

17 January 2018

Energy Markets Policy Team
Ministry of Business, Innovation & Employment
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Draft Electricity Pricing Review Terms of Reference

Cumulus Asset Management (Cumulus) welcomes the opportunity to submit on the Ministry of Business, Innovation & Employment's (MBIE) draft Terms of Reference. Cumulus is the majority owner of Electric Kiwi and also has significant wholesale trading interests in New Zealand electricity.

Cumulus supports the Electricity Pricing Review

We have included the submission we made to the Electricity Authority on its 2018/19 Appropriations as part of our submission on the Terms of Reference. The Appropriations submission details problems in the retail and wholesale markets which we would like addressed. At the time of submitting to the Electricity Authority we didn't know the details of the Electricity Pricing Review.

How the draft Terms of Reference could be improved

The broad and open-ended nature of the draft Terms of Reference could be a problem if the Pricing Review isn't able to get into the detail of the issues it is trying to deal with deeply enough to fully understand what the underlying problems are and/or what needs to be done to address them.

The Terms of Reference could be improved if they more clearly reflected, and were consistent with, the energy policies which resulted in the Pricing Review being in the Labour-NZ First Coalition Agreement. This would help ensure a more focussed and targeted review.

NZ First energy policy is clear "recent reviews in the UK and Australia have found major issues with similar 'market reforms' we adopted here". It would be helpful if the Terms of Reference directed the Pricing Review to consider these recent reviews.

Our submission on the Electricity Authority's Appropriations provided some details about how the problems the Australian and UK reviews identified with market concentration and retail-generation vertical integration also exist in New Zealand. Periodic issues with large incumbent generators using transient market power ("net pivotal position") also highlight these competition problems.¹ We note also that the Electricity Authority has acknowledged problems with incumbent retailers having incentives and the ability to inhibit competition.²

The Green Party energy policy also provides some clear directions on matters which should be looked at by the Pricing Review, which it would be helpful to include in the Terms of Reference. For example, Green Party policy is to "review the wholesale markets":

As new retailers enter the market, the wholesale markets through which they purchase from generators must be functioning efficiently and effectively to provide a level playing field, so that ultimately customers can get the best deal.

¹ For example, the Electricity Authority's investigation into Meridian's conduct on 2 June 2016 determined:

- Meridian (mis-)used its transient market power (the EA uses the term "net pivotal position") to raise final prices in the South Island in the range of \$3,000 to \$4,600 per MWh above levels justified by scarcity; and
- Meridian's trading conduct was not of a "high standard" and breached clause 13.5A(1) of the Code.

<https://www.ea.govt.nz/dmsdocument/22116>

² <https://www.ea.govt.nz/development/work-programme/evolving-tech-business/multiple-trading-relationships/consultations/#c16922>

The Green Party will commission an independent review into operation, competition and liquidity of the electricity Over-The-Counter (OTC) and Australian Stock Exchange (ASX) futures/hedge markets to ensure new entrant and independent retailers have reasonable access to products that allow them to hedge risk ...”

In our experience, lack of hedge market liquidity is holding competition back. We have noted, in various submissions and fora, based on our participation in many deregulated wholesale electricity markets around the world that New Zealand stands out as having among the lowest levels of wholesale liquidity relative to its size.³

The ability of innovative new entrants to enter the market, and gain market share, is severely hampered by the low levels of wholesale liquidity, which is caused by high levels of vertical integration. Wholesale liquidity needs to improve to create a more dynamic and competitive electricity market.

Collecting information on profit margins at each level of the supply chain

We anticipate the Pricing Review will encounter problems getting information on “The financial performance of suppliers across the supply chain, including but not limited to, gross and operating profits, return on capital employed (ROCE), and return on average capital employed (ROACE) ...”

For starters this direction appears to be far too wide. Taken literally it would require the Pricing Review to scrutinise the profitability of every market participant, including new entrant retailers, in the electricity sector.

If the Pricing Review is going to focus on identifying potential problem areas in the market it should investigate incumbent service providers, not small new entrants which lack market power. This would mean limiting the investigation into profit margins, at the retail and generation levels of the supply chain, to the big-5 incumbent gentailers.

The Pricing Review will face a number of challenges trying to get to the bottom of the profitability of the incumbent gentailers’ retail and generation operations e.g.:

- Contact Energy is the only gentailer that separately discloses its retail and generation financial performance;
- Some of the big-5 incumbent gentailers have multiple retail brands and arrangements;
- The related party transactions (including internal hedging) between their retail and generation businesses is non-transparent and implicit at best. Many of the issues that have been raised with EDB related party transactions, under the Part 4 regime, are relevant in this context; and
- Profitability is also masked by asset revaluations. It would be helpful for the Pricing Review to look at profitability on the basis of historic asset value (at the time the baby-ECNZs were corporatised), with adjustments for depreciation and subsequent investment.

Process and timing

We recognise the draft Terms of Reference reflects that the Pricing Review should determine its own process, but there is an expectation it will involve wide and multi-stage consultation.

We would like to see the Pricing Review engage with stakeholders through consultation early on in the process. It wouldn’t take much for the Pricing Review to initiate a consultation asking stakeholders to identify the most significant problems in the electricity sector, and the areas the Pricing Review should focus on. The Pricing Review can do this before forming its own views or undertaking its own analysis. The Commerce Commission has often consulted on emerging views, which provides useful precedent.

³ Cumulus, Submission by Cumulus Asset Management on the Consultation paper titled – Hedge Market Development: Enhancing trading of hedge products, 14 July 2015, at <https://www.ea.govt.nz/dmsdocument/19666>

We would like to see the Pricing Review engage in consultation at each step in its policy development process and shy away from a narrow 'propose-respond' approach to consultation and engagement with interested parties.

We would also like to see the Pricing Review use cross-submissions through-out its process. This is standard for Commerce Commission consultations, but the Electricity Authority makes much less use of cross-submissions than it could. Much of the consultation is likely to be highly contentious, so it would be good to enable interested parties the opportunity to test and challenge the views of other parties.

Concluding remarks

Cumulus is of the view the Terms of Reference for the review should explicitly direct the Pricing Review to look at:

- The extent to which recent reviews in Australia and the UK help identify potential problems in the New Zealand electricity sector;
- Why there is so much variation in the HHI across different electricity retail markets. Twenty-years after the introduction of retail competition there should not be concentration levels of 5055 and 4399 which there are in Tauranga and King Country, respectively;⁴
- Issues with market power, or transient market power, in the wholesale market (did the Genesis-Meridian asset swaps and the virtual asset swaps in the previous review go far enough?);
- Issues with vertical integration in retail-generation, which haven't received the attention it warrants or the attention there has been on EDB vertical integration; and
- Hedge market liquidity, including the impact of vertical integration.

Much of this could be achieved by adoption of aspects of the coalition partners' energy policies in the Terms of Reference.

Yours sincerely,

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⁴ https://www.emi.ea.govt.nz/Retail/Reports/IK41HT?_si=v|3,p|14

19 December 2017

Submissions
Electricity Authority
By e-mail: submissions@ea.govt.nz

Consultation Paper—2018/19 Appropriations

Cumulus Asset Management (Cumulus) welcomes the opportunity to submit on the Electricity Authority's (EA) proposed work priorities and appropriations for 2018/19. Cumulus is the majority owner of Electric Kiwi and also has significant wholesale trading interests in New Zealand electricity.

In making this submission, we note the terms of reference of the Government's Retail Price Inquiry haven't been announced but may have implications for some of the issues we raise.

Summary of Cumulus' views

It appears that the EA has taken on too many projects, and this may explain the inertia or slow progress on some projects. The EA could be more effective and efficient (operating at a lower cost than its proposed budget) if it adopted a tighter and more focussed work programme.

Cumulus would like to see a focus on dealing with structural issues in the wholesale and retail markets. There are high levels of market concentration (we shouldn't be observing HHI levels as high as 5000, twenty years after retail competition was enabled) and retail-generation vertical integration, which largely explains the low level of liquidity in the hedge market.

Areas Cumulus would like to see treated as priorities by the EA or the Government's Retail Price Inquiry include:

- issues of transient market power in the wholesale market;
- the impact of vertical integration in retail-generation on competition;
- hedge market performance and development (this is closely linked to the first two issues); and
- 'saves and win-backs' which should be treated as a 1 priority not 2.

Cumulus would like to see a more tightly focussed work programme

Cumulus is concerned about the large number of projects the EA has in its work programme.

Cumulus would like to see the EA adopt a 'less is more' approach to its work programme which has a tighter focus on dealing with competition issues. A tighter and better managed work programme would be more efficient and could lower the EA's budget requirements.

Market concentration remains an issue that is only slowly getting better

While the competitive landscape has improved over the last two decades, the retail and wholesale markets still have strong oligopolistic characteristics.

The extremely high levels of market concentration, with the largest three retailers having a market share of 64% and the big-five retailers a market share of 89%, highlight that New Zealand has a long way to go before it has a fully healthy and vibrant competitive electricity market.

The UK Competition and Markets Authority applies a 'rule of thumb' that HHI below 1000 is unconcentrated, markets with HHI between 1000 and 2000 are concentrated, and markets with HHI above 2000 are highly concentrated.¹ Based on this categorisation:

- there are no unconcentrated retail markets in New Zealand;
- Dunedin, Marlborough Nelson, Rotorua, and Taupo are concentrated (with Auckland's North Shore on the margin); and
- the rest of the country remains highly concentrated - with areas such as the Tauranga and King Country extremely concentrated with HHI of 5055 and 4399, respectively.²

The analysis the EA has undertaken looking at the savings consumers could make from switching to the cheapest retailers is a good illustration of the benefits to be gained from a stronger and more vigorously competitive retail market.

Experience in Australia and the UK highlight that market concentration and retail-generation vertical integration are big problems

The Australian Competition and Consumer Commission (ACCC) has investigated wholesale and retail market issues in much more depth than we are yet to see in New Zealand.³ The ACCC identified issues of high market concentration and retail-generation vertical integration as the cause of competition problems.

The issues with market concentration and vertical integration the ACCC identified are remarkably similar to New Zealand e.g.:

- The Australian retail market is highly concentrated with the biggest three Australia retailers having 70% market share, and the big-five making up 90% market share.⁴ This is little different to New Zealand.
- "The ACCC is ... considering whether high levels of vertical integration have an impact on wholesale prices."⁵
- "The ACCC is concerned about the impact that vertical integration may have on standalone retailers' ability to compete".⁶
- Vertically-integrated retailers have a range of advantages with at least one operator making "significant adjustments to its transfer price in February 2017 in order to reallocate costs between its retail and wholesale businesses".⁷

There have been various market reviews undertaken in the UK which have identified similar problems with market concentration, retail-generation vertical integration and tacit collusion.⁸ A recent OFGEM report, for example, noted that the six largest retailers account for 82% of the retail market and, despite substantial new entry, the retail market is still concentrated.⁹

¹ Competition Market Authority, Guidelines for market investigations: Their role, procedures, assessment and remedies, April 2013, pages 87 and 88.

² https://www.emi.ea.govt.nz/Retail/Reports/IK41HT?_si=v|3,p|14

³ ACCC, Retail Electricity Pricing Inquiry, Preliminary report, 22 September 2017.

⁴ ACCC, Retail Electricity Pricing Inquiry, Preliminary report, 22 September 2017, page 82.

⁵ ACCC, Retail Electricity Pricing Inquiry, Preliminary report, 22 September 2017, page 82.

⁶ ACCC, Retail Electricity Pricing Inquiry, Preliminary report, 22 September 2017, page 82.

⁷ ACCC, Retail Electricity Pricing Inquiry, Preliminary report, 22 September 2017, page 82.

⁸ See, for example, https://www.ofgem.gov.uk/sites/default/files/docs/2014/03/assessment_document_published_1.pdf and https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf.

⁹ Ofgem, State of the energy market, 2017, page 20.

Issues with vertical integration at different levels of the supply chain

There has been a lot of discussion about vertical integration in the context of EDBs and emerging technology, and the potential ways this could impact on competition.

A lot of the arguments and concerns have direct parallels with retail-generation vertical integration. The ACCC investigation, referenced above, provides good evidence of this.

Cumulus questions the lack of transparency around the financial performance of the big-five retailers' retail and generation businesses, and related party transactions. (Contact Energy's decision to separately report on its generation and consumer segments is a good start, but puts it out of step with the other incumbents.¹⁰)

Lack of hedge market liquidity is holding competition back

We have previously noted, based on our participation in many deregulated wholesale electricity markets around the world, that New Zealand stands out as having among the lowest levels of wholesale liquidity relative to its size.¹¹

The ability of innovative new entrants to enter the market, and gain market share, is severely hampered by the low levels of wholesale liquidity, which is caused by high levels of vertical integration. We remain of the view that the EA should act to improve wholesale liquidity and create a more dynamic and competitive electricity market.

Outstanding issue of mis-use or taking advantage of transient market power

The EA's investigation into Meridian's conduct on 2 June 2016 determined:

- Meridian (mis-)used its transient market power (the EA uses the term "net pivotal position") to raise final prices in the South Island in the range of \$3,000 to \$4,600 per MWh above levels justified by scarcity; and
- Meridian's trading conduct was not of a "high standard" and breached clause 13.5A(1) of the Code.¹²

Since then there have been other incidents where transient market power may have been used to raise spot prices.

Cumulus was surprised and disappointed there was no mention of these matters in the EA appropriations consultation. The EA had previously stated it would consider including a review of the high standard of trading conduct provisions in its work programme.

It is now over 18 months since Meridian's code breach and we would like to see the matter resolved. There are clear and quantifiable detriments to consumers and other market participants (particularly stand-alone retailers who don't get the benefit of the higher spot prices). We note Meridian also wants the EA to provide clearer guidance about what conduct is acceptable.¹³

Inappropriate use of information from the switching process

Cumulus is pleased the EA has added 'saves and win-backs' to its work programme.

We agree with the EA that "Saves and win-backs are at the crux of competition between retailers. It is important that new entrant retailers have a 'level playing field' for competing for customers. This

¹⁰ <https://contact.co.nz/aboutus/media-centre/2017/05/02/contact-energy-changes-reporting-segment>

¹¹ Cumulus, Submission by Cumulus Asset Management on the Consultation paper titled – Hedge Market Development: Enhancing trading of hedge products, 14 July 2015, at <https://www.ea.govt.nz/dmsdocument/19666>

¹² <https://www.ea.govt.nz/dmsdocument/22116>

¹³ <https://www.meridianenergy.co.nz/assets/Investors/Reports-and-presentations/Annual-results-and-reports/2017/Meridian-Energy-Integrated-Report-for-the-year-ended-30-June-2017.pdf>, at page 28.

project is important for promoting retail competition".¹⁴ We question the EA's rating the project as a 2 priority given its implications for retail competition.

Retailers should not be allowed to (mis-)use private customer information obtained through the switching process to try and prevent the switch from occurring. The EA has at least recognised this as an issue: "In the retail electricity market the incumbent retailer is notified that a customer intends to switch before the process is completed. This notification allows the losing retailer to use the information of a customer's intention to switch as a prompt to contact the customer to discourage them from switching, rather than use the information for its intended purpose, which was to complete the switch process" [emphasis added].¹⁵

Cumulus would like the 'saves and win-backs' policy aligned with telecommunications and a ban on "saves":

- private customer information from the switching process (including that they are switching retailers, and the retailer they are switching to) treated as confidential; and
- retailers only allowed to use information from the switching process to facilitate the switch, and not be able to use it for any other purpose including customer "saves".

Concluding remarks

The retail and wholesale markets are presently oligopolistic in nature, with a long-tail of small new entrants. We would like to see these markets develop into fully competitive markets.

Cumulus would like the EA to adopt a tighter and more focussed work programme which prioritises removal barriers to entry and growth of new entrant retailers, and addressing the issues that can arise from retail-generation vertical integration. We recognise the Retail Price Inquiry could impact on the EA's work programme.

Specific matters we would like addressed, be it by the EA or the Retail Price Inquiry, include:

- There are issues with market power, or transient market power, in the wholesale market, including the outstanding matter of Meridian's June 2016 trading conduct, and market performance during the 2017 winter;
- There are issues with vertical integration in retail-generation, which haven't received the attention it warrants or the attention there has been on EDB vertical integration;
- We would to see more work on hedge market performance and development (this is closely linked to the first two issues); and
- We are pleased the EA is having another look at 'saves and win-backs'. Our view is that retailers should not be able to use information obtained through the switching process for any other purpose than facilitating the switch (current arrangements allow retailers to misuse private customer information).

Yours sincerely,

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¹⁴ Electricity Authority Work Programme Report for the period 1 July 2017 - 31 October 2017, page 15.

¹⁵ Electricity Authority, Post implementation review of saves and winbacks, 29 August 2017, page ii.