948); and AT&T (1982).

e. COFECE (Mexican Competition Commission) made preliminary recommendations for the divestment of cornflour plants by Gruma.

73. Ofgem and the CMA highlighted that while vertical integration does offer benefits, it also reduces competition in the market:[41]

> **"*Vertical integration provides a financial hedge*** *against volatile wholesale energy prices and a natural hedge against balancing risk. As well as having less of a requirement to trade, integrated suppliers are also likely to have stronger credit ratings, allowing them to post lower levels of collateral… We consider that vertical integration reduces the cost of capital relative to similar non-integrated businesses, because it reduces exposure to volatile market risk. Given the capital intensive nature of power generation, this could yield a significant benefit to consumers through lower prices and better security of supply.* ***However, we consider that vertical integration also has costs in terms of reduced competition in energy markets. Low levels of liquidity in the wholesale electricity markets****, particularly for certain types of product at particular times, act as a barrier to entry for non-integrated suppliers. They also* ***act as a barrier to expansion for those non-***

[39] OECD *Structural separation in regulated industries - Report on implementing the OECD Recommendation* (2016), at p.9.
[40] Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2010 which provided a detailed description of the structural separation undertakings that the ACCC might accept from Telstra.
[41] *State of the Market Assessment* (March 2014) at 1.36–1.39

***integrated suppliers** already in the market. A lack of liquidity in the market for longer-term contracts **may also inhibit the ability of independent generators to secure finance for new investment, or raise their cost of capital**…*

*…**we do not consider that the benefits of vertical integration are so clear cut**…We also consider that **the costs to retail competition in terms of the barriers to entry and expansion resulting from vertical integration may be significant**—particularly in a market where competition is already weak…"*

74. Similarly the European Commission Art 17 Inquiry into European gas and electricity sectors found:

> *"Economic evidence shows that **full ownership unbundling is the most effective means to ensure choice for energy users and encourage investment.** This is because separate network companies are not influenced by overlapping supply/generation interests as regards investment decisions. It **also avoids overly detailed and complex regulation and disproportionate administrative burdens. [A non-separation approach]** would improve the status quo but would require more detailed, prescriptive and costly regulation and would be less effective in addressing the disincentives to invest in networks."*[42]

75. **NZ examples**

a. **Telco** in New Zealand has already gone down this path (Telecom NZ) and only found success after full separation with UFB (for similar structural reasons not unique to telco alone).

b. **Electricity** (1) Deregulation of the electricity market in the 1990s saw the generation assets of ECNZ being split to form the current 4 gentailers: Contact, Genesis, Meridian and Mercury; (2) EDB line of business limits (no retail); (3) EDB Rules (Part 6 of the Code).

76. We note that to change the Code and follow the orthodox approach taken by other regulators, the EA need only be satisfied the changes are *necessary or desirable* to promote its s 15 objectives under the EIA (incl. competition & supply).

77. At a minimum an access regime is required. However separation measures are likely simpler to implement and administer effectively.

## 3. Recognising vertical integration as a substitute for hedges biases the status quo

78. The EA biases the status quo and the incumbent gentailers' entrenched position because historically the incumbent gentailers never had to vertically integrate and could simply match retail to inherited generation. Electricity deregulation led to ECNZ's generation being split and the four legacy generation businesses were permitted to enter retailing, and now hold most retail customers formerly held by the EDBs. The gentailers account for about 86% of generation and 84% of retail, so have remained hedged.

## 4. Assumptions & inconsistencies

### i. EA's view on vertical integration as a substitute is inconsistent

[42]See 55 of European Commission, Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and Electricity sectors (Final Report) COM(2006) 851.

79. The IP argues that vertical integration is a viable risk management option (which it is not) but then confusingly finds that it would still expose retailers to risk:

> *While vertical integration is an option that is available to them for risk management, the current opportunities for vertical or quasi-vertical integration (with non-integrated generators) mainly involve intermittent generation.* ***Intermittent generation does not provide the same profile*** *as their residential load,* ***leaving them exposed to substantial risk***.[43]

80. The EA's acknowledgement of the remaining exposure to risk leads to labelling vertical integration as a "*distant substitute*" for OTC contracting more broadly. Despite this, the IP then later builds up vertical integration with Lodestone and Pulse as examples where vertically integrating presents a "*viable business model*" and "*may allow smaller retailers to grow their businesses*".[44] This is inconsistent with the IP's previous acknowledgement that these new renewable generation investment options are non-dispatchable and retailers would still be bottlenecked for hedge products to manage risk.

81. We note that even the benefits that vertical integration could provide (and expected / suggested by the EA) have not necessarily eventuated (eg Nova who is not an incumbent but is vertically integrated has retrenched losing more than 20,000 customers in the past 4 years).[45] This reflects that retailers (including vertically-integrated ones without SMP) are still largely reliant on the incumbent generators to firm risk.

82. The EA's inconsistent views on vertical integration leave a lack of clarity / decision making (which we would expect from a forward thinking industry regulator) and given the orthodox approach, the EA risks favouring the status quo and losing the confidence of the industry.

**ii. HoustonKemp's economic & policy analysis of vertical integration issues in the NZ electricity industry**

83. HoustonKemp, a well respected economics consultancy prepared its analysis of vertical integration issues in NZ on behalf of the IERs in the context of our 7 August 2024 letter to the EA requesting urgent action through a proposed Code amendment.

84. HoustonKemp found that:

    a. New electricity generation in New Zealand is projected to be delivered predominantly by variable renewable energy sources, ie, wind and solar. The electricity output from these sources is neither predictable nor controllable, so that production cannot readily be targeted towards periods of high prices. By consequence, the output of such forms of generation are of inherently lower value than those forms that are relatively more predictable and controllable.

    b. The only retailers that will take on the risk of providing price commitments (ie offtake arrangements) to variable renewable energy generators are inherently those that either own, or have access to contracts that are backed by generation sources that are predictable and controllable (eg thermal and hydroelectric).

    c. *"The development of demand side management arrangements and the related capability of consumers to adjust their immediate energy demand is unlikely to be a sufficiently close substitute to obviate the underlying, substantial requirement for risk management*

[43] IP Ch 3, para 7.3; See also Ch 4, 5.41(c).
[44] IP, Ch 4, para 5.29.
[45] *cf* the EA's Market Share Snapshot between 2020 and present [Electricity Authority - EMI (market statistics and tools)](#).

*backed by predictable and controllable forms of electricity generation. Access to the inherently higher value, risk mitigation properties offered by such dispatchable generation sources is therefore essential for the successful integration of variable renewable generation sources into the electricity system.*"

d. *"This presents a challenge for the future development of New Zealand's electricity system because:*

- *dispatchable sources of renewable generation are almost entirely owned by the four incumbent gentailers and there are substantial barriers to the entry of such sources in the future; and*
- *access to contracts that share some of the valuable, risk mitigation properties offered by dispatchable sources of generation are not widely available – the only type of hedging contracts that are widely available in New Zealand are baseload contracts, which do not encapsulate these risk mitigation properties.*

*It follows from these observations that, without greater access to hedging contracts that share the risk mitigation properties of dispatchable generation, the financeability of new variable renewable energy sources will typically require that they be developed by, or enter into offtake arrangements with, one or more of the four incumbent gentailers.*

*If sustained over time, this situation will worsen the current withering of competition and the lack of development of new generation capacity to be delivered when needed and at least cost."*

**iii. Vertical integration can often be harmful:**

85. The EA often presumes the efficiencies (benefits) of vertical integration as a starting point without testing the evidence on this and without giving proper weight to its potential countervailing inefficiencies (negatives). For example, vertical integration can:

a. hinder competition in related markets;

b. cause vertically integrated firms to underinvest in infrastructure (incentivised to not invest)

c. allow vertically integrated firms to exercise market power by raising prices (eg by withholding capacity);

d. lead to thin contracts market exposing retailers to wholesale price volatility deter entry / expansion;

e. increase risk of foreclosure;

f. create informational asymmetries (including with the regulator which makes it difficult to monitor and find misuse; also creates further entry barriers and reduces confidence in markets resulting in loss of investment); and

g. cause a chronic lack of liquidity.

86. The efficiencies that can be derived by the gentailers from vertical integration seem almost entirely financial or risk management based (ultimately a byproduct of high transaction costs because of a poorly designed and immature contracts market), rather than productive efficiencies. Benefits are also not clear cut with risks of harming competition - we refer to the comments by Ofgem at para 71. We urge the EA to properly consider the competitive effects

and optimal market design without placing undue weight on unquantified and ill-defined vertical efficiencies.

87. The thinning of contract markets (which we see present today and should be considered more carefully) are hallmarks of a misuse of market power by vertically integrated incumbents who are disincentivised to trade leading to low levels of liquidity (which act as a barrier to entry and expansion). This is an issue that the European Commission recognised in its enquiry into EU gas and electricity sectors:

"*electricity generation assets are in the hand of a few incumbent suppliers…giving the incumbents control over the essential inputs into the wholesale markets. Low levels of liquidity are an entry barrier to both gas and electricity markets*."[46]

### 5. Timeframes / EPR Recommendations

88. The NZCC has an 8-week statutory timeframe for de novo merger clearances (which includes market definition and competition assessment and determination for industries the NZCC will not "know").[47] Similarly its market studies have taken 12 to 16 months when it has had no particular industry expertise. By contrast, the EA has been made aware of these issues since the EPR made its recommendations in 2019. The EA's assumption that the EPR's recommendations have been satisfied is disingenuous given many of those recommendations have not been fully implemented and/or the anticipated effects have not happened. The EA knows this yet implies the recommendations were implemented which is wrong. For example:

   a. only base-load hedge products have been listed on the ASX (with limited liquidity and high transaction costs);

   b. The EA has now acknowledged that its implementation of ITP has been of limited benefit; and

   c. There remains limited OTC hedge product availability (the purpose of this RMR).

## C. Benchmarks & factual points

89. We do not consider that simply measuring response rates to RFPs is an adequate measure of hedge market competition. We consider that a 50% conforming response is poor, given non-price terms may be disadvantageous. Over time retailers would request less RFPs as they would expect to receive either unfavourable terms or non-conforming responses.

90. Even if offered pricing is nominally reflective of competitive markets, there are a number of ways that supply can be constructively withheld from including non-conforming offers (eg providing an offer for baseload when super-peak is requested) and onerous credit terms and requests for financial information disclosure which are misaligned with the risk of the trade.

91. There is still evidence that should be treated as highly concerning and enough to justify the need for a robust access regime / separation. This includes a low commitment to any RFP response (even non-conforming), low trade completion rates and the offer of consistently lower volumes than those requested.

92. We expand further on our other views of the RMR assumptions and conclusions in **Annex A**.

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[46] See 20 of European Commission, Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and Electricity sectors (Final Report) COM(2006) 851 (**EC Art 17 Inquiry into European gas and Electricity sectors Final Report**).

[47] Given the NZCC's view that the EA as the electricity industry regulator should be more efficient than the NZCC.

## D. ITP

93. The IP describes the ITP as largely an administrative burden suggesting it is merely "*a regulatory requirement of limited, if any, benefit*". While we appreciate the EA's recognition of previous submissions by the IERs and other stakeholders that the current ITP does not provide any meaningful value, the EA should not ignore (and should focus on) the original intended purpose of the ITP regime.

94. The purpose of ITP was following the EPR's recommendation to address transparency issues with determining incumbent gentailer self-preferencing (which should be a key focus in the IP but is ignored / potentially downplayed as gentailers prioritising their own usage). By ignoring the original purpose of ITP, the EA's conclusion is concerning and takes a view that could have been written by an incumbent gentailer.

95. The EA has identified self-preferencing but has not considered if this has a negative impact on competition. It also sets an unreasonable evidentiary burden of requiring a definitive finding of exercise of market power by the incumbent gentailers before it is willing to engage in separation. The OECD, Ofgem/CMA show that, if anything, the inability for the EA to penetrate this lack of transparency is evident in the ITP and suggests that corporate separation would be a sure way to address such issues (including the risk that such exercises of market power remain unnoticed).

Yours sincerely,

| | | |
|---|---|---|
| Emma-Kate Greer<br>Chief Customer Officer<br>[redacted] | Huia Burt<br>Chief Executive Officer<br>[redacted] | James Leslie<br>Chief Financial Officer<br>[redacted] |
| Margaret Cooney<br>Chief Operating Officer<br>[redacted] | | |

**ANNEX A: Comments and responses to assumptions and conclusions made**

| Reference | Risk Management Review assumptions/conclusions | Comment/Response |
|---|---|---|
| | **Electricity retail market competition context** | |
| Chapter 1, para 1.1 | Competition in the electricity retail market is critical to achieving better choices and more affordable electricity for consumers. … | Agreed. This statement aligns with the Government Policy Statement on electricity (GPS). The GPS has a heavy and repeated emphasis on competition including that "Effective competition is essential".[48]<br><br>The GPS recognises the central role of competition as a means to "affordable energy at internationally competitive prices" and "for our electricity system to deliver reliable electricity at the lowest possible cost to consumers." |
| Chapter 1, para 1.1 | An important enabler of retail competition is the availability of efficient risk management options for electricity retailers. Mass market retail customers are largely on fixed price variable volume contracts, so retailers need risk management options, such as over-the-counter hedge contracts (OTC contracts), to manage the price risk that arises from wholesale spot market volatility. | Partially agreed.<br><br>Except independent retailers (access seekers) need access to workably competitive liquid hedge markets provided by the incumbent gentailers (access providers) in order to compete on a level-playing field. |
| Executive Summary, page 2. | If efficient risk management options are not available, we would expect to see less competition, which would reduce the choices available to those consumers, and reduce the downward pressure on prices that is a key outcome of workable competition. | If the reference to "risk management option" is **replaced** with **a proper product market/s description of relevant hedge products**, we would agree. (See our comments in the submission on the improper framing & lack of context.)<br><br>This is the problem the electricity industry currently faces. Problems in the wholesale market "and have flowed through into the electricity retail market – exacerbated by the lack of adequate hedging supply – which has resulted in competition stalling or declining.<br><br>As the EA web site notes "*The hedge market is a **key part of the wholesale market**".* |
| Chapter 2, Para 4.8(c) & 4.20 | Medium retailers are overrepresented (compared to their market share) in the disruptive, architectural and radical innovations. … we are | Agreed to an extent.<br><br>While it is good to see the EA is considering innovation, its approach is not scientific. |

[48] Statement of Government Policy to the Electricity Authority under section 17 of the Electricity Industry Act 2010: New Zealand electricity industry, October 2024.

| Reference | Risk Management Review assumptions/conclusions | Comment/Response |
|---|---|---|
| | satisfied that at a general level other retailers, apart from the gentailers, have an innovation role to play, including by keeping the pressure on gentailers to innovate. | The approach also risks being seen to be picking " winners", and by extension "losers". It is not the role of the regulator to pick 'winners' and we are concerned that the EA is ranking market players and their perceived quality / contribution to the market and consumers.<br><br>This analysis only looks at one element of the benefits that independent retailers offer to consumers and competition; including by providing greater choice and lower (than otherwise) prices.Independents (whether generators or retailers) compete on price, quality, service and innovation<br><br>We are asking for the market settings to be right so that there can be workable and effective competition "on the merits". |
| | **Composition of the electricity retail market** | |
| Chapter 2, para 3.1 | New Zealand's electricity retailers, based on market share, break down into three broad groups: (a) Large retailers in blue (100,000+ ICPs) (b) Medium retailers in green (10,000 – 99,999 ICPs) (c) Small retailers in red (less than 10,000 ICPs). Other retailers are those with less than 1,000 ICPs. | See comments above re concerns about the EA ranking market players.<br><br>The NZ electricity market has 4 large (vertically integrated) electricity retailers, 0 medium sized retailers with the majority either small or very small.<br><br>The absence of medium-sized retailers highlights that the electricity retail markets have remained stubbornly concentrated over the last decade or so.<br><br>This can be contrasted with market share changes over time in workably competitive markets |
| Chapter 2, page 6. | Market share of medium and small retailers has plateaued since 2021 | With workable and effective market conditions the outcomes would have been better.<br><br>On any reasonable or objective metric, retail competition has stalled or gone backwards over the last several years.<br><br>We have detailed these issues, including quantified evidence, in various submissions over the last several years. For example, to recap (updated) from our submission on the 2024/25 appropriations:<br><br>• Between 2003 and August 2018, just 4 electricity retailers had exited the |

| Reference | Risk Management Review assumptions/conclusions | Comment/Response |
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| | | market. Between August 2018 and September 2024 another 24 exited.<br>• Independent retailer market share has stalled around 11% since May 2021.<br>• HHI for the overall NZ electricity retail market is about the same as it was in January-February 2020.<br>• CR1 is about the same as September-October 2021. CR2 is about the same as October-November 2019. CR3 is about the same as August-September 2018. CR4 is about the same as it was in August-September 2017.<br><br>Competition problems became more obvious following the Pohokura outage.<br><br>The period around the Pohokura outage is notable for further drops in switching rates from around 8% down to 6% and substantially lower for SME, commercial and industrial consumers. The switching rates for residential customers appears to have stabilised at a new low level around 6%, but the switching rates for SME, Commercial and Industrial customers are continuing to decline and are now around the 2% level.<br><br>The drop off in switching rates was reflected in the rate of growth of independent retailer market share coming to a halt and reversing - stalling around the 11% level early in 2021 with periods of decline since then.<br><br>With growth independent retailer market share essentially grinding to a halt, retail market concentration statistics have either flatlined or deteriorated.[49] |
| Chapter 2, para 3.11 | While it likely masks some complexities, this simple market composition analysis indicates:<br>(a) There do not appear to be material barriers to entry into the retail electricity market<br><br>(b) Barriers to expansion by new entrants are worth considering (from a retail competition perspective). ... | We previously commented that the barriers to entry in the electricity retail market are low - reflected in the large number of retailers in the market - but the barriers to growth and competition are high (reflected, for example, in (i) the low level of growth by independent retailers; (ii) the very small size of most independent retailers/new entrants; and (iii) the high level of exits from the market). |

[49] Refer to the section There is clear evidence retail competition has stalled and deteriorated.

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| | | However, given ongoing structural issues and strategic conduct there may be other barriers to entry. |
| | **Non-integrated retailers have raised competition concerns** | |
| Chapter 1, para 1.18 | This review does not specifically focus on retail pricing. We have not, therefore, made any preliminary findings relating to whether there is a margin squeeze. | There are a number of elements to the problem including price squeeze issues (not addressed by the Risk Management Review) and issues with access to base-load and peak/flexibility products. There are also issues with lack of liquidity for all types of hedge products and lack of liquidity for long-term hedging products forces independent retailers into more short-term (1-3 year) higher risk hedging. Independent retailers need to be able to access longer-term hedges to be able to fully divorce from short-term spot prices.<br><br>The segmented approach taken by the EA risks overlooking the broader legal and factual context which leads to the narrow framing of issues such that the solutions do not address broader competition issues. |
| | **Risk management can be thought of as a form of insurance** | |
| Chapter 3, para 5.4 & 6.9 | … risk management can be thought of as a form of insurance. The party transferring the risk pays a "risk premium" to offload that risk.<br><br>… As volatility increases, the suppliers of hedges take on increased risk.<br><br>… This implies that any supplier of risk management products … will … charge a higher risk premium to do so. | The use of the "insurance" analogy should be treated with caution. Each framing and reframing moves us further away from the core issue which is the lack of liquidity and hedge markets.<br><br>The EA would be better placed to take a proper economic analysis of the markets considering hedges as an essential input critically related to the spot market.<br><br>The usual understanding of insurance – as described in the RMR paper – is a unilateral trade where the insuree pays the insurer to protect against risk.<br><br>The hedge market is different. It provides a two-way protection for both the generator /trader(providing a revenue guarantee) and the retailer (protecting against price volatility).<br><br>We have concerns about an insurance analogy as it leads to the incorrect approach of ignoring the basic fact that hedges are an input to supply.<br><br>If the insurance analogy is to be used, the generator and retailer should both be thought of |

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| | | as simultaneously being the insuree and insurer – rendering obsolete the concept of a "risk premium". Essentially, hedging products allow access seekers and access providers to swap risk.<br><br>In short, we treat this analogy with caution and consider it detracts from the proper analysis, and we retiterate that a proper analysis should be adopted consistent with the EA's website. |
| Chapter 3, section 7 | Gentailers have an efficient hedge against this volatility | This is unsubstantiated and not consistent with workable or effective competition standards. Nor does it consider the harms.<br><br>We are not aware of any analysis that suggests that providing hedging in-house is more efficient than use of market-based / 3rd party arrangements.<br><br>We refer to our earlier points on international best practice (OECD, OFGEM/CMA etc) where vertical integration has been shown to have anticompetitive effects and separation was considered a necessary solution.<br><br>We consider that the concerns the EA has raised about electricity distributors providing services in-house rather than through 3rd party arrangements and competitive tender – including that they may have a bias in favour of self-supply even if this may not be the least cost option – should be considered to have direct parallels with incumbent gentailer vertical-integration i.e. the Authority has not accepted electricity distributors providing services in-house is most efficient and they should not assume gentailers doing the same with hedging is either. |
| Chapter 4, para 2.10 | When considering the degree of substitutability between different risk management products, we must be careful to keep in mind that the relatively close substitutability we currently observe in the market between OTC super-peak hedges and other products could merely be reflective of the exercise of existing market power by the providers of OTC super-peak hedges. If prices for these hedges are currently | We remain concerned that despite some caveats, complements and non-functional substitutes are treated as full substitutes.<br><br>The EA is correct to identify the risk of the cellophane fallacy here, however, it is confusing that the IP then does not give this much weight when considering the substitutability of hedges (we say hedges here because we do not consider demand side management to be a substitute to an input). This accords with our real-world experience. |

| Reference | Risk Management Review assumptions/conclusions | Comment/Response |
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| | higher than competitive levels, industry participants may be making substitution decisions that would not be reasonable were prices for these hedges instead at competitive levels (ie, lower). Accordingly, in a workably competitive market for hedges, the substitutability of these alternative options may be lower. | |
| | **What the evidence told us** | |
| Executive Summary, page 2 | There are several close risk management substitutes for an OTC contract-based portfolio (baseload hedges and any super-peak hedges, peak hedges or caps) eg, baseload hedges combined with one of battery renting, demand response or retail tariffs. However, these alternative options are only starting to be deployed in the New Zealand market, so may not yet – and perhaps for a few years – be able to discipline the prices of shaped OTC hedge contracts. | Incorrect. We disagree (fundamentally on an economics principle basis) with the EA's view that demand side management is a substitute for an essential input. As the EA itself on its website correctly defines, the hedge market is a key part of the wholesale market without which both retailers and generators would be exposed to the volatility of the spot market.<br><br>The recognition that many of these risk management options are (1) not currently (and not expected to be for a while) deployable in large quantities and (2) nevertheless still reliant on gentailers to support as the firming of risk relies on dispatchable generation which the gentailers predominantly own. |
| Executive Summary, page 2 | Retailers to date have been able to secure substantial shaped hedge cover through OTC contracts, but the market for shaped cover is neither deep nor liquid. Over a third of the time retailers only receive one offer to requests for shaped hedges. | We disagree with this conclusion. The market for all forms of hedging contracts in the NZ electricity market is neither deep nor liquid. No evidence is included in the Risk Management Review that would indicate liquidity issues are limited to shaped products (scarcity of supply includes generation). |
| Executive Summary, page 2 | The evidence points to fuel or capacity scarcity often being the driver behind the current thin and illiquid market for shaped hedge cover. | Scarcity is a function of not having workable and effective competition in markets throughout the supply chain. This is an excuse used by some gentailers to obfuscate the reasons for refusal to supply/or to otherwise limit access by 3rd path retailers.<br><br>However, given that gentailers are the best placed to invest in new generation to increase generation supply we would expect that the EA considers that the framing of issues must include the broader context. This would naturally lead to the view that there is an underlying problem that |

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| | | affects both generation and hedge markets due to market power. |
| Chapter 4, page 4 | We have found no evidence of unjustifiable discrimination in the pricing of OTC contracts | Failure to find evidence is arguably evidence that the EA has not investigated adequately. Given such market structure, we would find other regulators and courts to expect self-preferencing.<br><br>The IP notes gentailer self preferencing supply but does not interrogate this. The EA would need to look at retail pricing behaviour to determine if this is 'unjustifiable' or not. This has not been done. The IERs believe this behaviour is unjustifiable.<br><br>Given such market structure, we would find other regulators and courts to expect self preferencing.<br><br>The question we pose is why the EA would think the incumbent gentailers would not act in their self interests (and implies the incumbent gentailers would default to charitable behaviour)?<br><br>The fact of discrimination should not be justified. The very reason for adopting international best practice (which the EA seems determined to avoid) is because of the evidential challenges and the expectations of rational economic behaviour of when parties have incentives to discriminate.<br><br>Just because certain conduct is "rational" does not mean it is efficient or consistent with the promotion of competition. |
| Executive Summary, page 2 | Our analysis indicates that the prices for OTC baseload and peak hedge contracts are likely to be competitive. … | The IERs do not consider the EA has provided a reasonable or sound basis for the claim "Spot prices are competitive" or that this is supported by its monitoring of "spot market behaviour against the new trading conduct provisions."<br><br>The EA has previously explained why trading conduct monitoring can only imperfectly detect exercise of market power, regulators have imperfect information and determining whether prices reflect workably competitive markets requires subjective judgement e.g. in relation to risk of future hydrology and rainfall. This does not provide a sound or certain basis for an |

| Reference | Risk Management Review assumptions/conclusions | Comment/Response |
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| | | unqualified claim that "Spot prices are competitive".<br><br>The EA previously noted trading conduct monitoring has limits in the extent to which it can detect exercise of market power: "While the new rule is designed to address both transitory and sustained exercise of market power, the nature of any sustained exercise of market power alongside the data available for the wholesale market may mean that <u>the only impact of the new rule may be to temper extreme behaviour</u>. That is, the new rule may have no effect on the exercise of market power that occurs at the margin, as it is difficult to detect this." [emphasis added][50]<br><br>In a similar vein, the EA has noted "monitoring may not be able to detect more subtle exercises of significant market power" and "Monitoring has its limits as a tool for mitigating the exercise of market power. Regulators must work with imperfect information. Traders have very strong incentives to design ever more sophisticated trading strategies and, as noted earlier, even small changes in offers can have a large effect on prices. For example, economic withholding and conserving high opportunity cost water can look the same. Opportunity cost is essentially subjective, as people can take different views on what the future will bring and apply different risk preferences." [footnote removed][51]<br><br>We agree with Octopus Energy that "If the EA wants to establish the extent to which the wholesale market resembles a workably competitive market it should, at the very least: (i) update its WMR analysis; (ii) address the "uncertainties" it was concerned about in the WMR final report; and (iii) analyse incumbent generator (gentailer) profits."[52] |
| Executive Summary, page 2 | ... However, we could not reach the same conclusion for OTC super-peak hedge contract prices as they trade at a substantial unquantified | It is implausible that prices in the spot and OTC markets are competitive or that non-competitive prices could be limited to super-peak products. It is the same significant and/or substantial market power that gentailers can (ab)use in relation to super-peak products that they can exercise in |

[50] Electricity Authority 2022, Post Implementation Review..
[51] Electricity Authority, Promoting competition in the wholesale electricity market in the transition toward 100% renewable electricity Issues Paper.
[52] Octopus Energy, Reply to Letter from Chair of the Electricity Authority and Chair of the Commerce Commission- Measures to a ensure level playing field for competition, 31 July 2024.

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| | premium over ASX baseload prices adjusted for shape. | the spot and OTC markets (given interdependencies of each market). |
| | **Is market power impacting on risk management?** | |
| Chapter 1, para 2.1 | For a gentailer to hold substantial market power in relation to risk management, we consider a number of conditions need to hold true:<br>(a) Shaped hedge contracts are a necessary aspect of efficient peak time risk management<br>(b) Having flexible generation and fuel is a pre-requisite to sustainably offering those shaped hedge contracts<br>(c) There are high barriers to building new flexible generation capacity for all participants, including gentailers<br>(d) Gentailers have the ability and incentive to individually influence the price or supply of hedge contracts, for reasons other than fuel scarcity, despite there being other suppliers and/or substitutes. | The EA in the IP appears to have deliberately and incorrectly defined the market which is inconsistent with the own approach it takes to hedge markets on its website and evidence of economists in the past. It is clear that the incumbent gentailers have market power in the supply of hedges.<br><br>Not all risk management is substitutable for an input.<br><br>We do not think the EA should or needs to focus exclusively on substantial market power. The EA has pointed out the "focus in this review is different to – and broader than – the misuse of market power test under the Commerce Act."<br><br>However, in its 22 May 2009 Investigation Report the Commerce Commission concluded: "*the four main generators…have a substantial degree of market power in the wholesale electricity market*." The Report was subsequently peer-reviewed by Von der Fehr who confirmed those findings. Similar views were reached by Oliver Browne, Stephen Poletti & David Young.[53]<br><br>Both MDAG and the EA concluded that "some generators are frequently pivotal and have the ability, and incentive, to exercise significant market power that has an economically inefficient outcome." [54] The EA considered "accurate" MDAG's observation that "… at various time and locations, parties have the ability and incentives to exercise significant market power in the New Zealand spot market. Generators are frequently gross pivotal across wide areas of the spot market."[55]<br><br>The EA, in its Wholesale Market Review (WMR) reports (2021 and 2022), noted high wholesale prices in recent years reflect gas supply and other market uncertainties, but also some evidence of market power being exercised. |
| Chapter 1, para 2.2 | For the purposes of this analysis we accept that the first three of the conditions above can be satisfied at this point in time, … On balance though, we consider that: (a) The evidence is mixed in relation to whether the fourth condition is satisfied for unilateral substantial market power; (b) We have not seen any evidence to suggest that coordinated market power is being exercised. | |

[53] Oliver Browne, Stephen Poletti & David Young (2012): *Simulating market power in the New Zealand electricity market,* New Zealand Economic Papers, DOI:10.1080/00779954.2011.649566
[54] Electricity Authority, Wholesale markets - Trading conduct Decision Paper, 1 June 2021.
[55] Electricity Authority, Wholesale markets - Trading conduct Decision Paper, 1 June 2021.

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| | | Much of the EA's WMR findings and analysis are directly relevant to the RMR and whether there is evidence of significant and/or substantial market power (and the use of that market power in hedge markets to the detriment of not just retailers but also generators).<br><br>There are various other reviews and analyses the EA has undertaken which provide evidence there is either significant and/or substantial market power, including from the November 2019 UTS decision. |
| | **Notwithstanding substantial evidence, key uncertainties remain** | |
| Executive Summary, page 3 | In drawing together our preliminary findings we encountered some key uncertainties:<br><br>• While the evidence points to scarcity, it did not definitively show why some gentailers sometimes elected not to respond to requests for proposals for shaped hedges, or why some gentailers provided non-conforming responses. | Scarcity issues may have exacerbated problems in the electricity market, but they don't change that the underlying problem is a market power/weak competition problem. As noted, scarcity reflects a lack of workable or effective competition. |
| Executive Summary, page 3 | • Nor could we determine from evidence whether the prices of OTC super-peak hedges were consistent with competitive prices, and whether the increase in OTC super-peak prices (as a percentage of ASX baseload prices) that we observed over the assessment period is justified. | It is implausible that prices in the spot and OTC markets are competitive or that non-competitive prices could be limited to super-peak products. It is the same significant and/or substantial market power that gentailers can (ab)use in relation to super-peak products that they can exercise in the spot and OTC markets (given interdependencies of each market).<br><br>Again, this goes to the need for the EA to consider the holistic context to frame the IP to account for such market conditions. |
| | **Context matters – the sector is changing** | |
| Chapter 1, page 3 and para 1.4 | Wholesale market volatility will continue … increasing wholesale market volatility will drive increased demand for risk management options, as retailers seek to manage their increased risk, … | Agreed. But if supply increases this will reduce that volatility. |
| | … while at the same time it may become more difficult to supply OTC contracts and other risk management products that | The EA has not provided any evidence to substantiate this claim. We consider that it would be no more difficult to provide hedging to 3rd party retailers using market-based |

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| | meet retailers' needs, as the generation mix changes. | mechanisms than it would be to provide in-house to their own retail businesses.<br><br>This goes to the importance of the framing (workable and effective competition) of issues present. The scarcity of supply and reliance on gentailers to firm intermittent generation should not be ignored when considering that hedge products are an essential input to reducing the risk of volatile spot prices (which we expect will worsen as the proportion of intermittent renewable generation increases).<br><br>If the EA was to reduce barriers to entry and increase competition the supply side will not expand to the 50%-80% needed. |
| Executive Summary, page 3 | There is a substantial change occurring in the sector ... This context – more demand for risk management; relatively less flexible generation to back hedge contracts; viable risk management substitutes still developing – is highly relevant in the short and medium term. That is, all other things being equal, these three aspects will likely impact retail competition, and therefore choice and price for consumers, during the next few years at least. | The impact on retail competition will depend on the extent to which the EA addresses the broader problems in the electricity market; including in relation to the level of competition/market power in the wholesale market and access to (and overall supply of) hedging products needed for a level playing field / so that independent suppliers can compete. |
| | **There is a risk that the Authority should respond to** | |
| Executive Summary, page 4 | ... there is also a plausible driver that has competition implications, eg, refusing to supply products on appropriate terms to counterparties who are downstream competitors, indicating that some level of market power could have been in play. | Agreed in so far in that there needs to be a liquid hedge market. But disagree with input that is functionally and economically different.<br><br>This is more than a "plausible driver" and is the underlying market failure that needs to be addressed (goes to the framing/context issues in the IP). The electricity industry faces the classic competition problem where the access provider – that competitors need to obtain services from in order to compete – also competes in the same markets. This problem can exist regardless of whether the access provider has a monopoly or is an oligopolist provider of the service. |

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| Executive Summary, page 4 | It would be prudent to progress on the basis that the availability and pricing of shaped hedges, as part of any risk management portfolio, currently matters and will continue to matter in the medium term. | Agreed, but the EA should not make prior assumptions that access will only be needed in the short to medium term.<br><br>We expect that these issues may even worsen in the long term as spot price volatility increases as intermittent non-dispatchable generation grows (proportionally). |
| Executive Summary, page 4 | It would support retail competition in the short to medium term (ie, at least during this period of change) to deepen and increase the liquidity of OTC hedges, and increase price transparency for shaped products. | Agreed, but the EA should not make prior assumptions that access will only be needed in the short to medium term.<br><br>We expect that these issues may even worsen in the long term as spot price volatility increases as intermittent non-dispatchable generation grows (proportionally). |
| Executive Summary, page 4 | Any strengthening of the market for shaped hedges must not, however, get in the way of all retailers being incentivised to develop and invest in other risk management options (including demand response and tariff options; investment in batteries), and participating in other emerging flexibility initiatives. We expect that both gentailers and non-integrated retailers will contribute to the development of these options, and that development will be faster in a more diverse retail market. | Independent retailers are seeking a level-playing field where we have non-discriminatory access to hedge products needed to compete.<br><br>It is not apparent that this would give rise to artificial distortions against other options where they are efficient. |
| Chapter 8, para 5.2 on | In this section, we discuss key criteria that might be required for any policy intervention in the risk management space, flowing from the evidence and analysis in this review. ...<br>• cut through the complexity of the market on both the supply and demand side<br>• ensure incentives for participating in all types of risk management are maintained – demand response, syndicated batteries, Huntly firming options etc | The independent retailers consider that the criteria should be stripped back to whether/how well the policy options promote competition in the electricity industry (including addressing broader regulatory or market structure failures).<br><br>The EA should not be scared to be an active regulator in enacting change that is necessary and desirable.<br><br>There is nothing in the criteria related to reliable access and supply of hedging products. We consider this is important as hedges are an essential input to retailers and the absence of this critical input increases barriers to entry / expansion. |

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| | • ensure incentives for investing to supply risk management options are maintained<br>• ensure risk management options that have alternative uses – demand response, batteries – have access to other markets to help make them economic for risk management<br>• consider ability to supply, which in turn relates to fuel supply conditions<br>• ensure transparency for pricing methods, and be able to validate pricing outcomes<br>ensure transparency around market prices and quantities is ongoing and timely | We consider that the proposed criteria is unduly convoluted and more likely to provide false negatives – resulting in options that would best promote the EA's statutory objective being rejected. |

**ANNEX B: Appendix 3 from 7 August 2024 IERs letter to the EA**

# Appendix 3: EPR and MDAG conclusions about the state of the market

96. There have been a number of reports, working groups, EA projects and commentary about the issues in the wholesale and retail electricity markets. For the purpose of this letter, there are two key reports that provide context and support for the IERs' position that urgent structural change is now necessary:

   a. Electricity Price Review (**EPR**) Final Report[56] dated 21 May 2019; and

   b. MDAG: Price discovery in a renewables-based electricity system – Final Recommendations Paper[57] dated 11 December 2023.

**EPR**

97. The EPR report made a number of conclusions and recommendations, including in relation to the wholesale market. The recommendations included disclosure obligations on the gentailers regarding their internal transfer prices and gross margins, and mandatory market making obligations.

98. While some of these recommendations have been implemented to various degrees, the implementation of the recommendations has not achieved the desired outcomes (for example, the recommended market making obligations were implemented only in relation to baseload contracts, and not peak and cap products).

99. The EPR report identifies a number of problems in the wholesale market, consistent with the ongoing concerns expressed by the IERs. These problems continue to persist in the market.

100. Regarding separation of generation and retail businesses, the EPR noted:

> *P.41: "We do not favour the option of forcibly separating the generating and retailing activities of vertically integrated businesses. We consider the benefits of vertical integration outweigh the costs, even after the costs of promoting competition in a vertically integrated industry are included…. However, the benefits of allowing vertical integration should be shared more widely – hence our recommendation for mandatory market-making."*

101. However, it is also noted:

> *"If our recommendations do not result in the intended improvements, more far-reaching measures may be needed, such as options we did not favour."*[58]

102. The EPR report was released 5 years ago. Despite the implementation of some of the EPR's recommendations, the lack of competition in the wholesale market has only increased, mandatory market-making provisions have not resulted in any meaningful change, and the benefits of vertical integration have not been shared more widely. It is clear that the intended

[56] Electricity Price Review: Final Report (mbie.govt.nz): See *Section D: Reinforcing wholesale market competition* (pp41-)
[57] Appendix_A2_-_Final_recommendations_report.pdf (ea.govt.nz)
[58] (fn 7 in EPR Report): See our options paper for these options, which included retail price caps, splitting vertically integrated companies and requiring small distributors to amalgamate.

improvements have not resulted and therefore, it is time to revisit the more "far-reaching measures", such as structural separation.

## MDAG

103. In the MDAG report, the group noted that the key pillars of a well functioning wholesale electricity market are:

a. Accurate pricing;

b. Tools to manage risk;

c. Competition; and

d. Public confidence.

104. It is clear from the report that they do not consider that the electricity markets are currently functioning well, and the transition to renewable sources will only increase the market power of the gentailers and slow our progress towards decarbonisation. Relevant statements include:

*6.18 "our system will be more sensitive to the weather…Spot prices will become more volatile… we do need to make sure participants have access to the necessary tools to manage and mitigate increased spot price volatility."*

*7.26 "A thinning of competition for flexibility products could tear at the fabric of the broader market. That is because flexibility products provide a critical bridge to integrate intermittent supply into products suitable for retail consumers. Put simply, weaker competition for flexibility products could also undermine competition in the retail and new investment markets."*

*7.27 "Our view is that the risk of declining competition for longer-duration flexibility contracts must be proactively managed – rather than adopting a 'wait and see' approach."*

105. The report made a total of 31 recommendations including:

a. A requirement for hedge market transparency;

b. Market making obligations for flexibility products;

c. Development of a competition dashboard.

106. MDAG recognised the need for flexibility (hedge products):[59]

*"Flexibility products are becoming increasingly important as the system shifts to renewable generation sources but there is no market-making in this type of contract."*

107. There has not been any urgency in implementing the MDAG recommendations and the risks identified by MDAG are already playing out, including the decline in retail competition and a lack of investment in new generation. Many of the issues identified by MDAG are the same as

[59] MDAG: Price discovery in a renewables-based electricity system – Final Recommendations Paper dated 11 December 2023, recommendation 24

those identified in the EPR and the EA cannot afford to wait a further 5 years before taking action.