5 November 2024

Energy Competition Task Force
By email: TaskForce@ea.govt.nz

Request for feedback on level playing field measures

Meridian appreciates the opportunity to provide feedback on the Energy Competition Task Force's (Task Force) consideration of level playing field measures.

Meridian supports a competitive, dynamic and innovative retail market

We support a retail market with a multitude of diverse parties competing intensely to win and retain consumers. Such a market is most likely to drive efficient prices, high standards of customer service, the development of innovative products and, ultimately, value to consumers. As a major participant, Meridian's experience is that New Zealand's electricity retail market is highly competitive and is delivering on these outcomes.

With around 40 retailers, New Zealand has almost double the electricity retailers per capita as Australia and over 20 times the electricity retailers per capita as the United Kingdom. Market concentration measures for New Zealand's electricity retail sector have declined consistently over the last 20 years.[1] And New Zealand's domestic retail prices rank 7th cheapest out of 26 OECD countries.[2] New and innovative electricity products are being deployed all the time. It is clear that this is a market that is delivering value for New Zealand consumers.

In considering the performance of New Zealand's retail market, it is also important to keep in mind what markets are designed to deliver. We absolutely want wholesale and retail markets that delivers prices efficiently. But ultimately, we want markets that maximise benefits for New Zealand consumers. For many this will mean that their power is secure and

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1 https://www.emi.ea.govt.nz/Retail/Reports/R_HHI_C?_si=v|3
2 https://www.gov.uk/government/statistical-data-sets/international-domestic-energy-prices

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that their bill is as low as it can be. For others, it may be about having access to innovative, low-carbon, products and services. We want to see an electricity sector that is capable of delivering on all of these possibilities. Our view is that this is best achieved through competitive and open markets made up of a diverse range of commercial operators all striving to meet the needs of their customers. We encourage the Task Force to keep this front of mind as it considers the options for interventions in this space.

It is unclear in what way the existing playing field is not level

Work stream 1D of the Task Force's work programme is considering measures to ensure a level playing field between generator-retailers and independent retailers. It is unclear to us in what way the current "playing field" is not level. Different retailers have adopted different approaches to managing wholesale market risk and to developing offerings that will appeal to New Zealand consumers. These are choices which every retailer is free to make. Some participants, such as Meridian, have chosen to vertically integrate to manage wholesale market risk on behalf of their customers. Other retailers have opted to operate without generation support but instead utilise the options available on the hedge market to manage this risk. This is a deliberate and strategic choice. In fact, some of the independent retailers that operate in New Zealand also participate in electricity markets overseas and have adopted a vertical integration strategy in those locations. There is nothing preventing them doing the same in New Zealand, if this is what they consider is best for their shareholders and their customers. Indeed, Meridian adopted a vertically integrated structure when it entered the Australian electricity retail market.

There is an important distinction to be made in seeking a level playing field in order to ensure that all participants can enter a market and make decisions on how they would like to compete, versus seeking to curtail the competitive advantages (or nullify the competitive disadvantages) that firms are experiencing as a result of their strategic decisions. This distinction was discussed previously by NERA in a report prepared for Meridian:[3]

> *"The…aim to ensure independent retailers can compete on a level playing field appears on its face to be an uncontroversial objective. However, there is an economic difference between "levelling the playing field":*
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> > *a. Before firms make their business model and investment decisions; and*
> >
> > *b. After firms make their business model and investment decisions.*
>
> *There is a risk that "levelling the playing field" after firms make their business model and investment decisions effectively amounts to "changing the rules of the game" in favour of one*

[3] https://www.ea.govt.nz/documents/2595/Meridian-submission-Internal-transfer-prices-and-segmented-profitability-reporting.pdf

business model over another. In respect of electricity supply, risk management is fundamental to competing, and is a cost of doing business, incurred by both incumbents and entrants. Some firms choose to manage risk by vertically integrating (i.e., investing in generation) and others choose not to. Care is needed that any attempts to "level the playing field" do not:

> *a. Undermine the efficiencies the vertically integrated firms anticipated when making their investments, as this would deter future investment; or*
>
> *b. Give a "leg up" to firms that have opted not to make the investments, if "giving a leg up" could result in social costs (e.g., deterred investment that would have been efficient)."*

These considerations remain relevant in the current context: in contemplating the need to "level the playing field" the Task Force should not have a preference for (and is not best placed to judge) one business model over another or seek to advantage one type of participant over another. Ultimately, it would only result in greater costs for consumers if New Zealand were to subsidise or support inefficient business models through a misguided belief that there was a need to level the playing field.

Rather, a clear focus on ensuring that inefficient barriers to entry in the retail market are addressed and that firms can compete and succeed (or fail) based on their performance and strategic choices is most likely to ensure that benefits to consumers are maximised over the long term. At a minimum, the Task Force should be very clear about what aspects of the current playing field are not considered to be level and the source of the market failure (in contrast to a participant's strategic choice) that has led to this being the case.

Vertical integration is an efficient business model that delivers benefits to consumers

Implicit in claims that the current playing field is not level is the idea that vertically integrated retailers operate with some kind of unfair advantage that is not available to competitors who choose not to vertically integrate. In considering options to level the playing field, at the extreme end are options to forcibly disaggregate businesses in one form or another. While this does not – at this stage – appear to be within the Task Force's suite of possible options, it is worth briefly recapping on recent considerations of the merits of vertical integration, if only because vertical separation might be an option advocated by other parties seeking to gain a commercial advantage.

Vertical separation has been thoroughly considered on multiple occasions and the conclusion is consistently that it would not be in the interests of consumers. The 2009 Ministerial Review concluded that vertical integration was beneficial to consumers and highlighted the criticality of a liquid contracts market in mitigating the downsides of vertical integration. The previous Government's Electricity Price Review found that vertical integration can provide significant benefit to consumers, supports new generation being built, and that improvements to contract markets can mitigate any concerns while retaining the consumer benefits of vertical integration. MDAG concluded from its comprehensive assessment of the wholesale market that ownership separation between generation and retail activities should not be adopted as a backstop tool.[4] The Electricity Authority rejected vertical separation in its review of wholesale market competition and noted that Internal Transfer Prices of generator-retailers are transparent and "the methodologies suggest that, in principle, any participant could replicate the Internal Transfer Prices that gentailers apply."[5] These findings are consistent with the academic literature, as reviewed by Dr Richard Meade for the Electricity Retailers Association of New Zealand.[6]

There is clearly a wealth of evidence that vertical separation would work to the detriment of consumers and that, in contrast, vertical integration is an efficient business model that delivers consumer benefits. There is nothing preventing smaller retailers investing in generation to realise these same benefits. Indeed, some of the smaller retailers operating in New Zealand are backed by global companies with multi-billion dollar valuations and extensive experience in investing in and managing generation assets. Such resources and expertise could readily be brought to bear to adopt the same approach in the New Zealand market if these entities chose to do so. It is possible that part of the reason they are choosing not to invest is the persistent hope that regulators will, at the expense of other market participants and ultimately consumers, deliver an intervention that replicates the benefits of vertical integration for those entities.

Independent retailers have a range of financial hedging options available

Retailers that choose not to adopt a vertical integration strategy still have access to a range of hedge options to assist them in managing wholesale market risk. As the Task Force will be well aware, the four large generator-retailers are required to market make electricity futures on the ASX exchange with a bid-ask spread of 3 per cent. This ensures that there are hedge contracts available for transaction every business day at a fair price determined by the market. With the four generator-retailer market makers and a further commercial market maker providing bids and offers, there is a diversity of views informing the market price and multiple parties providing minimum volumes.

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[4] https://www.ea.govt.nz/documents/4335/Appendix_A2_-_Final_recommendations_report.pdf

[5] https://www.ea.govt.nz/documents/3017/Decision_paper_promoting_competition_through_the_transition.pdf

[6] https://www.cognitus.co.nz/_files/ugd/022795_90a6a69bdaca4de9b752db7798bf2a2d.pdf

Performing the role of market maker comes with significant cost to Meridian and other market makers. Nevertheless, we recognise the contribution to liquidity that market makers have made, with the ASX market commonly trading at double the physical volumes trading in the spot market. This means that independent retailers have ready access to a fairly priced and liquid hedge market as a means to insulate themselves against wholesale market volatility. The Authority has previously undertaken analysis which shows that independent retailers can effectively hedge through ASX futures at prices similar to what the generator-retailers typically assume for their ITPs.[7] Indeed, Meridian commonly purchases contracts on the ASX to support our own retail book as a complement to the natural hedge provided by generation.

In addition, independent retailers are able to enter into hedge arrangements with a range of different counterparties via the Over The Counter (OTC) market. Meridian regularly offers a range of different contracts in response to OTC requests from independent retailers. In total, we will commonly transact 2-3 OTC contracts per week. We endeavour to respond to all pricing requests from independent retailers and to do so in a consistent manner, regardless of the counterparty. While some independent retailers have been vocal about generator-retailers failing to offer contract terms or prices that they consider reasonable, our experience – in contrast – is that some of the same independent retailers have sometimes been slow to progress negotiations with us for underlying ISDA agreements. In considering both the ASX and OTC markets, we would strongly reject any suggestion that independent retailers do not have access to reasonably priced hedge contracts to assist them in managing their wholesale market exposure and to support them in growing their retail businesses.

Options to "level the playing field"

As noted above, Meridian considers it is unclear how the current playing field for retail competition could be considered unlevel. In our experience, this is a highly competitive and dynamic market with multiple participants adopting a variety of approaches to attracting customers, organising their businesses, and managing risk. It should ultimately be consumer preferences and market performance that determines which approaches are successful. As such, we consider that the Task Force should adopt a cautious approach to defining the problem (i.e. the market failure) and identifying any options or interventions to be pursued. In particular, the Task Force should be wary of inadvertently discouraging efficient business models or encouraging inefficient business models as it undertakes its work.

[7] https://www.ea.govt.nz/documents/2591/Internal-transfer-prices-and-segmented-profitability-reporting-updated-20-April.pdf

It is also important to note that, in the long term, prices for end-consumers will best be served by ensuring efficient and timely generation investment, something that large, vertically integrated companies are well-placed to provide. For example, BCG identified that over $10 billion in new utility-scale renewable generation capacity will be required by 2030 as New Zealand continues its decarbonisation path.[8] Ensuring that investment incentives are maintained to deliver on this requirement should also remain at the forefront of the Task Force's thinking as it considers wider intervention options.

Clear triggers should be identified for adopting any fallback measure

We recognise that the options to be identified under work stream 1D are intended as fallback measures should other measures in the Task Force's work package be deemed to have failed. It would be helpful if the Task Force clearly defined the triggers that would result in these fallback measures being deployed i.e. what is the measure of success they have in mind. There is a very real risk that, once developed, fallback measures are deployed prematurely simply because they are ready to go without further design work required, even when the case for making such an intervention has not been clearly made. To avoid this, the triggers for deploying these options should be set and published in conjunction with their design. We recommend triggers for the deployment of these fallback interventions are closely tied to the problem definition or market failure that is perceived in this space so that a strong focus remains on delivering benefits to consumers and avoiding any risk of unintended consequences.

Please contact me if you have any queries regarding this response.

Nāku noa, nā

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[8] https://web-assets.bcg.com/b3/79/19665b7f40c8ba52d5b372cf7e6c/the-future-is-electric-full-report-october-2022.pdf