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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.

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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 market**. 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.

[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.

[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:

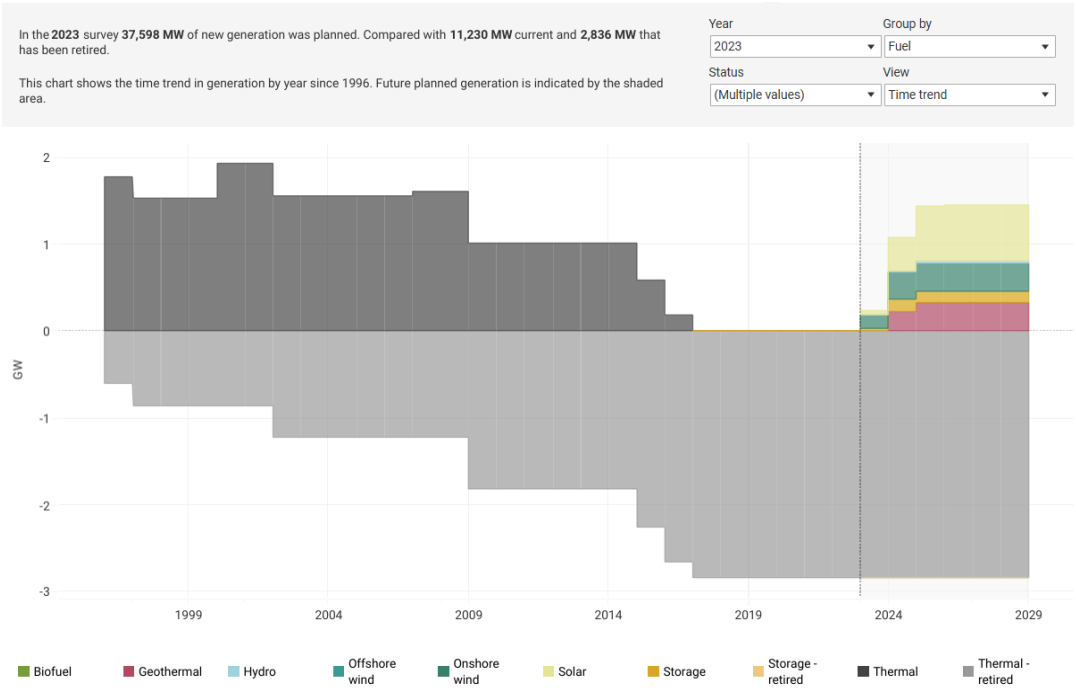
    a. "…key concerns for security and **reliability** occur because of the potential speed of **demand growth** and whether **generation**, transmission, and distribution **can respond appropriately, quickly enough**."[16]

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.* ***<u>However, we consider that vertical integration also has costs in terms of reduced competition in energy markets</u>. 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**.

[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 Chief Customer Officer Emma-Kate.Greer@2degrees.nz	Huia Burt Chief Executive Officer huia.burt@thecollective.energy	James Leslie Chief Financial Officer james.leslie@flickelectric.co.nz
Margaret Cooney Chief Operating Officer margaret.cooney@octoenergy.com		

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] 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. 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.) 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. 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. 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. 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 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. The NZ electricity market has 4 large (vertically integrated) electricity retailers, 0 medium sized retailers with the majority either small or very small. The absence of medium-sized retailers highlights that the electricity retail markets have remained stubbornly concentrated over the last decade or so. 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. On any reasonable or objective metric, retail competition has stalled or gone backwards over the last several years. 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: ● Between 2003 and August 2018, just 4 electricity retailers had exited the

Reference	Risk Management Review assumptions/conclusions	Comment/Response
		market. Between August 2018 and September 2024 another 24 exited. ● Independent retailer market share has stalled around 11% since May 2021. ● HHI for the overall NZ electricity retail market is about the same as it was in January-February 2020. ● 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. Competition problems became more obvious following the Pohokura outage. 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. 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. 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: (a) There do not appear to be material barriers to entry into the retail electricity market (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.

Reference	Risk Management Review assumptions/conclusions	Comment/Response
		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. 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. … As volatility increases, the suppliers of hedges take on increased risk. … 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. 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. 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. 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). 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. If the insurance analogy is to be used, the generator and retailer should both be thought of

Reference	Risk Management Review assumptions/conclusions	Comment/Response
		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. 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. 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. 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. 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. 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
	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. 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. 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

Reference	Risk Management Review assumptions/conclusions	Comment/Response
		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. 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. Given such market structure, we would find other regulators and courts to expect self preferencing. 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)? 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. 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." 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
		unqualified claim that "Spot prices are competitive". 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 the only impact of the new rule may be to temper extreme behaviour. 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] 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] 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.

Reference	Risk Management Review assumptions/conclusions	Comment/Response
	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: (a) Shaped hedge contracts are a necessary aspect of efficient peak time risk management (b) Having flexible generation and fuel is a pre-requisite to sustainably offering those shaped hedge contracts (c) There are high barriers to building new flexible generation capacity for all participants, including gentailers (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. Not all risk management is substitutable for an input. 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." 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] 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] 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.

Reference	Risk Management Review assumptions/conclusions	Comment/Response
		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). 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: • 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). 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

Reference	Risk Management Review assumptions/conclusions	Comment/Response
	meet retailers' needs, as the generation mix changes.	mechanisms than it would be to provide in-house to their own retail businesses. 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). 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. 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.

Reference	Risk Management Review assumptions/conclusions	Comment/Response
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. 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. 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. 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. … ● cut through the complexity of the market on both the supply and demand side ● 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). The EA should not be scared to be an active regulator in enacting change that is necessary and desirable. 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.

Reference	Risk Management Review assumptions/conclusions	Comment/Response
	● ensure incentives for investing to supply risk management options are maintained ● ensure risk management options that have alternative uses – demand response, batteries – have access to other markets to help make them economic for risk management ● consider ability to supply, which in turn relates to fuel supply conditions ● ensure transparency for pricing methods, and be able to validate pricing outcomes 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.