



4 May 2017

Rory Blundell
General Manager Market Performance
Electricity Authority
P O Box 10041
Wellington 6143

Dear Rory

RE: Enquiry into FPVV vs ASX prices and PIR of save protection scheme

This letter is on behalf of a group of small new entrant independent electricity retailers we refer to as The Alliance of Independent Retailers (TAIR). All but one of the group do not own any generation assets but rely on the wholesale spot, OTC and ASX futures markets to buy electricity for on-sale to our customers. We are privately owned and 'independent' of the incumbent vertically integrated (VI) Gentailers.

Our group is creating real retail competition. We have to attract each new customer on the basis of our differentiated products and services. That is, we are starting without a database of customer details which the incumbent VI Gentailers have and might use to cherry pick customers. With limited growth in total customer numbers retail competition is effectively a zero sum game – any customer growth by our group is basically matched off with a loss of customers for the incumbent VI Gentailers.

Members of our group have communicated with you individually over an extended period of time about our concerns relating to FPVV vs ASX prices and the failure of the save protection scheme. We understand your team is currently progressing work on both these topics. The purpose of this letter is to provide combined feedback for your consideration as you complete your enquiry and review respectively.

Enquiry into FPVV vs ASX prices

As you know members of our group have anecdotal information from unsuccessful FPVV tender results with commercial customers that our price offers are 'out of the money' compared with other tenderers. The ASX market is the comparator for this FPVV commercial tender market. It is the only benchmark we have for forward prices and is also the market we rely on to purchase electricity and manage our exposure to spot market risk over the term of a FPVV contract.

We have been able to confirm our approach of benchmarking against the ASX in this tender market is consistent with the approach of incumbent VI Gentailers. The latest financial result announcements for the incumbent VI Gentailers provide some useful insights.

Meridian Energy: At about 17 minutes in the Interim Result webcast¹ presentation on 22 February Paul Chambers, CFO, said retail volumes declined by 11.6% with about two-thirds of this in the large corporate and industrial sector where contracts rolling off were not matched by re-signs principally because we saw competitor pricing compared to the ASX counterfactual dropping to levels we felt uncomfortable with.

Both Meridian and Contact Energy disclose information about the ‘transfer price’ they use between their generation and retail segments.

The following table summarises Meridian’s transfer price².

	Dec-16	Jun-16	Dec-15	Jun-15	Dec-14	Jun-14	Dec-13	Jun-13	Dec-12
	1H2017	FY2016	1H2016	FY2015	1H2015	FY2014	1H2014	FY2013	1H2013
Transfer price from Generation Segment to Retail Segment \$/MWh	67 - 73	67 - 73	80 - 85	80 - 85	80 - 85	80 - 85	80 - 85	80 - 85	85.0

This ‘transfer price’ can be graphed against ASX prices. The following graphs show the Meridian transfer price compared with the ASX settlement prices at the Benmore node the trading day before calendar quarter.

At 31 December 2015 the majority of the ASX prices were above the price Meridian is selling electricity to its retail segment. For the other quarters the ASX market does not provide a competitive source of electricity or benchmark for an independent retailer to compete with this stated transfer price after the first year of a FPVV contract.



¹ See <https://www.youtube.com/watch?v=xU-u-k1rMdg>

² Sourced from the Financial Results section of Meridian Energy’s Interim and Annual Reports



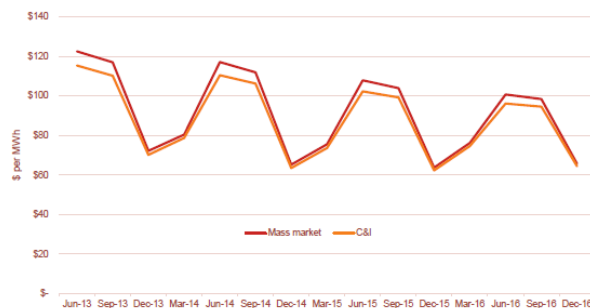
Contact Energy included the following page in its result presentation³ for the 6 months ending 31 December 2016.

Transfers of value between the two segments appropriately reflect market conditions

Inter-segment electricity transfer price

- » The fixed price, variable volume transfer price between the Customer and Generation segments is set in a manner similar to transactions with independent retailers. On this basis, the transfer price enables an accurate picture of the financial performance of each segment.
- » A prudent retailer, offering fixed price variable volume products would contract their forecast load incrementally up until the start of the contract period. For the Customer business, 90 days before the start of a quarter the electricity transfer price is fixed and takes into account:
 - The simple average of ASX settlement prices for the preceding 3 years for the quarter to be contracted
 - Adjustments for location, seasonality and line loss which are based on the Customer business load profile for preceding 12 months

Inter-segment electricity transfer price



This is a clear explanation of how Contact set its transfer price:

“For the Customer business, 90 days before the start of a quarter the electricity transfer price is fixed and takes into account:

- *The simple average of ASX settlement prices for the preceding 3 years for the quarter to be contracted*
- *Adjustments for location, seasonality and line loss which are based on the Customer business load profile for the preceding 12 months”*

We are perplexed about why an historic ASX settlement price would be used to price obligations to supply electricity into the future. Contact comments in their February 2017 Half Year report that⁴

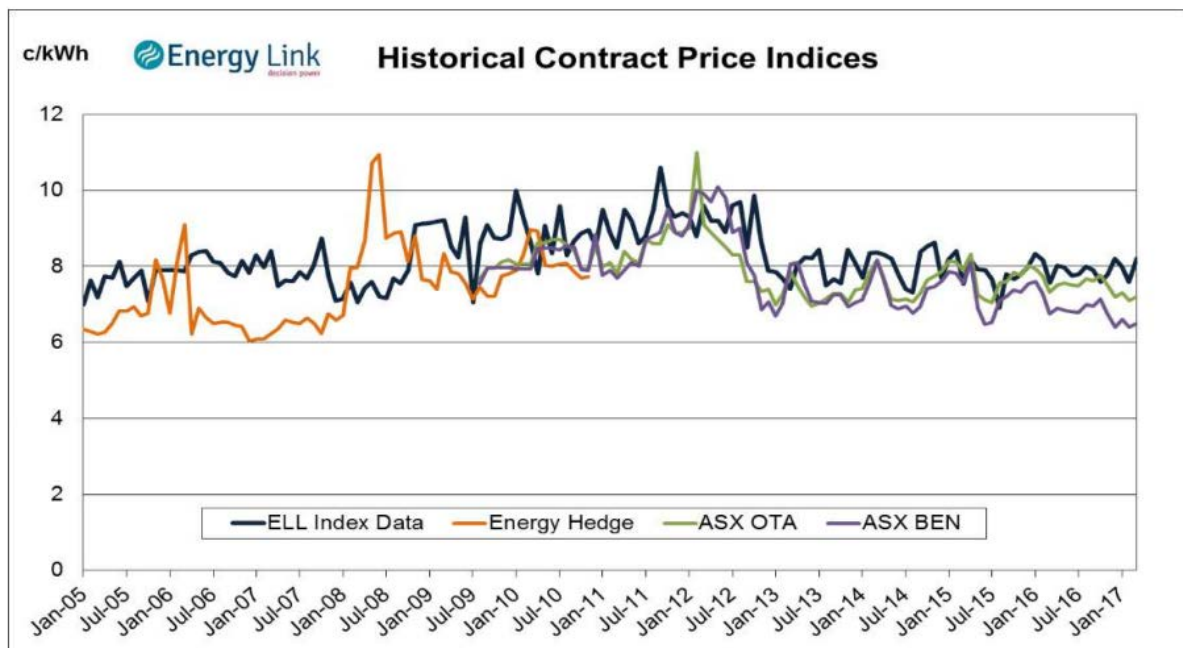
³ See page 15 <https://contact.co.nz/cenergymedia/contactenergy/files/pdfs/corporate/cen-hy17-presentation.pdf?la=en>

⁴ See page 7 <https://contact.co.nz/cenergymedia/contactenergy/files/pdfs/corporate/cen-hy17-report.pdf?la=en>

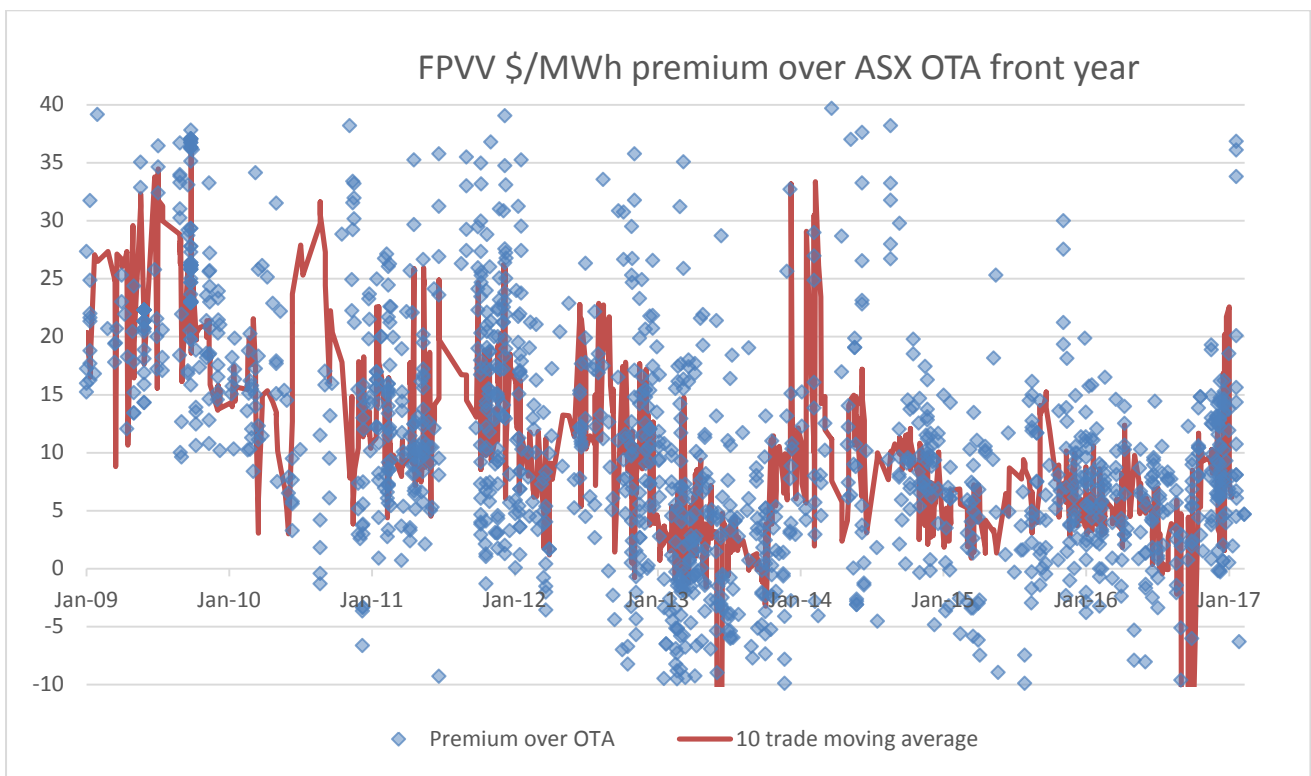
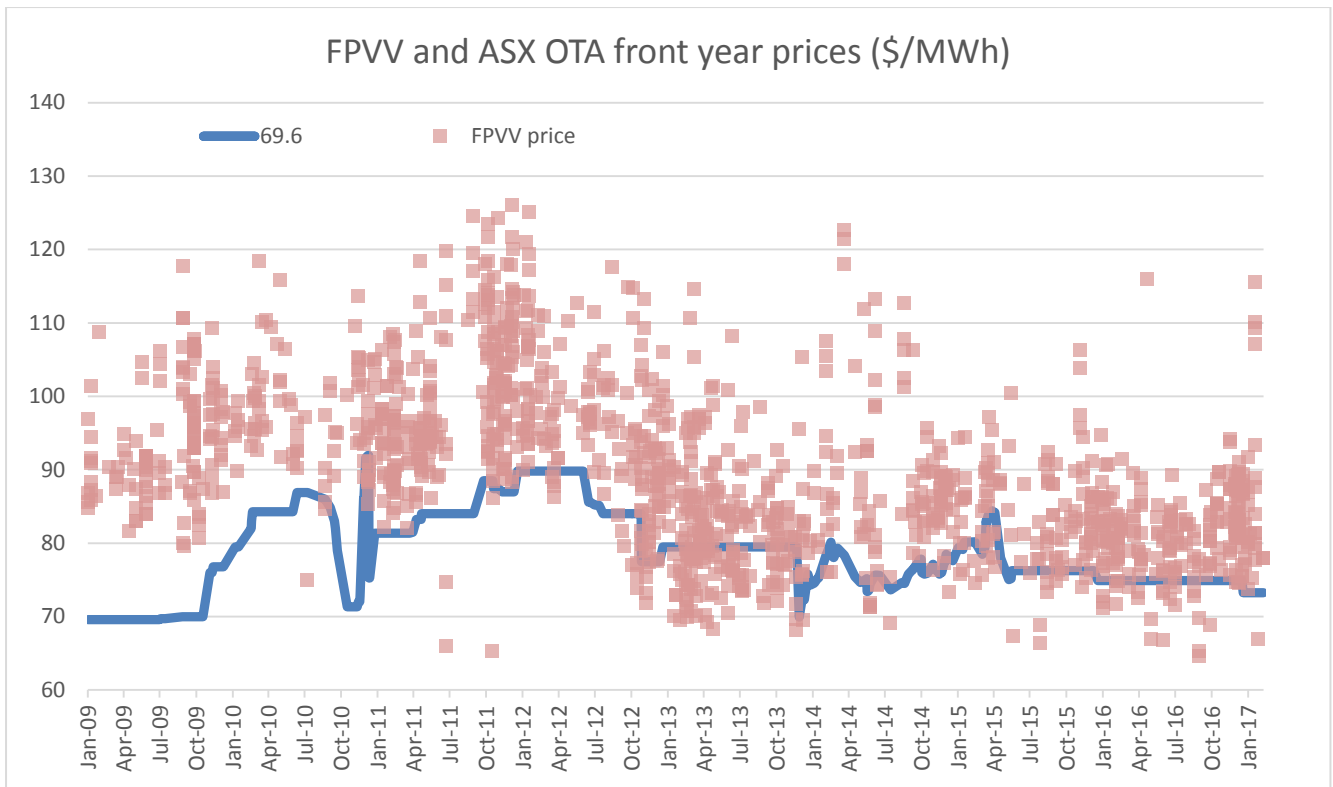
"C&I electricity netback was down by \$2/MWh with the prices on contracts of new customers tracking the ASX futures prices down."

Data about forward looking ASX prices at Benmore are included in the graphs above on comparing Meridian's transfer price with forward Benmore ASX prices. Independent retailers are not able to use historic ASX prices as a proxy for valuing future FPVW contracts as these prices are (obviously) no longer available. The only way for a non-VI retailer to value a forward looking FPVW contract is to benchmark against a forward looking ASX price as this is the market for managing the spot price risk of a forward looking contract.

The EnergyLink Index data against ASX at OTA and BEN is insightful. The margin between ELL FPVV Index and the ASX at OTA has been much narrower in the last year than previous periods – including a period in 1Q2016 when the ASX price was higher than the Index.



Our own analysis – which does not make any adjustments to any of the hedge disclosures – clearly shows a reduction in the margin as well as a negative margin for FPVV contracts compared with the ASX.



There are some limitations to the above analysis (such as using raw FPVV disclosures and only the OTA node) but the results are sufficiently obvious for us to request the Authority investigate this issue more thoroughly.

In our view there are numerous reasons why a FPVV contract should be priced at a margin above a FPFV ASX contract:

Attributes of FPVV contract	Attributes of FPFV ASX contract
Completely Variable volume – while the price may be sculptured to reflect the demand profile this adds cost and complexity to the contract	0.1MW fixed contract
Unknown / unpredictable volume on a minute by minute basis – which have to be matched with purchases from the spot market	0.1MW fixed contract
Additional costs to serve the customer: eg monthly invoices, call centre, reconciliation, etc	Not applicable
Credit risk associated with counterparty	Not applicable
Retail prudentials – reflect both variable volume and variable spot prices have cashflow consequences and are less predictable than a margin call	Margin call
Network prudentials also reflecting both variable volume and variable spot prices have cashflow consequences	Not applicable
Variable term adds complexity and cost	Known term
Retailer profit margin above the cost of inputs for the FPVV contract	Not applicable
Unlikely retailer can change the fixed price if the spot market price moves so the risk of the contract becoming unprofitable must be priced in	Can trade out of contract if market price moves
Unlikely retailer can cancel the contract	Can trade out of contract if want to
Costs associated with negotiating a bespoke contract	Standard terms and conditions

Conclusion and suggested solution

We conclude that the incumbent VI Gentailers can, and do, price FPVV contracts below the ASX benchmark. VI Gentailers can, on an ongoing basis, price FPVV contracts below the ASX benchmark because they have both a generation margin (notionally ASX less spot or OTC /internal transfer less spot) and a retail margin (notionally retail less ASX /internal transfer). Consequently even at less than ASX they will have positive (generally) gross cash margins. This does not apply to an entity that is dependent on the ASX.

Pure independent retailers do not, obviously, have this choice. In our view, the behaviour of the incumbent VI Gentailers in pricing FPVV contracts below ASX is anti-competitive because:

- the FPVV contract with a customer is at a price level below the cost of entry for competitors - taking into account the differences in the two types of contracts – see table above
- it represents a use of substantial market power – VI Gentailers are profitably holding FPVV prices below the input costs faced by competitors (ASX) for a sustained period of time

We appreciate the Authority is not interested in the competitive behaviour of participants⁵. The group is therefore preparing to make a complaint to the Commerce Commission.

We understand that the Authority has received successful tender data from a number of the VI gentailers – this is positive. We caution against publishing data on the ASX and its performance until we have been able to review the data using an independent but TAIR appointed specialist.

If the hedge market disclosure requirements are not providing the Authority with the right information to investigate our concerns, then we suggest this be improved by establishing a system so that FPVV contracts, including prices, are monitored and analysed to ensure a competitive market is operating.

Post implementation review of the Save Protection Scheme

The objective of the save protection scheme was stated by the Authority⁶ to be “to promote retail competition”. The 2014 Consultation paper goes on to say⁷:

“The Authority considers that the proposal is for the long-term benefit of consumers. While some consumers would no longer be able to receive save offers, this effect would be outweighed by broader competitive effects including:

- *increased marketing activity by acquiring retailers, making it more likely that a customer would receive an improved offer from another retailer*
- *increased retention activity prior to any switch being initiated, making it more likely that a customer would receive an improved offer from their current retailer*
- *lowering of barriers to entry and expansion for smaller/new entrant retailers, which will have an important role in driving competition and innovation.*

The Authority expects that the proposed amendment will facilitate retail competition for the long-term benefit of consumers.”

The Authority’s Decisions and Reasons paper describes the save protection scheme:

1.2.2 The Code prohibits a losing retailer from initiating contact to offer inducements to any of its customers that are acquired by another retailer, if the gaining retailer has chosen save-protection. The prohibition extends until the switch is complete. The losing retailer will still be able to save a customer by offering an inducement if the customer initiates contact with that retailer prior to the switch being complete.

1.2.3 In addition, if a retailer opts-in for save protection, it is prohibited from carrying out saves itself, unless the customer initiates the contact.

⁵ See paragraph A.28 in the Authority’s interpretation of the statutory objective relating to promoting competition <http://www.ea.govt.nz/dmsdocument/9494>

⁶ See paragraph 5.2.1 of the Consultation paper t <https://www.ea.govt.nz/dmsdocument/18175>

⁷ Ibid page D-E

1.2.4 The Authority has decided not to prohibit the losing retailer from attempting to persuade a customer from returning after a switch is completed. That is, save-protection is not intended for win-backs. This is a key change from the initial proposal described in the June 2014 consultation paper.

The qualitative cost benefit analysis of the proposal listed the following benefits and costs and concluded benefits exceed costs. **We disagree.** Our experience about each expected benefit and cost is detailed below. Most of these qualitative benefits have been described as if all retailers were expected to opt-in to the save protection scheme. Incumbent retailers have not opted-in⁸.

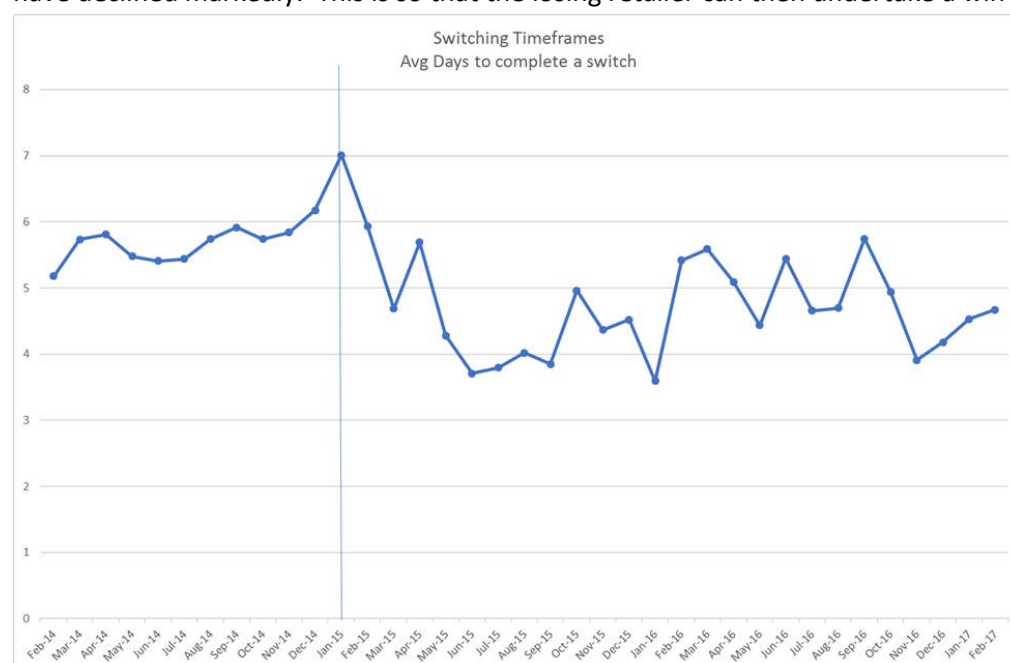
Below we list the benefits and costs from the Authority's CBA analysis – in bold – and our response.

Benefits:

- **Lower barriers to entry and expansion for small and new entrant retailers – new entrants will be confident that incumbent retailers will not be able to leverage the switching system as a way of retaining their customers**

The switching system has been leveraged by incumbents as a way of retaining customers. There has been a marked improvement in the speed with which switches are processed. The save protection scheme has encouraged the incumbents to improve their switch processes so that switches are completed faster – so that they can then undertake a win-back.

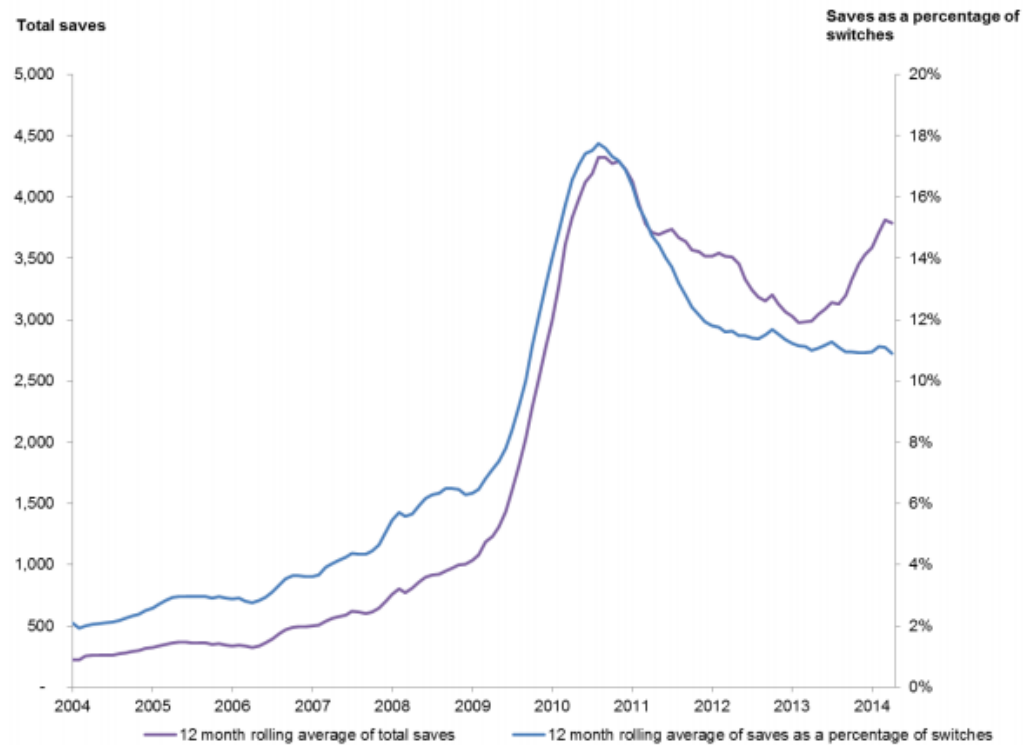
Days for gaining retailers to complete a switch for customers lost by one new entrant retailer have declined markedly. This is so that the losing retailer can then undertake a win-back.



The following graph was included in the Consultation paper.

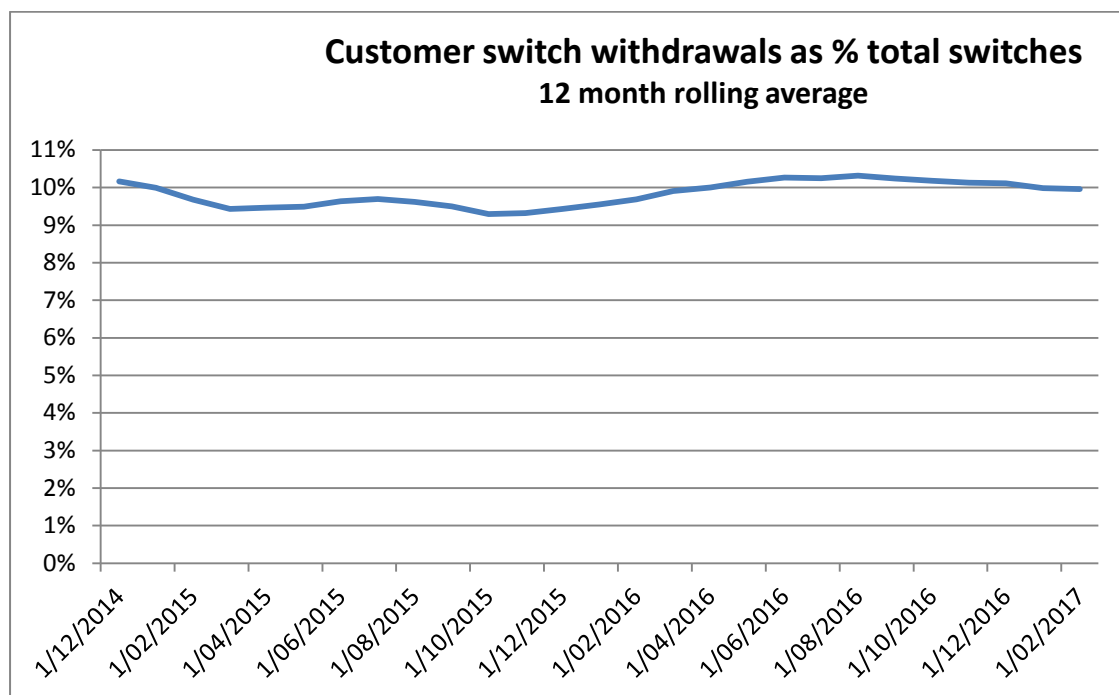
⁸ We note Genesis and Energy Online, one of their brands, joined the scheme when it started and left as soon as it was possible to do so.

Figure 1: CR coded switch withdrawals as a total and as a percentage of switches (12-month rolling average), over the last decade

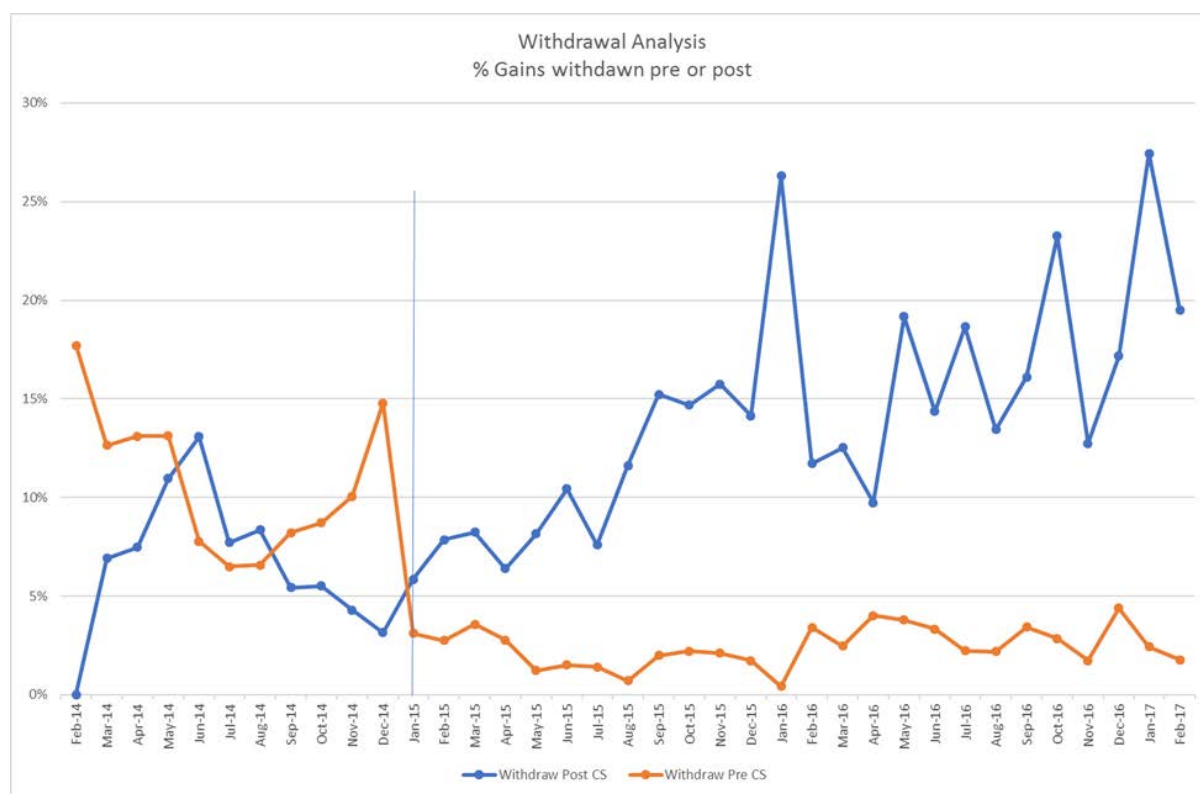


Source: Electricity Authority

We have updated the Authority's graph to show there has been no change in the ratio of customer withdrawal switches to total switches overall since the save protection scheme was implemented, despite a marked increase in the number of retailers.



However, the customer withdrawals or win-backs post switching have increased. Our group of save protected retailers are experiencing a much higher rate of customer withdrawals than the national average. The following graph is for one of our group.



- **Increased acquisition activity by save-protected retailers – protection from saves and early win-backs will make acquisition activity more cost-effective**

The incumbent VI gentailers have not opted-in to the scheme and are therefore at will to offer any customer they rate as valuable a better price than is generally offered in order to win them back from a new entrant.

This selective save or win-back activity is easy for incumbent retailers as they have billing history of their customers and can target the customers they do not want to lose. This means that over time, new entrant retailers will have a portfolio of less valuable customers – not that they are aware of this at the time the customer joins because, as a new entrant, they do not have any billing history.

The proposed benefit of making acquisitions more cost effective has not been realised because the cancelled switches plus win-back rates are so high as to be driving huge increases in acquisition costs. For example, in the major centres the customer withdrawals averaged 37% in February 2017 (and 63% in Hamilton). The regional data is interesting as for some rural areas there are very often no customer withdrawal switches. Is this for the long term benefit of consumers?

	Gains	Losses	Net	Customer withdrawn	
Auckland	2800	2800	0	1088	39%
Hamilton	439	439	0	277	63%
Tauranga	227	227	0	69	30%
Wellington	823	823	0	315	38%
Christchurch	1097	1097	0	282	26%
Dunedin	350	350	0	97	28%
Main Centres	5736	5736	0	2128	37%

- **Encourage retailers to pre-emptively offer their existing customers a better deal**

There is no incentive for incumbent retailers to offer their entire customer base a better deal. The only customers that receive a better deal are the few that the incumbent decides are worth saving. There is no transparency about these bespoke offers. Further, the rest of the incumbent's customer base is subsidising the lost revenue due to the deals offered to saved customers.

New entrant retailers must promote their best deals to potential customers at the outset in order to be able to attract customers to switch.

Mercury is creating loyalty by offering a price and locking customers in for 3 years. Mercury comments extensively on its customer loyalty in its Half Year report for the six months to 31 December 2016:

"Annualised switching rates were more than 3% lower than the market average reported by the Electricity Authority"

"Customer numbers increased by about 11,000 over the period, largely due to better retention of existing customers ..."

"Another significant contributor to loyalty is the popularity of Mercury's fixed-price contracts."

"This is the single-most successful retail offering in terms of uptake in the New Zealand electricity market, with a third⁹ of Mercury customers opting for the certainty of contracts."

- **Support innovation in the retail market**

New entrant retailers are driving innovation in electricity retailing. This is a necessary aspect of being a new entrant as you have to differentiate yourself from the incumbents in order to attract customers to join you. The save protection scheme does not support innovation as the scheme is not providing new entrants with any protection. The incumbents are managing the switching process to enable it to win back valuable customers.

- **Drive reductions in retail cost-to-serve (est at \$200 per ICP in June 2014)**

This is not our experience. As discussed below churn is increasing retail costs – and these costs are ultimately borne by the consumer.

⁹ A Mercury spokesperson at Downstream Conference in March 2017 said this ratio was 40%

- **Enhance customers' ability to find a deal that suits their individual needs**

Overall, about the same number of switches are being withdrawn now as prior to the introduction of the scheme (discussed above). It is these ~10% of switching customers that may be being offered a better deal as a result of their decision to commence a switch. The existence of new entrants offering differentiated products and services might enhance the ability of customers to find a deal that suits their individual needs – it is not the existence of the save protection scheme that creates that opportunity.

Costs:

- **Increased compliance costs for retailers (and the EA)**

There is no evidence the Authority has incurred anymore compliance costs since the scheme was implemented despite undertaking to complete analysis and monitoring in its Decisions and Reasons Paper. Compliance costs are higher for our own group than they would be if the scheme was successful – reflected partly in the level of correspondence this group has had with the Authority about the inadequacies of the scheme.

- **Increase in acquisition, retention and win-back costs**

This is an area where the new entrant retailer is at a significant disadvantage to incumbent VI Gentailers. The VI Gentailers have established customer bases that are at a size well above the economies of scale necessary to run a profitable retail activity. New entrants, however, are building up a customer base with associated systems. The cost to acquire each new customer is significantly higher for a new entrant than an incumbent. As well as an imbalance in operating costs, a pure independent new entrant has only retail revenue to cover costs.

In our view, VI gentailers are exhibiting predatory pricing – they are lowering their prices to specific customers in order to achieve a save or win back and locking these lower prices in for a sustained period of time, for example a 2-3 year contract. In addition, a VI gentailer is prepared to incur this price below what is being offered generally to their customer base for a period of time.

- **Increase in retailer overhead costs**

This is discussed above in relation to the economies of scale of setting up a new entrant retailer.

In our view the scheme has resulted in very few, if any, of the benefits the Authority expected and the costs for new entrants have been disproportionate and substantial.

Recent comments from the VI gentailers confirm our view:

Genesis Energy CEO speech at Downstream Conference in March is quoted on Energy News¹⁰ as saying:

“While there has been talk of companies like Google and Apple developing products to compete in the energy space, England says it is likely that competitors “closer to home” are going to disrupt the existing model.

“We’ve actually been protected by industry by regulation – by barriers to entry that make it hard to come in and set up a gentailer in the electricity space.”

¹⁰ Energy News “Full economic benefit of batteries must be realised – England”

Contact Energy commented in its Half Yearly report¹¹:

"Average customer numbers were down by 1,100 in 1H16 due to the continued elevated level of competition, including price discounting by large competitors."

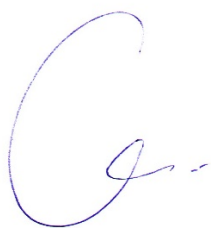
*Mass market ... tariff down \$6/MWh due to continued discounting, 2H16 tariff down \$2/MWh"*¹²

Solution sought

Our group urge the Authority to revise the Code to disallow reactive win-backs for 30-60 days after a switch is processed. This would not be an opt-in proposal but apply to all switches / retailers, which is consistent with some of the feedback on the original proposal that it should not be optional.

We would welcome the opportunity to discuss this information with you.

Yours sincerely



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GM of Commercial and Regulatory

Vocus Group

¹¹ See page 3 <https://contact.co.nz/cenergymedia/contactenergy/files/pdfs/corporate/cen-hy17-report.pdf?la=en>

¹² See page 21 <https://contact.co.nz/cenergymedia/contactenergy/files/pdfs/corporate/cen-fy16-presentation.pdf?la=en>