FLICK

2 November 2023

Consultation: Advancing New Zealand's energy transition
Energy and Resource Markets
Ministry of Business, Innovation & Employment
P O Box 1473
Wellington 6140

By email: electricitymarkets@mbie.govt.nz

Dear team

Re: Measures for transition to an expanded and highly renewable electricity system

Flick commends MBIE for the detailed analysis of issues facing the electricity sector in this electricity market measures paper (EMM) and appreciates the opportunity to provide our perspectives.

Flick is a pioneer of independent electricity retailing in New Zealand, coming to market with an innovative and disruptive business model in 2014 with the vision of bringing smart energy choices to life to put Kiwis in charge of their power. Flick has always been for the customer; our value proposition is "We are deliberately on the customer's side". As a disruptive independent retailer, we've grown to more than 35,000 customers with ambition to be a significant player in the market. In partnership with our shareholders, Ampol and Z, we intend to drive electrification of Aotearoa households and businesses through increased investment in the sector. This investment will be forthcoming to the extent that the regulatory settings enable a level playing field in the retail electricity market and provide confidence in the wholesale market.

Flick believes competition and innovation is critical to the long-term benefits of consumers in terms of reducing prices and delivering social and environmental outcomes in the sector now and as New Zealand transitions to a highly renewable electricity system. We have little confidence that current market settings will support an efficient transition – a view that aligns with many others in the industry.[1] So it is imperative there is action to ensure regulatory settings support decarbonisation through electrification and address increasing energy costs and the high cost of living for the benefit of all New Zealanders.

[1] The Electricity Authority's market participant surveys show there is low confidence current market settings will support an efficient transition.

A competitive wholesale market, where prices are efficient and reflect the long run marginal cost of new generation, is a prerequisite for enabling competition and innovation in electricity retailing.

We see significant issues in both the electricity retail market and the electricity wholesale market. From our perspective:

- The electricity retail market is critical to promote innovation, delivering long term benefits to consumers; and
- Efficiency in the electricity wholesale market is also critical for energy affordability and reducing energy hardship.

Electricity retail market

The Electricity Authority's 2022 perception survey revealed 52% of respondents disagree new entrant retailers operate on a level playing field with established retailers.[2] Flick holds this view. The market is stagnating with minimal increase in independent's market share over the last 2 years. If this is not addressed, the long-term result will be a reduction in competition and innovation to the detriment of Kiwi consumers.

Flick believes that:

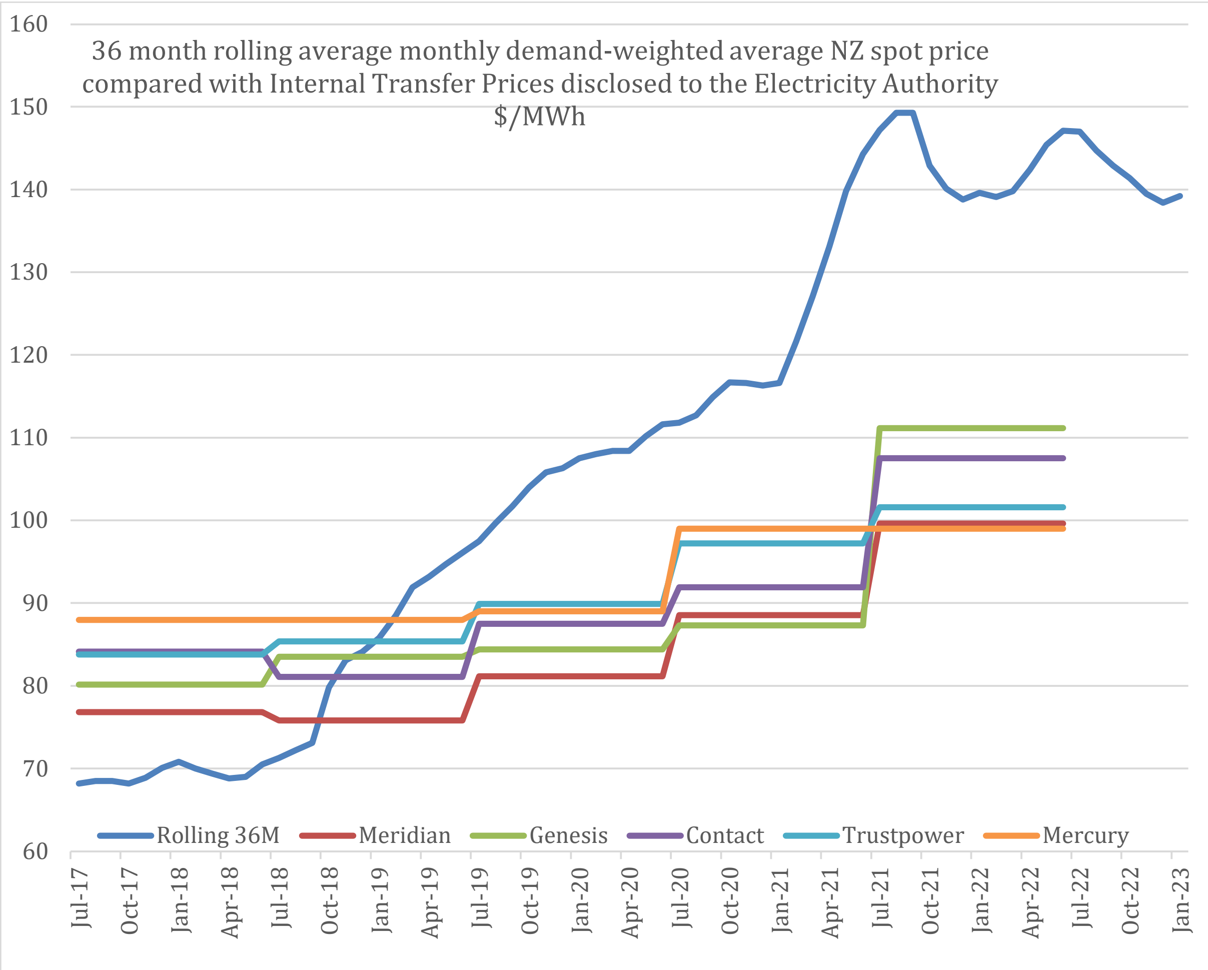
<u>Independent retail competition is necessary for the market to deliver the best outcomes for consumers in the long-run</u>

- Economic theory suggests that competition leads to positive outcomes for consumers and the economy over the long-term including improvements in efficiency, consumer welfare, economic growth and innovation.
- For example, regulation promoting competition in New Zealand's telecommunications market resulted in retail revenue collected from customers decreasing 8.4% in real terms over ten years while telecommunications investment was $17.3 billion over the same period.
- Flick has a strong history of innovation which has driven benefits to consumers across the industry, including:
    - World's first retailer to pass through wholesale prices to the mass market
    - NZ's first retailer to directly pass through all distribution price signals
    - NZ's only retailer offering generating customers the spot price for exported generation
    - NZ's first retailer to offer an option of Time of Use pricing or Flat pricing in all regions delivering consumers choice and control
    - World-first carbon tracker app
    - Award winning Flickin' Best Plan Promise, checking that consumers are on the best plan for their usage profile every 90 days.

[2] Only 25% of respondents agreed there is a level playing file. https://www.ea.govt.nz/documents/596/Survey_of_electricity_industry_participant_perceptions.pdf

Independent retailers face a higher cost of electricity than gentailers

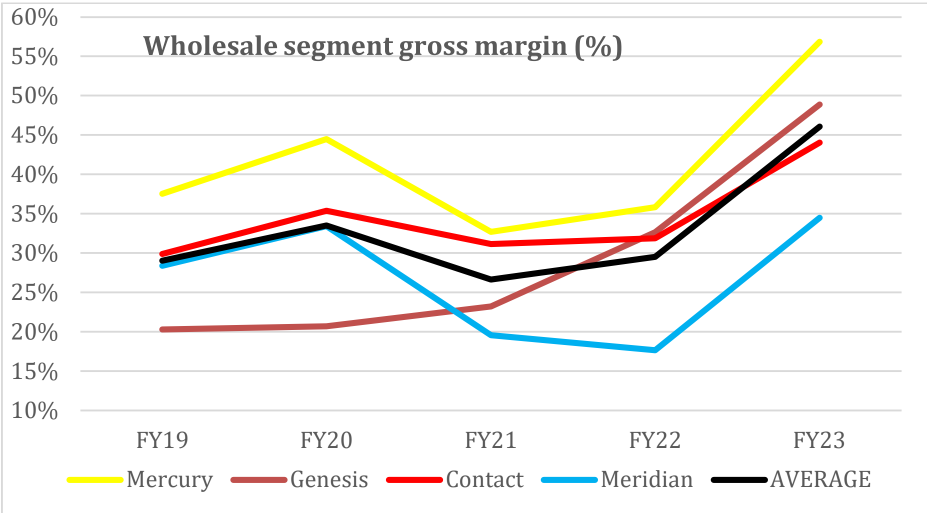
- Gentailers' retail businesses 'purchase' electricity at a fixed price for their 24/7 variable volume from their generation business at internal transfer prices that are well below market prices. Meantime the market prices are determined by gentailer's generation businesses and paid by independent retailers.
- The following graph compares the gentailers' internal cost of electricity (internal transfer price ITP) with a proxy for the cost faced by independent retailers purchasing from the wholesale market. It compares the ITP data disclosed to the Electricity Authority (Authority) (up to 30/6/22) with a rolling 36 month demand weighted national spot price. Gentailers' ITPs have been below market since 2019. ITPs have not increased in line with market prices.



- Costs to manage location, shape and volume risk are not incurred by the retail arm of gentailers.
- Gentailers' retail businesses have no exposure to intra (peak/off-peak) or inter-day volatile spot/hedge prices. Meantime, gentailers are not prepared to sell electricity to independents so that they can manage this risk (eg. shape and cap hedge product)
- ASX and OTC products are priced by gentailers taking into account their views on risks associated with supplying that electricity in the future. Independent retailers pay for these risks while a gentailer's retail business does not.

<u>Gentailers are increasingly running their retail businesses at a loss, making profits from wholesale</u>

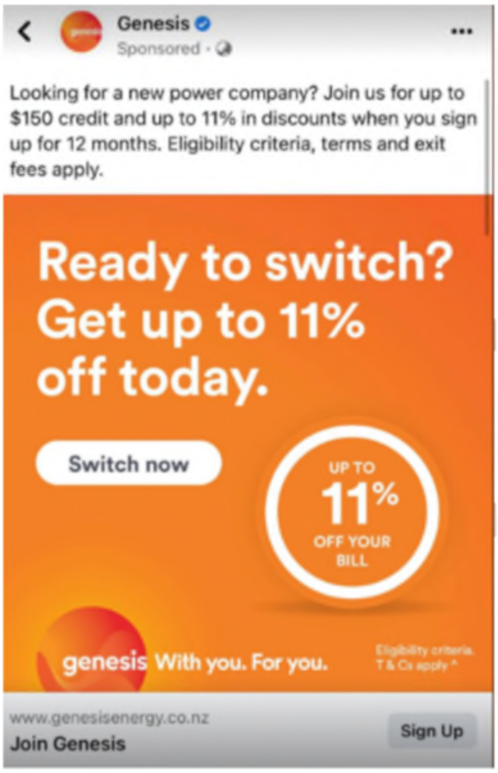
- Gentailers' retail prices are below their internal cost of electricity – gentailers have been explicit about this in recent financial reporting and market announcements.
- Our observations show that increases to Wholesale margins appear to be subsidising artificially low retail prices, allowing Gentailers to continue announcing strong overall profitability.
- Retail businesses of such scale would only be run at a loss to drive competition out of the market.
- Tight supply and increasing demand have driven wholesale gross margin growth in the past 2 years, disconnecting wholesale market pricing from the cost of generation. Looking at data since FY19 (which includes the step change in wholesale prices on October 2018), the margins were (except for Meridian) the lowest in FY21 but have increased markedly since then. The average gross margin of the gentailers stepped up 20 percentage points from FY21 to 46% in FY23 – to the highest gross margins for each gentailer's generation business in the last 5 years.

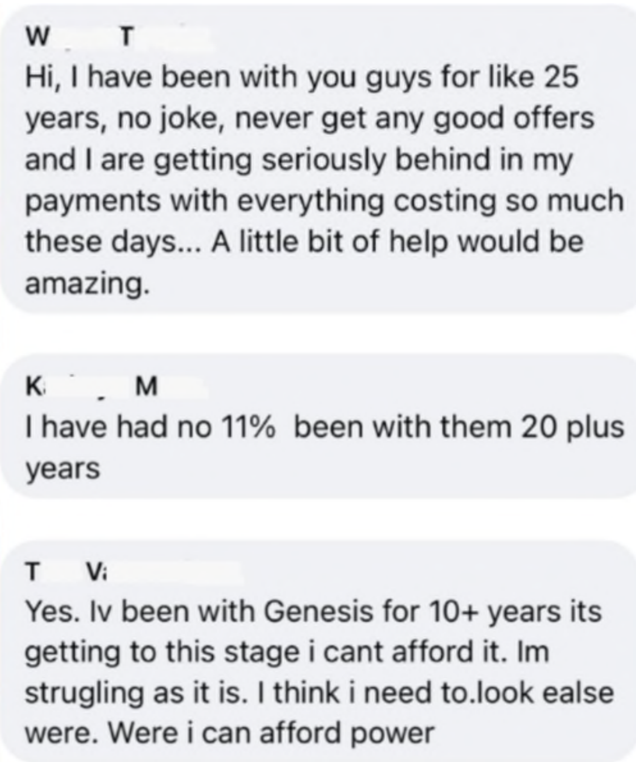


- Also over the past 2 years, spot prices have settled significantly below wholesale futures contracts. The elevated futures market is facilitating a value transfer from those that predominantly buy from the wholesale market (independent retailers) to those that do not (Gentailers). In other words, Gentailers are being overcompensated by independents for the economic value of their generation.
- Some gentailers have made it clear that internal transfer prices (ITPs) are not used in determining retail prices and adjustments to ITPs are made based on significant judgement. For example, Mercury derive their ITP from an internally generated price path, and then apply a $13/MWh downward adjustment due to management judgement.
- We are concerned that Gentailers are pricing retail based on their marginal cost of generation, or solely based on competitor activity in market. Both of these approaches would create a price squeeze on independent retailers as the marginal cost of generation is significantly lower than wholesale market prices.

<u>There are significant barriers to entry (and scale) for independent retailers</u>

- Independent retailers are competing for market share against the cheapest Gentailer price plans which are only available to new customers.
- Dominant large incumbent gentailers have a large sticky customer base that can be used to fund acquisition pricing to out-compete new entrants. Meanwhile new entrant independent retailers must be active in acquiring customers to grow.
- Loss-leading for new customers may be acceptable but MBIE should assess whether this behaviour is a function of using market power over an extended period of time to the detriment of workable competition.
- OurPower has recently exited the market, noting, "We can no longer buy electricity at a competitive price from the ASX. It's therefore not sustainable to continue operating". This can also be viewed through the lens that wholesale prices are fine (as the Authority asserts) but retail prices are being held artificially low, inhibiting competition.
- As a result of differential pricing and large joining incentives, consumers are increasingly losing trust in electricity retailers.





- Gentailer dominance in the electricity market impacts the success of independent retailers. Market entry is technically easy but the barriers to growing to financially viable scale are significant (or insurmountable given 27 retailers have exited the market since August 2018). In our view a lack of competition in electricity retailing will curtail investment in innovation which has the potential to (and has proven to in other markets such as telco) deliver lower overall system costs for the long term benefit of consumers. (Q.19)

Practical solutions to ensure a level playing field for all retailers

Competition is important across electricity retailing and generation to underpin innovation for the long-term benefit of consumers.

There is a case for detailed analysis of market dominance in the generation market and the potential of this to (continue to) stymie competition in electricity retailing (as well as stymie market share growth by independent generators). (Q.22)

MBIE must look at structural changes now to address competition issues – this includes deciding on the threshold where the Authority's behavioural compliance regime no longer promotes the long term benefit of consumers. (Q.21)

All players must have equal access to risk management products.

- Liquidity in the contracts market should be improved by introducing market making in 'shape' and 'cap' products, and baseload products out 5 years (instead of the current 3 years). (Q.23)
- Gentailers should be required to prove that their retail business 'buys' electricity from their generation business at the same price the generation business sells/offers electricity to an external third party. That is, there is non-discriminatory pricing across all the generator's customers and no cross subsidies within the vertically integrated group. Gentailer's generation business should be indifferent to selling electricity to its retail arm or any third party. (Q.23 and Q.24)

Flick's suggested practical solutions include:

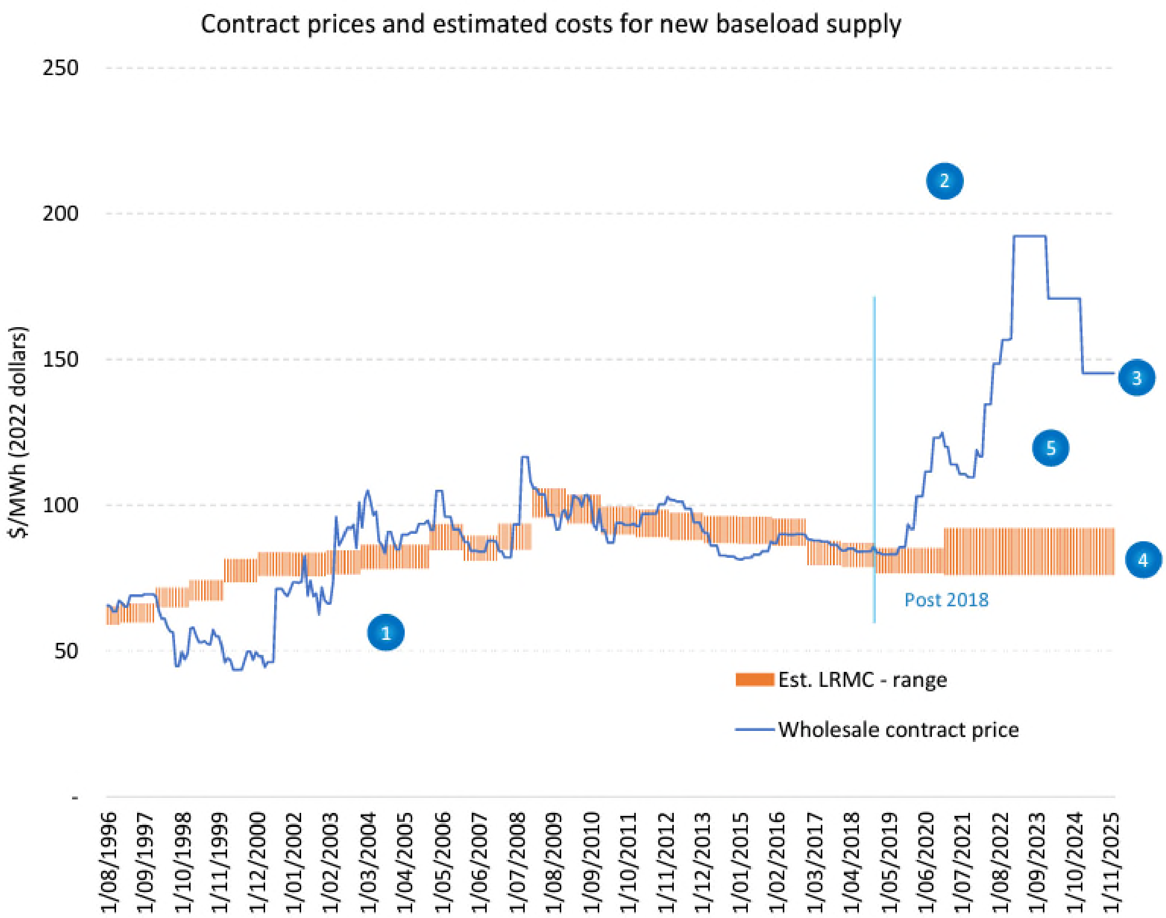
Option	**Description**
Structural reform Effort: Hardest Effectiveness: Highest	Structural reform to remove vertical integration. This is the gold standard. As MBIE notes, MDAG recommended "If structural solutions are ultimately required, they should be put in place with the least possible delay. That means some initial scoping work would make sense as a precautionary step, even if it turns out structural options were not ultimately needed".
Non-discriminatory pricing regulation Effort: Easy Effectiveness: High	The Electricity Authority could make an Urgent Code amendment to require non-discriminatory wholesale pricing (and no cross-subsidies) by gentailers. Gentailers would be required to treat their retail business like a third party charged the same price for electricity as the gentailer sells electricity to other retailers (already happens in NZ telco market).
Regulate retail price differentials	The Electricity Authority could amend the Code to require retailers to provide non-discriminatory retail pricing across their

Effort: Easy Effectiveness: Low-Medium	mass market customer base. This would mean new customer pricing cannot be subsidised by the incumbent "loyal" customers.
Operational separation Effort: Medium Effectiveness: High	Operational separation of gentailers (a step further than non-discriminatory pricing as requires separate business units with their own overheads).

Electricity wholesale market

- The wholesale electricity market is currently not a workably competitive market. After gentailers have ensured electricity supply for their retail business, the balance of their generation is offered in the 'market' at prices well above the long run cost of new generation capacity. The Authority has already concluded gentailers hold and exert market power some of the time. (Q.18)
- The Authority's review of wholesale market competition concluded that some offers do not reflect underlying conditions - "*some of the price increases since the Pohokura outage appear to be unexplained by the underlying conditions*". The unexplained (dummy variable) is $38/MWh which is higher than the published average gross margin of gentailers.
- The OTC market has limited products and liquidity for independent retailers to effectively manage energy risk.
    - We have experienced a lack of responsiveness to our RFPs, we received 0 responses to one all-of-market RFP and regularly only receive 2-3 responses
    - Responses are typically priced with high premiums to ASX pricing (usually 6-10%)
    - Responses are often non-conforming, meaning different time periods or locational nodes to the request are offered.
- While hedge prices tracked close to the Long Run Marginal Cost (LRMC) of new generation capacity up to late 2018 there is now a significant margin above the cost of both generating electricity from existing plant and constructing new generation capacity. Concept Consulting published the following graph and concluded "*Notwithstanding the uncertainty about the [LRMC] estimates, it is clear that contract prices exceed longer-run costs of new supply*".[3]

[3] Page 5 https://www.ea.govt.nz/documents/2156/Information-paper-Generation-Investment-Survey-2022-Concept-Consulting-.pdf



- Flick agrees with MBIE that the market dominance / concentration of gentailers with stored (hydro/flexible) energy will increase as the proportion of electricity generated from intermittent fuels increases. (Q.18)
- Dominant incumbent generators are financially incentivised to maintain the status quo and keep electricity supply tight to maximise revenue from their larger portfolio of existing generation assets (and maintain the financial valuation of these assets).
- While there may be a number of new and independent generators entering New Zealand, nervousness about market power and the incumbents' ability to manipulate prices to benefit their larger portfolio of assets will quickly see this turnaround. This is a real issue when only 20% of respondents to the Authority's 2022 survey (excluding gentailers) agree new entrant generators can operate on a level playing field with established gentailers.[4]
- Flick encourages MBIE to consider the correlation of the renewable generation mix and the role of a diversely correlated mix in reducing costs and the need to 'firm' intermittent generation. Improved diversity, including from offshore windfarms, can be expected to reduce price volatility and reduce the amount of time when owners of flexible generation have the ability to exert market power. Price

[4] https://www.ea.govt.nz/documents/596/Survey_of_electricity_industry_participant_perceptions.pdf

volatility in the market, without equal access to appropriate risk management products (eg FPVV), makes life harder for independent retailers.
- The competitive tension achieved by having a higher proportion of generation supplied by non-incumbent gentailers will be positive for electricity retailing, innovation and consumers.
- MBIE should focus on how the regulatory regime can ensure generation build is efficient over time and address the current environment of tight supply with associated high prices. Offshore wind projects may require unique funding arrangements given the long lead time between making the final investment decision and first power.

Practical solutions to ensure a more effective wholesale market and reduce costs to consumers

As discussed above, competition is important across electricity retailing and generation to underpin innovation for the long-term benefit of consumers.

There is a case for detailed analysis of market dominance in the generation market and the potential of this to (continue to) stymie competition in electricity retailing (as well as stymie market share growth by independent generators). (Q.22)

MBIE must look at structural changes now to address competition issues – this includes deciding on the threshold where the Authority's behavioural compliance regime no longer promotes the long term benefit of consumers. (Q.21)

Flick's suggested practical solutions include:

Option	**Description**
Virtual disaggregation of hydro storage and generation Effort: Medium Effectiveness: Medium	Virtual disaggregation of hydro storage and generation by reallocating (via auction) a significant tranche of flexible contracts from the primary holders of flexible supply (such as Meridian and Mercury) to other wholesale market participants. (MDAG suggestion D17, para 3.64))
Split Meridian's generation assets Effort: Medium - Hard Effectiveness: Medium	Require split of Meridian's storage (Pukaki and Manapouri). Sale of Tekapo stations has not improved storage management as the Water Management Agreement mimics Meridian's management of Tekapo when it did manage it.

Other feedback

The following is feedback on the other parts of the Issues Paper

Part 4: Responsive demand and smarter systems

Flick supports regulatory settings that promote competition in new markets that reward consumers for altering their behaviour for overall system benefits. Parties in these markets must have confidence the market will be competitive in order to commit to investing in innovations.

Some retailers are already active in these markets alongside aggregators. Independent retailers are incentivised to encourage customers to change their consumption behaviour in response to price signals to reduce exposure to buying electricity high price periods during high demand (as there are no shaped hedge products that manage this risk).

Flick supports equitable access to relevant data for all players. This would be most efficiently achieved with a central registry.[5]

Part 5: Whole of system considerations

Flick is concerned that the same issues are surfaced numerous times with minimal momentum for improving outcomes. We suggest the current regulatory structure does not support efficient collaboration or a universal understanding of issues.

Flick supports a review of the structure and responsibilities of entities involved in regulating the energy sector. Whatever the outcome of a review, regulatory agencies must be appropriately resourced to enable timely regulatory intervention.

Flick would welcome the opportunity to discuss any of the topics covered in this submission. Feel free to contact me.

Yours

[unsigned as sent electronically]

Chief Executive Officer

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[5] We do not support the Authority's proposal to solve this issue by enabling distributors to deal with MEPs directly. The metering segment of the supply chain is essentially a monopoly/oligopoly that has not been subject to any scrutiny. The Authority's workaround results in MEPs recovering their costs twice – from retailers and now also distributors.