

MEETING WITH INDEPENDENT RETAILERS

10am, Wednesday, 6 September 2023

Board members: Anna Kominik (Chair)

Authority staff members: Sarah Gillies (Chief Executive)
Paul Sullivan (Acting Manager, Wholesale Market Policy)
Doug Watt (Manager, Monitoring)
Jo Goudie (Principal Analyst, Wholesale Market Policy)
James Goodchild (Senior Analyst, Wholesale Market Policy)

Attendees:

s9(2)(a)

1. Purpose

This summarises issues that independent retailers might raise during this meeting.

2. Background

Independent retailers may want to discuss competition issues in the wholesale electricity market and innovation in the retail market.

Some independent retailers (such as s9(2)(b)(ii) & s9(2)(ba)(i)) have raised concerns with the Authority and other agencies about the competitive challenges they face. The Authority has responded to some of these concerns in other forums.

The basis of the concerns is the comparative advantage of vertical integration in managing spot price risk and a claim that vertical integration limits competition across the supply chain. Some independent retailers argue this comparative advantage is at odds with promoting retail competition. Four of the five major electricity generators are vertically integrated with retailing arms (ie 'gentailers').

The underlying issues from the independent retailers are:

- Retail prices are lagging wholesale prices as gentailers look through short term price volatility and smooth prices for their retail customers.
- This means that business models that rely on hedging to manage spot price risk (ie independent retailers) are facing falling margins.
- This is more apparent for those independent retailers that mostly sell into the residential market which has the most peaky load.

As a result, independent retailers argue that gentailers should supply independent retailers on the same terms as their retailing arms via their internal transfer prices.

Known concerns raised by s9(2)(a) & b

At a meeting with Authority staff on 12 June, s9(2)(b) & c raised these concerns:

- Independent retail competition is necessary for the market to deliver the best outcomes for consumers in the long run.
- Independent retailers face a higher cost of electricity than gentailers. Short-term market energy is priced off the ASX forward curve. ASX futures have been higher than retail prices for some time, meaning procurement via this method or over the counter has generally been a loss-making exercise.
- Gentailers are increasingly running their retail businesses at a loss, making profits from wholesale.
- There are significant barriers to entry for independent retailers.

Recent comments from Octopus Energy NZ

Marcia Poletti, Head of European System Change at Octopus Energy UK spoke at a session of the Commerce Commission's Regulatory Roundtable on Tuesday 29 August. The session covered the UK and European perspective on flexibility, regulation of electricity distribution businesses and changing business models. Some relevant points were made:

- More visibility is needed of the low voltage network
- Potential for demand response for price and security management
- There is a risk to synchronised demand actions that are large enough to have system wide effects – EVs starting to charge at 9:00pm

Octopus has also commented that “the wholesale market is broken” in the context of gentailers using wholesale market profits to absorb retail market losses and that “spot prices are 20 percent higher than they should be”.

Marcia stated that Meridian was net pivotal 90%¹ of the time and said that implied it could set the spot price 90% of the time. However, wholesale electricity prices indicate that Meridian is net pivotal 2% of the time, it is necessary for dispatch 90% of the time (sometimes call gross pivotal or just pivotal). Net pivotal implies that a generator can raise the spot price and profit. The gross pivotal number is a measure of relative size.

Staff met with s9(2)(a) of Octopus Energy NZ on Friday 1 September and discussed the interaction between the wholesale and retail markets, futures prices, and hedge market products. Octopus staff felt reassured that its concerns were heard.

Section 36 complaint to Commerce Commission

In March 2023, s9(2)(b) & c asked the Commerce Commission to investigate misuse of market power by the four gentailers as a potential breach of section 36 of the Commerce Act. Section 36 is designed to prevent businesses with substantive market power from suppressing competition.

Commission staff assessed the complaint as both a complaint of predatory pricing and of a margin squeeze by the gentailers directed at independent retailers.

The Commission considered that the evidence did not support any one individual gentailer, or multiple gentailers, having a substantial degree of market power in either a wholesale or retail electricity market. Further, it did not consider that the gentailers' pricing strategies directed towards

¹ A pivotal generator can unilaterally influence spot market prices by offering its generating capacity at offer prices above competitive levels. If a pivotal generator has financial incentive to exercise this ability, then the generator is termed net pivotal. Whether a generator is net pivotal relies on the magnitude of their demand (their physical position) as well as hedge transactions (financial positions) undertaken in other markets.

new customers constitute taking advantage of any market power they may have, or have the likely effect of, substantially lessening competition in a relevant market.

The Commission closed the enquiry and will be taking no further action at this time.

Gentailer financial results

The four gentailers published their 2022/23 year end financial results over the last two weeks. The independent retailers are likely to be critical of gentailers using wholesale market profits to absorb retail market losses.

This view is that retail businesses of gentailer scale would only run at a loss to drive competition out of the market, where increases to wholesale margins subsidise artificially low retailer prices, allowing gentailers to continue announcing strong overall profitability. With the implication that gentailers are essentially making their profits from independent retailers, rather than end consumers.

EBITDAF	Contact	Genesis	Mercury	Meridian
Retail	-\$14m (down \$31m)	-\$11m (down \$67m)	-\$5m (down \$43m)	\$103m (up \$16m)
Wholesale	\$518 (down \$39m)	\$520m (up \$166m)	\$844m (up \$299)	\$760m (up \$85m)

3. The Authority's retail competition focused work

Review of wholesale market competition

Following a period of sustained high wholesale electricity prices since mid-2018, the Authority launched a review into competition in the wholesale market in March 2021 to consider if the electricity market is working for the long-term benefit of consumers.

The review was completed with the publication of a decision paper on 12 May 2023. One of the Authority's conclusions was that while fundamental structural reforms are not currently justified, some market settings will need to evolve to support the transition, and this is reflected in the Authority's wider work programme as well as specific actions noted in the review.

- The electricity market has served consumers well, competition is most likely to deliver the best outcomes for consumers, and it remains appropriate to rely on current regulatory settings to mitigate the risks from market power in the transition.
- Proactive trading conduct monitoring and enforcement, and promoting entry by new generation and more flexible demand and demand-side participation are currently the best ways to mitigate risks from market power in the transition.
- 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.

Disclosure of internal transfer prices and retail gross margins

The report of the electricity price review, published on 21 May 2019, noted concerns that the pricing practices used within gentailers for transferring electricity between their generation and retail businesses may be undermining competition. Independent retailers and consumers may be disadvantaged if gentailers, which control the greater part of electricity supply, provide electricity at below fair market prices to their own retail arms.

The Authority amended the Code to require the disclosure of retail internal transfer price (ITP) information and retail gross margins (effective 30 November 2021). These provide an evidence base to support an appropriate level of confidence in the competitive operation of the electricity

The Authority has published retail gross margins of all retailers with more than 1 percent of ICPs and the gentailer's ITP disclosures for the financial year ending 2022, while no evidence to date has been found of market failure, the Authority will complete a post-implementation review to ensure the disclosures are fit for purpose.

Working group members represented a diverse range of industry interests: 2degrees, Contact Energy, Genesis Energy, Manawa Energy, Mercury, Meridian Energy, Prime Energy, and The Energy Collective.

- Access to competitive risk management products, on competitive terms and conditions, is a foundation of an efficient electricity market which ultimately serves the long-term interests of consumers.
- Exchange traded and OTC markets each have distinctive but complementary roles to play in supporting risk management in a competitive and efficient electricity market.
- It provides guidelines for behaviours which support improved performance of the OTC market and which will ultimately translate into outcomes that are in the long-term interests of consumers.

Out of scope

[REDACTED]

Out of scope

5. Talking points

- New Zealand is transitioning to a renewable power system and will be for some time.
- During this transition, thermal costs will increase with the price of carbon and the decreasing frequency that these plants will operate.
- Forward prices – the input cost of independent retailers – reflect risks of low hydro storage and are high, particularly in winter.

On intermittent generation and 'firming'

- As intermittent generation is built to displace thermal generation, the value of firming will increase.
- Flexible generation used for firming can't be sold to an independent retailer without taking on spot price risk.
- Selling a shaped contract means taking on spot risk
- Spot price risk is high now, and will get higher
- So the value of firming is high and will increase. By way of illustration:
 - A 100MW gas peaker costs around \$100m, and can generate 24/7 if need as long as it has fuel
 - A 100MW battery costs about \$180m, and can generate for 2 hours at full capacity
- We expect shaped contracts to reflect these increased costs
- You could ask if any of the retailers are considering investment in generation or batteries to manage peak price risks.

On innovation in retailing

- We expect to see innovation, particularly around demand response, as the amount of intermittent generation increases.

s9(2)(a)