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Electricity Authority

By email to: levelplayingfield@ea.govt.nz

Tēnā koe

Response to "Non-discrimination obligations: Retail Price Consistency Assessment, uncommitted capacity and other matters"

Contact Energy welcomes the opportunity to comment on the Electricity Authority's consultation paper *Non-discrimination obligations: Retail Price Consistency Assessment, uncommitted capacity and other matters*.

In this covering letter we raise five key matters:

1. Support for the proposed change away from the concept of uncommitted capacity
2. Proposing that the RPCA becomes a disclosure-only regime as it is not reasonable to hold us to account for matters outside of our control
3. Highlighting the risks to consumers of the proposed segmentation
4. A request for greater clarity on the relationship between sales of OTC risk management contracts and the internal energy cost used for the RPCA
5. Highlighting the continued confusion about the role of market power in this regime.

We have also provided a brief summary reminder of the other material concerns we raised with this regime in our last submission that are not yet addressed in this consultation.

Attached to this letter are full responses to the consultation questions.

We support the proposed change away from uncommitted capacity

We support the proposed option 2 approach of shifting away from uncommitted capacity and focussing on 'risk management contracts'. However, we remain confused about the continued focus only on our generation capacity rather than our full portfolio, including hedges we have bought off other participants, ASX trades, etc. This is not reflective of the way we run our business. We frequently augment our generation capacity with other trades, demand response contracts etc.

We also agree that it is in our interests to offer risk management contracts to all reasonable requests from third parties, except in rare cases where it would put us in an 'intolerable risk position'. We are comfortable that we will be able to provide evidence of this via our risk tests to demonstrate when an intolerable risk position emerges.

However, we recommend a further change to the proposed record keeping requirements to better reflect industry terminology. This is set out in response to question 7 in the attachment.

The RPCA cannot be a compliance regime

We recommend that the Authority adjusts the RPCA to be a disclosure only regime. This is because the key measures disclosed under this regime are out of the control of the disclosing parties. Any attempt at enforcement may therefore breach a reasonableness test as there is no action a non-compliant party can take to become compliant. Disclosing organisations must rely on broader changes to market conditions, which cannot be a basis on which to enforce penalties.

The RPCA consists of three key metrics, none of which can be changed by the disclosing party to improve the resulting margin figure:

1. **Retail revenue.** Prices in the retail market are set by competition, not by individual participants. We agree with the Authority that it would be a poor outcome if this regime resulted in price increases for consumers.[1] We therefore do not consider that the regime should be designed by assuming increased retail prices are necessary for compliance.
2. **Non-electricity costs.** These must be set using principled cost allocation methodologies. We seek to be efficient in these costs, so it is unlikely that there will be room to reduce these costs further to improve compliance with this regime.
3. **Costs of electricity.** No one participant sets the wholesale costs of electricity. The cost of electricity in the RPCA is likely to consist of two main parts:
    a. **Short-term** costs of electricity - The consultation paper notes that short term costs of electricity (up to 3 years out) could be based on a simple combination of baseload and standardised super-peak

[1] Para 3.65(f).

hedges. This was also demonstrated in a recent paper by Concept Consulting for the Authority.[2]

b. **Longer-term** costs of electricity – which are based on levelised cost of eelectricty (LCOE), informed by the cost of building new plant and fuel.

We do not consider it reasonable to assume that a participant to this regime has the power to change the futures prices or LCOE.[3]

The results of the RPCA will help inform the Authority and help direct their work programme. However, the tools to change the outcome do not sit with individual participants.

We also consider that this makes much of the requirements to justify the outcome of the RPCA redundant. We would simply be reporting on market conditions outside of our control that we have no special insight into beyond informed market observers and the Authority itself.

The proposed segmentation creates material market risks

We strongly disagree with the proposed segmentation. We are concerned that it may lead to poor outcomes for consumers.

Geographic segmentation

Hedges cannot be bound to a particular region. FTRs allow retailers to freely manage locational energy risks. Differences in margin between different regions will therefore purely be a reflection of retail pricing. Given the Authority does not expect this regime to affect retail pricing, we are unsure why it is proposing a focus on regional pricing decisions? We are unsure what the expected impact of this segmentation is?

Geographic segmentation will likely show that some NZ regions are cross subsidising others due to the different ability for customers in different areas to pay. We are concerned about the market signal this will send.

Segmenting new customers

We consider that the market dynamics for retaining retailers existing customer volumes are materially different than acquisitions to grow a customer base. It is unrealistic to expect large retailers to make a marginal decision based on the ability to monetise its existing customer base.

In times of high market stress, a simplistic model may show it is more efficient to stop replenishing customers lost to churn, and monetise the existing 'as if'

[2] https://www.ea.govt.nz/documents/8615/Appendix_D_Concept_report_-_cost_and_benefit_assessment.pdf

[3] While some other shorter-term risk management tools may also be part of the test, they are likely to be immaterial to the calculation compared given the volume of trades on ASX and the standardized superpeak contracts.

hedges. However, this does not take into account a dynamic response from other competitors and consumers.

- To stop acquiring new customers a retailer would need to increase in-market prices or withdraw offers.
- However, all other retailers would face this same incentive, and would respond in kind in a repeated game. That means that when the market is under stress, all in-market prices would be high, or not available.
- This would disincentivise churn as customers would be better off staying with their existing retailer
- This in turn would mean that retailers are unable to reduce customer numbers, and would therefore not be able to monetise their 'as if' hedges.[4]

While smaller retailers are able to change retail volumes in response to market conditions,[5] we expect that if Contact Energy attempted to carry out such a strategy, that we would be accused of profiteering, limiting competition and consumer choice.[6] It would also provide a confusing message to customers, and therefore not reflective of a long term retail strategy. It is therefore not an accurate reflection of the true market dynamics for large retailers who are mindful of the long-term impact such a strategy can have on brand and their social license.

Because of this dynamic, retailers will typically build a hedge book based on current retail numbers, with an expectation of churn in and out. In the short term, this hedge book is effectively a fixed cost as there is no expectation it can be easily monetised based on market conditions. This doesn't mean there is no competition, it just means we compete on our marginal cost to serve rather than assessing each new customer compared to the costs of the underlying hedge.

However, a retailer looking to grow its retail book will need to build (or buy) a hedge book to support this growth. This requires a more deliberate decision on whether the costs to hedge this growth can be recovered from customers.

We therefore recommend that acquisitions to retain existing customer volumes are not segmented out from the remainder of the base. This segmentation will materially increase the complexity of the disclosures, and does not appear justified given the market dynamics described above. However, it may be appropriate to provide additional reporting for instances where a large retailer is actively growing their customer volumes.

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[4] If the market stress is transitory, then competition would resume again when prices return to equilibrium. If the increased market costs are permanent, then ultimately a new equilibrium will be reached at a higher price point, and again the incentive to acquire new customers will remerge.
[5] https://www.stuff.co.nz/business/350354467/why-electric-kiwi-closing-new-customers
[6] https://www.rnz.co.nz/news/business/528381/households-still-hurting-from-wholesale-price-surge

Greater clarity is required on the relationship between OTC trades and the internal cost of energy

We are unsure what the intended relationship is between OTC risk management contracts we sell and the internal cost of energy we must use for the RPCA.

The guidance provides conflicting statements on the intended role of OTC contracts in setting our internal cost of energy:

- Paragraph A.2 states “The purpose of the RPCA is to test whether a gentailer is discriminating on the price of risk management contracts it makes available to independent retailers”. This implies a focus on OTC trades as the key data underlying the internal cost of energy.
- Paragraph A.37 states that: “all externally traded hedge contracts are relevant to the cost of electricity”. This seems to imply some sort of weighted average of all trades, including ASX, standardised superpeak, OTC, CFDs, PPAs, etc.
- However, paragraph A.82 implies a more narrow focus on “baseload [ASX] + super-peak hedges”
- Similarly paragraph A.90 also has a narrow focus on cases where “prices of its own risk management contract trades in the same period, and for similar risks, terms and tenor are materially different to those it assumes for pricing its internal supply”.

We consider that the broader requirement implied in paragraphs A.2 and A.37 is impractical. The vast majority of OTC risk management contracts purchased by independent retailers do not have “similar risks, terms and tenor” to those that a large retailer would purchase. We therefore cannot see how they could be included in the RPCA test.

Continued confusion about market power

In our last submission we highlighted that much of the logic of the non-discrimination regime relies on an unproven assumption of market power. This has not been addressed in the latest paper. The latest paper continues to contradict itself throughout on whether market power is a necessary condition, which has implications for the design of and compliance with the regime. For example,

- At paragraph A8 the draft guidance says that the RPCA “does not require proof of substantial market power”
- However, at para A113 the guidance says that compliance will be assessed against how a “market participant without market power is likely to act in the circumstances”. This appears inconsistent with the statement above. As we highlighted in the last consultation paper it reads as though participants without market power (like Contact Energy) are exempt from this requirement. In our last submission we noted that this is unlikely to be

the outcome sought by the Authority, but are now unsure given it has been repeated in this paper too.

- The logic for the paper also often relies on assuming (not proving) market power. For example, at paragraph 3.65(f) the Authority notes that "gentailers should already be managing their margin squeeze risk as part of their Commerce Act risk management". Only parties with substantial market power are captured the Commerce Act margin squeeze tests.

We propose that a regime that "does not require proof of substantial market power" should not rely on demonstrating market power when assessing compliance.

Matters that remain unaddressed

In our last submission we raised a number of material concerns with the proposed design of this regime. Below we highlight the most material of those that have not yet been addressed in this consultation paper.

- the requirement for equal access to commercial information will either result in something akin to virtual disaggregation, or excessive disclosure. This must be addressed with urgency. As it currently stands the draft would require changes to role descriptions, and may trigger a restructure. Sufficient time is needed to allow that process to complete.
- The regime puts at risk competitive price discovery for OTC risk management contracts
- The guidance to hold prices open for 5 days provides an exploit that will be taken advantage of by counterparties
- The regime requires excessive reporting, unnecessarily increasing the costs of compliance, and raising material risks to competition.

We look forward to seeing how these are resolved in the final decision in May

Ngā Mihi

[redacted]

Brett Woods

Head of Regulatory and Government Relations

Contact Energy

Attachment: Response to Consultation Questions

Questions	Contact Energy Response
Retail Price Consistency Assessment	
Q1. Do you agree with the Authority taking a forward-looking approach to the RPCA? If not, why not?	We consider that there are benefits and costs of both approaches, and do not have a strong view one way or the other. We note that a key limitation of a forward-looking approach is that it will make systematic errors in more dynamic markets. In periods like we are in currently where input prices are increasing then the results are likely to show a narrower margin than a backwards looking approach would. This is because at the time of reporting, decisions on price changes over the next 12 months would not yet have been made, and therefore could not be quantified or reported. One change that could help minimise this error is to allow for input costs to be fixed at the date of reporting (accounting for seasonal effects). For example we are expecting material changes in network charges over the next three years at least. At the date of reporting the RPCA we will not know how these will flow out across each region. Keeping these costs

Questions	Contact Energy Response
	static will avoid guess work and mirror the treatment of revenue figures, which will also be kept static.
Q2. Do you agree with the Authority applying an as-efficient standard, including an allocation of common costs, to the retail cost component of the RPCA? If not, what standard should be applied and why?	We agree with this approach. Other standards are highly subjective, and usually only used where there is not a competitive market to compare costs to. In this case the Authority has the benefit of considering the cost base across four large competitors, and a long tail of other providers.
Q3. Do you agree that the Authority should not be publishing benchmarks for the cost of electricity, the as if portfolio of hedges and retail costs, and should instead provide higher level guidance to gentailers (eg, their cost of electricity should be calculated to minimise the risk adjusted cost of supply)? If not, please explain why and set out how you consider that benchmarks should be constructed.	We agree that the Authority should not publish benchmarks. The Authority has insufficient understanding of each large generator-retailers cost base, nor its appetite for risk to develop a benchmark of any practical value.
Q4. Do you have any comments on our proposed approach to geographic and customer segmentation? If you don't agree, please explain why and set out the alternative segmentation that you think the Authority should apply. Whether or not we require geographic segmentation, we would also be interested in your views on the best regional	As noted above, we strongly disagree with the proposed segmentation. It raises material risks for consumers, and materially increases the complexity of the regime with no clear rationale.

Questions	Contact Energy Response
classification to apply when the Authority analyses the RPCAs (NRRs, EDB areas, GXPs or something else).	
Q5. Do you have any comments on our proposed approach to price smoothing? If you disagree with our approach, please set out your preferred alternative, and how it is consistent with ensuring that there is a 'level playing field' to promote competition between gentailers and independent retailers.	We agree that price smoothing is a key feature of a competitive market. Large retailers take a long-term view and risk harming brand value, and customer trust if they cause price shocks to consumers.
Q6. Do you have any comments on the proposed date for the first RPCA disclosures? If you are a gentailer, and have concerns about your ability to meet that timeframe, please explain these in detail	We consider that having in place the requirements from 1 July this year will be very challenging for a regime that will only be finalised in May. We expect many large generator retailers will need to apply for a range of extensions. A disclosure only RPCA can likely be reported on by September this year, but will likely include a number of simplifications to meet the timeframes.
Uncommitted capacity	
Q7. Do you prefer Option 1, Option 2 or our previous proposal on uncommitted capacity? Do you have any feedback on how Options 1, 2 and our previous proposal on uncommitted capacity could be improved?	We support option 2. This better reflects the way we operate our business. Our Board explicitly sets our risk appetite that is adhered to via our commodity risk management system. We consider that this is a

Questions	Contact Energy Response
	reasonable interpretation of the requirement demonstrate intolerable risk where trades are not entered into. However, we recommend a further change to the proposed record keeping requirements. Clause 13.236S(2)(a) requires Contact to keep records of "the total capacity of the gentailer to offer risk management contracts, over the next 3 years". This has many of the same problems as the original uncommitted capacity requirement. It is difficult to predict our entire portfolio including buy and sell trades to report on total capacity to offer risk management contracts. Instead we propose that this clause requires gentailers to disclose their expected "risk adjusted generation capacity". This is more familiar terminology and likely better reflects the information that the Authority wishes to collect.
Q8. Do you have any feedback on the interplay between OTC monitoring requirements and the appropriate reporting where gentailers rely on 'intolerable risk position' in response to a request for a risk management contract?	
Internal non-discrimination policies and audit requirements	
Q9. Is it useful and/or helpful to provide greater specification in the Code of the requirements for a non-discrimination policy?	We are happy with the level of specificity. However, we note that our feedback in our last submission has been mis-understood. While we consider the entire regime excessive (given the

Questions	Contact Energy Response
	lack of evidence of a problem, the risks to the efficient operation of the market, and the material compliance burden) we did not say that "it was excessive to require [our] Board to review and approve [our] NDO policy". The issue we raised was that it was excessive for the NDO policy to be reviewed every year. Yearly review is not a requirement of any other policy we manage, under the Financial Markets Act, Privacy Act, Fair Trading Act, and other obligations under the Electricity Industry Participation Code and more. We consider it more appropriate to have a requirement for the policy to be 'regularly' reviewed.
Q10. Do you support the requirement for external audit of compliance with the NDOs? Why or why not?	We are comfortable with these requirements. However, we consider that greater clarity is required about the standard auditors are assessing against.
Q11. Is an annual audit of these requirements appropriate, or would a different timeframe be better? Why? Do you have any comments on the alignment of the timing with other gentailer audit obligations?	We expect to carry out the audit of these requirements alongside our other yearly audit activity. We therefore consider annual auditing appropriate.
Q12. Would the codification of the audit requirement impose significant additional costs? What would you estimate these costs to be?	We have not yet had the time to assess the costs of auditing.
Regulatory statement for the proposed amendments	

Questions	Contact Energy Response
Q13. Do you have any comments on the impact of the proposals in this paper on the regulatory statement set out in the October consultation paper?	We continue to disagree with the rationale and quantification of the benefits of this regime. Nothing in this paper has changed the view we expressed in relation to the last consultation.
Appendix A – Draft RPCA guidance for consultation purposes	
Q14. Do you agree with the proposed general approach to the RPCA, including the approach to implementation and potential evolution of guidance? If not, why not and what would be an alternative approach?	As noted in the body of this response, we do not consider that the RPCA can be a compliance regime, as the measures we are reporting on are outside of our control. We also consider that the proposed segmentation has a high risk of unintended consequences for consumers, as covered in the main body of this response.
Q15. Do you agree with the proposed overall calculation approach to the RPCA? If not, why not? In what way could it be improved and why?	We propose that the RPCA is a disclosure only regime, and that there is no segmentation carried out, except for retailers looking to grow their customer volumes.
Q16. Do you agree on the draft guidance with respect to customer coverage, and the approach and criteria for identifying and reviewing RPCA segments? Do you agree that RPCAs should be reported by NRR? Please provide reasons and any proposals to improve. Note, you do not need to duplicate responses	We consider that services offered to support hardship should be excluded. For example Contact Energy is currently the only provider in the market offering prepay services. These customers have a materially higher cost to serve, but we continue to offer this service so that customers with a poor credit rating are able to have an electricity service. It would be a perverse incentive, if this regime disincentivised the offering of higher cost services to meet hardship needs.

Questions	Contact Energy Response
to the earlier question on the proposed segmentation.	
Q17. Do you agree with the proposed approach to calculating average retail prices per MWh, including that each RPCA assessment should be based on retail prices as at the assessment date? If not, why not?	As noted in response to Q1 this approach will cause systematic errors when input costs are changing. To mitigate this risk input costs must also be fixed at the point of reporting (accounting for seasonal effects).
Q18. Do you agree with the proposed approach to calculating non-energy costs, including the proposed approach to shared and common costs and attribution of costs to bundled services? If not, why not? Note, you do not need to duplicate responses to the earlier question on the efficiency standard for retail costs.	No further comment.
Q19. Do you agree with the proposed approach to expected cost of electricity? If not, why not? We would particularly welcome any views on proposed guardrails (eg, minimising risk adjusted cost of supply) and possible alternatives, and on our approach to changes in method between assessments.	We are comfortable with the proposed approach. The level of discretion provided is necessary to account for the different underlying costs each major generator-retailer faces due to the differences in their portfolio and their customers usage patterns, etc.

Questions	Contact Energy Response
Q20. Do you agree with the proposed guidance on the assessment of results, including the factors the Authority may consider in determining the appropriate follow up for negative or small positive RPCA results? If not, why not and what would be an alternative approach? Note, you do not need to duplicate responses to the earlier question on price smoothing.	No, as noted above, we do not consider that the RPCA can be a compliance regime. It is not reasonable to hold a party to account for factors it does not have control over.
Q21. Do you agree with the proposed approach to RPCA disclosure and reporting? If not, why not?	We are comfortable with the proposed reporting of the RPCA.
Appendix B – Proposed Code amendments	
Q22. Do you have any comments on the drafting of this Code amendment? Are we missing anything? Is there anything that we should not include?	No further comment.