28 November 2019

Dr. Brent Layton
Chair
Electricity Authority

By e-mail: HME.feedback@ea.govt.nz

Dear Brent,

Urgent implementation of the Government hedge market reforms needed to promote competition and deliver better outcomes for consumers

Summary of Electric Kiwi and Haast's views on the need for mandatory market-making

- We agree with WAG that "A hedge market is an essential part of an efficient and competitive electricity market"[1] and "A well-functioning hedge market provides a robust and transparent view of future electricity price expectations, and an efficient means for parties to manage risk."[2]
- We also agree with WAG that "… the business models of the vertically integrated utilities are harmful to liquidity and consumers because they limit hedge market liquidity and as a consequence competition. This gives the large vertically integrated utilities an unacceptable level of pricing power in both the wholesale and retail markets."[3]
- Electric Kiwi and Haast agree with the Minister of Energy and Resources that addressing hedge market problems is one of the most pressing electricity industry issues.
- Electric Kiwi and Haast support the Minister's direction that timely and expedient implementation of hedge market reforms is more important than coming up with a "better" solution or the Authority's desire to take the time needed to develop the so-called "best" solution.
- The Minister noted "The policy intent was for the market making arrangements to remain voluntary as long as they proved effective at providing for an active market for trading electricity hedge contracts."[4] The voluntary market-making arrangements have failed this criteria. Electric Kiwi and Haast do not consider mere hedge market "enhancements" would satisfy the Government reform decisions.
- Consistent with the Authority's principle that "Options that can be implemented in stages are better", Electric Kiwi and Haast support urgent Code amendments to mandate market-making, followed by a review to develop a longer-term enduring solution.
- Electric Kiwi and Haast recommend the Authority develop mandatory market-making provisions which have the following features: (i) Mandate market-making for largest 5 vertically-integrated utilities (Contact, Genesis, Mercury, Meridian and Trustpower); (ii) No portfolio stress or opt out mechanisms; (iii) Spreads of 1%; (iv) Covers baseload quarterly out 3 years, baseload monthly out 6 months, and peakload quarterly contracts out 3 years; and (v) 3 MW on the bid and offer for all contracts with 3 reloads of 3 MW each.

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[1] WAG, Hedge Market Development Recommendations Paper, 26 June 2015.
[2] WAG, Hedge Market Development Recommendations Paper, 26 June 2015.
[3] Cumulus. Submission by Cumulus Asset Management on the Consultation paper titled – Hedge Market Development: Enhancing trading of hedge products, 14 July 2015.
[4] Cabinet Paper: Ministerial Review of the Electricity Market, Regulatory Impact Statement.

Introductory comments

Electric Kiwi and Haast Energy Trading's interest is in ensuring a strong and thriving competitive landscape develops where retailers operate on a level playing field, and aren't hindered from providing consumers, including those currently missing out on the benefits of competition, competitive prices and service.

Progress in promoting and developing a fully competitive electricity market has been disappointing over the last two decades. The wholesale and retail markets are characterised by high degrees of market concentration. The incumbent gentailers continue to have significant levels of both transitory and ongoing market power. The market is oligopolistic with 5 large vertically-integrated incumbent gentailers, and a tail of small and very small independent retailers. One regrettable consequence of the Electricity Industry Reform Act was that it substituted lines-retail vertical-integration for wholesale-retail vertical-integration.[5] There are also local market issues such as the impediment to competition in Tauranga resulting from the TECT dividend arrangements.

A characteristic of the electricity retail market is that it is easy to enter but hard to grow; that is, there are barriers to growth rather than barriers to entry, with independent retailers only growing at about 1% per annum in aggregate recently, and only having a combined market share of 6% after 20 years of a "competitive retail" market.

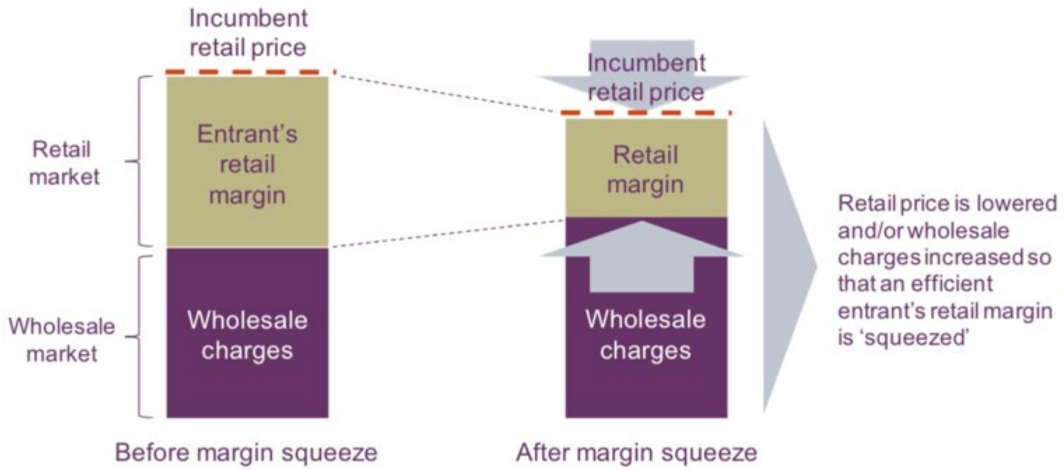
Electric Kiwi and Haast have been clear a prohibition of saves and winbacks and mandatory market-making are the two most important initiatives, barring further structural reforms, to remove barriers to competition and are the two most important projects on the Authority's work programme for delivering (short and long-term) benefits to consumers. These options should be prioritised for urgent implementation as directed by the Minister.

The risk of unintended consequences from continued delay in resolving problems with the hedge market has been substantially detrimental to consumers. It has resulted in a continuance of the handbrake on independent retailers' ability to aggressively compete for new customers on price. Electric Kiwi is low cost, nimble, and offers more innovating product offerings than any of the incumbents, but is hampered by limits on wholesale price risk management, and higher effective wholesale costs than the incumbent operators.

Ensuring there is an appropriate 'margin' between retail and wholesale prices is critical to the success of competition in highly concentrated, vertically-integrated, industries such as the New Zealand electricity retail market. In order for the Authority to determine the extent to which there is a problem in the hedge market it should undertake margin or price squeeze analysis (see Figure 1).[6]

[5] The Electricity Industry Reform Act does at least provide precedent for ownership separation, which could be applied to the 5 largest incumbent retailers, as well as how corporate separation and arms-length rules could be applied.
[6] https://www.oxera.com/wp-content/uploads/2018/03/Margin-squeeze_1.pdf

Figure 1: Oxera margin squeeze mechanics



Source: Oxera

There are a number of ways the Authority could go about this, including (price discrimination test) determining whether the vertically-integrated service providers face lower (internal) wholesale costs than independent retailers. Under the 'hypothetical reasonably efficient operator test' (REO) margin squeeze is demonstrated by showing that the margin between the wholesale input costs incurred by the (independent) retail competitors and the (internal) price which the incumbent supplier incurs is insufficient to allow a reasonably efficient service provider in the retail market to obtain a normal profit.

Another test is the 'equally efficient operator test' (EEO) or the 'as-efficient competitor' test. A margin squeeze could be demonstrated by showing that the vertically-integrated incumbent supplier's own retail operations could not trade profitably on the basis of the hedge market products (and pricing) available to its (independent) retail competitors by the wholesale operating arm of the vertically-integrated incumbent supplier.

The Authority has emphasised that "The Authority can make better decisions if it receives better information" and "The more and better quality data the Authority has access to, the better its decisions will be". We agree. Electric Kiwi and Haast have already provided substantial material and evidence including in correspondence and submissions to the Authority, submissions to the Electricity Price Review, the joint UTS 2018 complaint, and material recently presented to the Authority by ecotricity, Electric Kiwi, energyclubnz, Flick Electric, Pulse and Vocus. Ultimately, though, the Authority has compulsory information gathering powers under the Electricity Industry Act and we don't. The Authority can require the type of information from the vertically-integrated incumbent suppliers to undertake the type of margin and price squeeze testing we illustrated above.

"Better" versus "best" – the divergence between the Minister's expectations and the Authority's position

Electric Kiwi and Haast agree with the Minister that mandatory market-making is "one of the most important [EPR Panel] recommendations to improve the electricity market". The Minister is well justified "to make clear the Government expects the Authority to give this matter high priority". We welcome that the Minister "want[s] to be assured the fragility previously observed in the wholesale market at times of stress is not repeated in future" and that she "do[es] not want to wait for a "better solution" that might never be found".[7]

[7] Hon Dr Megan Woods, Minister of Energy and Resources, Cabinet Paper, Electricity Price Review: Government Response to Final Report, 3 October 2019.

It isn't obvious the Minister's position is well aligned with the Authority position that "analysis of problems and opportunities with market making is not yet complete, and so we do not have a specific issue around which to design any solution" and that the Authority "…want[s] to ensure we implement the solution that best addresses problems and opportunities with market making".

The Minister "do[es] not want to wait for a "better solution" that might never be found" but the Authority wants to find the "best" solution.

Attempts to downplay the recommendations from the EPR Panel

The Authority states: "The EPR Panel made recommendations regarding market making in its final report to the Minister which was completed in May 2019 – before the voluntary market making arrangements were amended to replace the portfolio stress provision with the five days a month withdrawal from market making provision. The EPR Panel's final report was released to stakeholders on 3 October 2019."

The Authority appears to have ignored that the Government also received advice from MBIE (who acted as Secretariat to the EPR) and that hedge market conditions have further deteriorated since May 2019. This is confirmed by evidence provided by the independent retailers to the Authority.

The changes to voluntary market arrangements during this time are largely cosmetic and have achieved little more than rearranging the deck chairs on the Titanic.

The Authority does not need to delay development of new hedge market arrangements or try to reinvent the wheel

The Authority has commented that "Many participants and stakeholders have expressed a clear preference for specific interventions, ie, incentivised or mandatory market making, and which parties should bear the costs of intervention". These "stakeholders" include the EPR Panel, which recommended the Authority "Introduce mandatory market-making obligation unless the sector develops an effective incentive-based scheme", and the Minister of Energy and Resources who accepted the EPR recommendation and "consider[s] this to be one of the most important recommendations to improve the electricity market".

This is important context for the Authority's subsequent comment that "For any intervention to work effectively and provide long-term benefit to consumers, it is important to first fully understand the problems and opportunities that need addressing". The Authority is NOT starting from the beginning of a policy development project. The EPR Panel has already undertaken problem identification (First Report) and options identification and evaluation (Options Paper) and the Minister has made her decision on this matter.[8] The Authority had opportunity to engage in the EPR process, including the submission process, and did so. The issue of hedge market development has also been a constant issue over the life of both the Electricity Commission and the Electricity Authority.

The Authority's Hedge Paper, in effect, goes back to square one and starts the review of hedge market issues over again. It also appears the Authority has put aside the EPR Panel analysis and submissions as these aren't referred to in the Hedge Paper. The Hedge Paper problem definition is retrograde compared to both the EPR Panel analysis, and the previous WAG Hedge Market Development Recommendations Paper. The Hedge Paper appears to have a heavy bias that no problem exists.

[8] It is also not the Authority's usual practice to start with problem definition before moving to options identification. The Authority's TPM review is a good example of this where it actively rejected submissions that it should consult on problem definition and then on options identification, and instead the Authority when straight to consultation on its proposal.

The hedge market suffers from standard vertical-integration issues

The core Hedge Market problem is a combination of market concentration (the retail and wholesale markets are both oligopolies) and high degrees of vertical-integration.[9] This is highlighted by Figures 2 – 5 below.

Figure 2: Wholesale-Retail Vertical integration trend

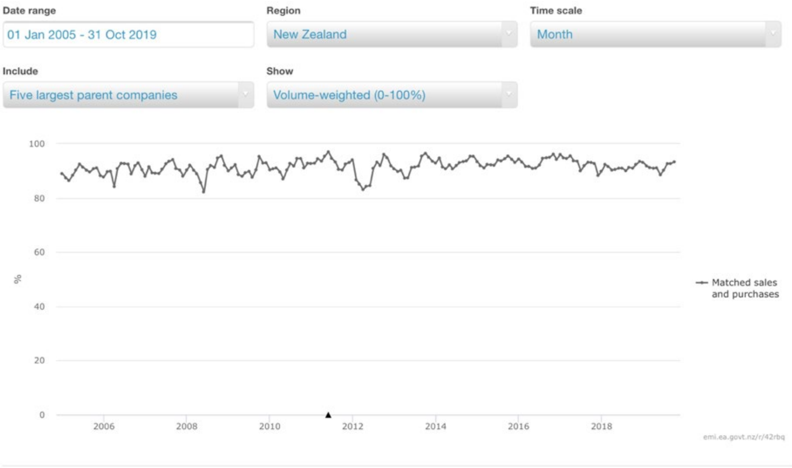
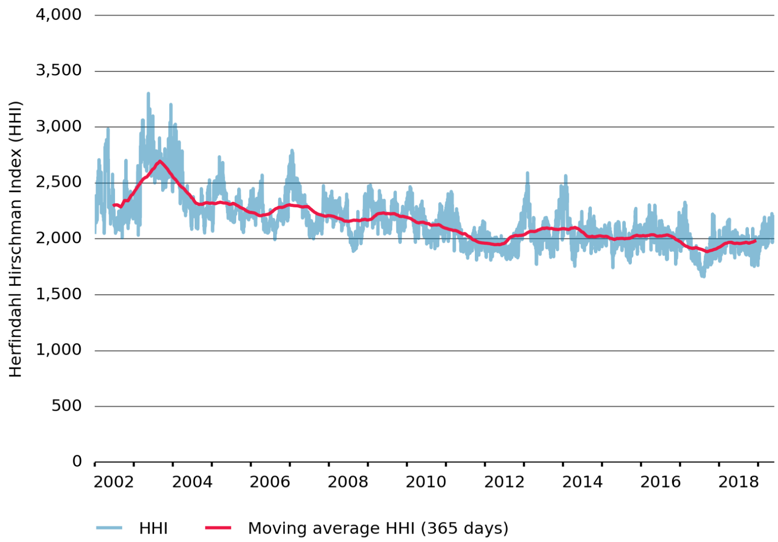


Figure 3: Wholesale electricity market HHI trend



[9] The Authority only mentions vertical-integration where it quotes the Minister, states vertical separation is out of scope and when discusses funding of hedge market arrangements.

Figure 4: Wholesale electricity market CR1 trend

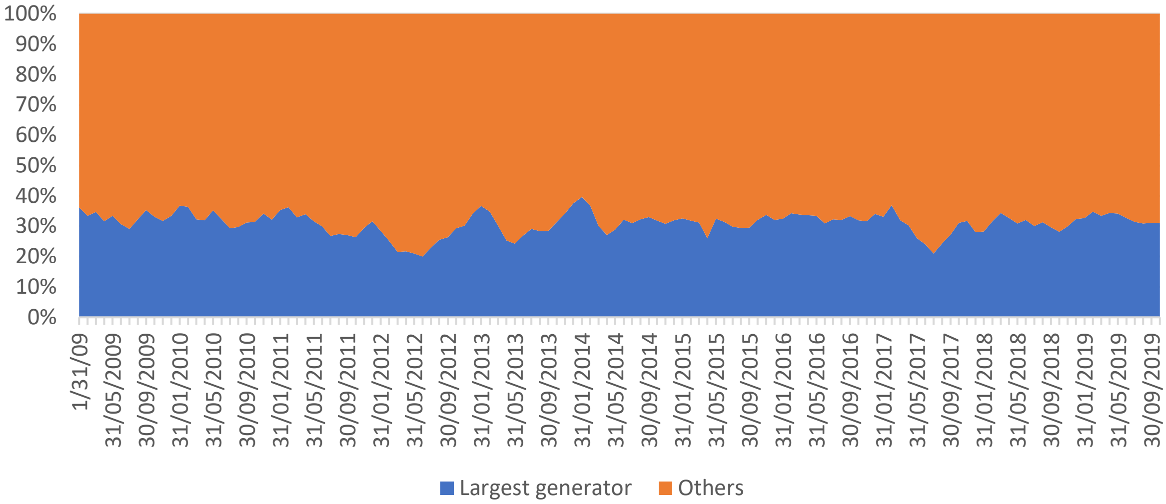
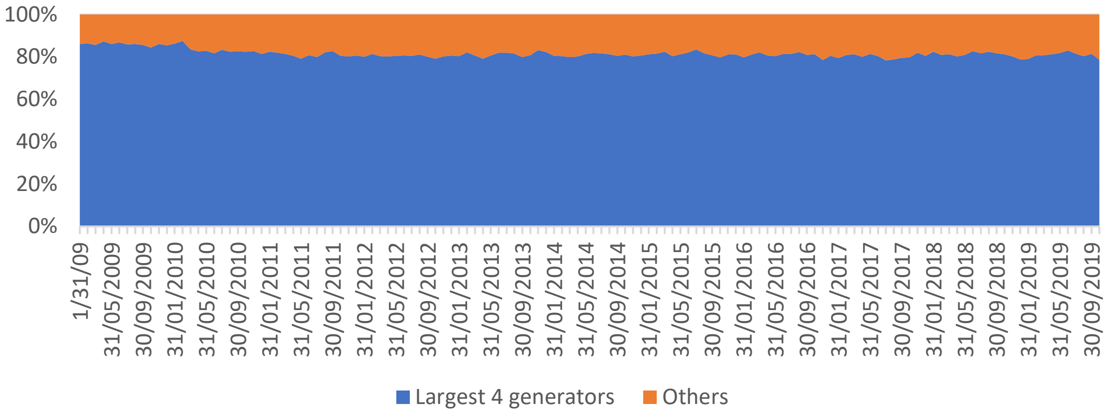


Figure 5: Wholesale electricity market CR4 trend



Based on our observation of different markets, the New Zealand market has among the highest levels of vertical-integration and lowest levels of hedge market liquidity globally. The extremely high levels of market concentration are reflected in the fact the largest three retailers have a market share of 59% and the big-five retailers a market share of 86%.

WAG identified hedge market problems that result directly from vertical-integration in its 2015 advice to the Authority e.g.:[10]

> "In its discussion paper, the WAG outlined its view that, … vertical integration … can reduce liquidity in hedge markets, and make it difficult for independent generators and retailers to compete. The WAG continues to hold this view."
>
> "… vertical integration has implications for hedge market liquidity. It reduces the incentives for some parties to trade with others and to manage different aspects of risk through hedge markets, and also plays into perceptions of market power. This issue is compounded by the concentration in ownership of generation assets, which means there can be a limited number of trading counterparties."

The WAG position was reinforced by the views of two of its members, Phillip Anderson and Stephen Peterson, that "Based on our observation of different markets, the New Zealand market has among the highest levels of vertical integration and lowest levels of hedge market liquidity globally. We believe these high levels of vertical integration will prevent the development of a workably competitive

[10] WAG, Hedge Market Development Recommendations Paper, 26 June 2015.

hedge market without a credible threat of imminent regulation from the Authority" and "it is [the largest vertically integrated utilities'] business models which prevent competition thriving on its own".[11]

The Authority previously acknowledged vertical-integration as an issue, commenting in 2015 that: "… developing a liquid hedge market for electricity is somewhat difficult in New Zealand because of the high degree of vertical integration between generators and retailers. Vertical integration … creates a "natural hedge", meaning that vertically integrated companies have a reduced need to offset their risks with others, which reduces liquidity in hedge markets".[12]

The ACCC identified problems which we believe are also an issue in New Zealand: "the combination of vertical integration and concentration in the NEM has reduced contract market liquidity and is making it harder for all parties to effectively manage their wholesale price risk" and "In certain regions of the NEM, particularly South Australia, the level of liquidity and the advantages enjoyed by vertically integrated retailers make it difficult for new entrants and smaller retailers to compete effectively in the retail market."[13]

The EPR similarly summed up the problem well highlighting that vertical-integration can hinder competition, result in an illiquid contracts market and expose independent retailers to price or margin squeeze e.g.:

> "Vertical integration … can hinder competition because independent generators and retailers will find it hard to compete if vertically integrated companies refuse to deal with them or do so only on unfavourable terms."
>
> "Some independent companies have said there are discriminatory pricing terms. The Electricity Authority, for example, investigated claims that vertically integrated companies were systematically discounting prices to commercial and industrial consumers below prices to retailer competitors in the contract market. The Authority found prices to be lower in 12 per cent of the contracts for which it had data … We do not have the Authority's data, but at face value 12 per cent seems sufficiently high to warrant concern."
>
> "Another drawback of vertical integration is that it can result in less use of contract markets – where companies buy and sell electricity ahead of time to lessen their exposure to wholesale price volatility. Vertically integrated companies have no inherent need for contract markets, whereas independent generators and retailers rely on them heavily. If large portions of the generation and retailing sectors have little use for contract markets, there will be low liquidity and muffled price signals, making it difficult and costly for independent companies to manage electricity price risks. An effective contract market, in contrast, supports ready access to contracts on reasonable terms, and sends clear price reference points for buyers and sellers."

The Minister of Energy and Resources agreed with the EPR Panel's problem definition noting "The Review found that the voluntary wholesale hedge market does not always work effectively" and that "The current hedge market can become "illiquid", especially when the system comes under stress, such as during dry hydrological conditions. This can result in some independent retailers becoming exposed to purchasing wholesale electricity at high spot prices, and/or losing confidence that the price of hedge contracts offered in the market is reasonable. In recent times, some independent retailers have gotten into financial difficulty and left the retail market, thus reducing competition. This situation may also be holding back independent retailers from expanding, also limiting retail competition."[14]

Electric Kiwi and Haast's observations about the impact of vertical-integration and absence of material speculation in New Zealand electricity

The competition implications of having a heavily vertically-integrated market are central to understanding the problem and the exacerbators of the problem. The conduct of the incumbent gentailers can be understood by the incentives and ability to undermine the hedge market and retail competition which the vertically-integrated incumbent suppliers have e.g.:

1. Market-making is a cost for vertically-integrated incumbents which they would rather not bear.

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[11] WAG, Hedge Market Development Recommendations Paper, 26 June 2015.
[12] Electricity Authority, Consultation Paper, Hedge Market Development: Enhancing trading of hedge products, 1 May 2015
[13] ACCC, Restoring electricity affordability and Australia's competitive advantage Retail Electricity Pricing Inquiry — Final Report, June 2018, page 150.
[14] Hon Dr Megan Woods, Minister of Energy and Resources, Cabinet Paper, Electricity Price Review: Government Response to Final Report, 3 October 2019.

2. Market-making increases the competition the vertically-integrated incumbents see in the retail market. If market-making collapses and retail competition retreats they will have more market power to extract higher retail prices.

3. Price competition in the retail market is led by independent retailers, as evidenced by Powerswitch showing in greater than 90% of regions the lowest rates are offered by independent retailers (as at 13 November 2019) despite those retailers having only 6% market share.

4. The vertically-integrated incumbents, as the market-makers and generation owners, control the marginal wholesale price which independent retailers see, they have an unambiguous incentive to make both the hedge market and spot market prices as high as possible.

In an efficient market speculators would enter the hedge market and sell an over-valued hedge contract if the risk adjusted return on capital justified it. However, the poor information disclosure and trading conduct regimes the Authority has overseen mean the perceived risk of speculating in New Zealand electricity is very high. A speculator will rightly conclude they are on the wrong side of significant information asymmetries regarding both upstream gas and downstream thermal plant availability. Similarly, the unaddressed trading conduct issues in the market deter speculators by exposing them to the risk that the large vertically-integrated players will tune spot market outcomes to benefit themselves and harm speculators. As a result, New Zealand's electricity hedge market has very low participation from speculative capital.

The Hedge Paper wrongly assumes many participants have an appetite to materially speculate, in our experience this is simply not true. Speculating is explicitly forbidden by the risk management policies of many independent generators, retailers, lines companies, and aggregators. Many of them have a risk management policy which effectively makes them price takers.

Our view is that the large vertically-integrated incumbents have both the incentive and the opportunity to overvalue the forward curve. We believe the current forward curve cannot be explained by market fundamentals using either a short or long run cost basis. The 30% difference between gentailer stated LRMC for new geothermal plant and the 2022 baseload Otahuhu price are hard to reconcile with a workably competitive market.

WAG correctly anticipated that "Market making arrangements may be fragile"

The WAG advise to the Authority in 2015 contained, for example, the following warnings that have subsequently been borne out:[15]

> "Confidence in hedge market arrangements relies on the large generator retailers to support liquidity in those markets.
>
> …
>
> "The market makers may … see diminishing returns from further developments in hedge markets. Potential developments that provide additional benefits to wider stakeholders, but little benefit to the existing market makers, may not be supported.
>
> "… there is a risk of stasis, whereby the market makers choose to pull back from their current activities, or choose not to support further developments. Such an outcome would not be conducive to forward momentum in the hedge market. Nor would it be in the long-term benefit of consumers.
>
> "The WAG notes that there are some signs that suggest that the market making arrangements may be fragile, evidenced by:
>
> "… Some of the market makers suggesting that there is a risk they will pull back from their activity, due to concerns about 'free riding' behaviour. This was most evident in the submission from Contact Energy, which stated: … "Contact believes that the risk of voluntary market makers pulling out due to free-riding is one of the most substantial risks to the future of the hedge market." …"

[15] WAG, Hedge Market Development Recommendations Paper, 26 June 2015.

When the WAG considered what progress should look like in 2015 a gentailer dominated group agreed that spreads should track towards 3%, liquidity in profiled products develop, and a breakdown of the voluntary arrangements should lead to a mandated solution. The inability of the Electricity Authority to demonstrate meaningful improvements in the 4 years since the WAG review, or impose a mandated solution when arrangements broke down is a significant failure which is now leading to consumers bearing significantly higher price rises than they otherwise should have.

Genesis' 2015 submission to the Authority was prescient

Electric Kiwi agree with the submission comments made by Genesis in 2015. Genesis could just as readily resubmit the same viewpoints in response to the latest Hedge Paper:[16]

> Genesis Energy is disappointed the Authority has not provided any real options for market making initiatives in the ASX Futures market, such as those relating to incentives or thresholds for a mandatory regime. We suggest the Authority needs to take the initiative and work with the sector to develop some workable options to improve market making. Evolving market making obligations to a more certain and durable framework is the single most important improvement the Authority can do for the ASX Futures market.
>
> **Need to develop market making options**
>
> A well-functioning hedge market benefits all participants and consumers. The current reliance on volunteer market making has been essential to the establishment of the current ASX Futures market. However, we suggest the ASX futures market now requires a more certain and durable market making scheme for it to continue.
>
> Increasing the number of market makers is the best way to improve the durability and usefulness of the ASX Futures market in all products. We suggest the positions of the major participants on the need for clearer market making obligations are well known, and some of these positions are incompatible with the continuation of a voluntary approach to market making. Therefore, we have
>
> reluctantly come to the view a regulatory alternative is likely to be required if the ASX Futures market is to continue to provide value.
>
> The Paper does not include any of the detailed exploration of regulatory options for improving market making. We are disappointed with this lack of progress, but we accept it creates an opportunity for the Authority to work closely with the sector in developing regulatory options.

Liquidity is price and volume, not just volume at any price

With regards to the Hedge Paper's discussion of liquidity and volume available to trade in sections 4.14-4.24, liquidity should be measured as volumes and prices. For example, we consider a good shallow liquidity benchmark would be at least 3 MW on the bid and ask at a spread of 1%. But deeper liquidity should also be measured, for example the price difference between which a participant could buy 10 MW and sell 10 MW based on the bids and offers at a point in time.

The discussion regarding whether contracts are offered at any price on the close is a pointless exercise – liquidity is both price and volume. The Authority could apply a workable competition lens to the data and ask whether a reasonably efficient independent retailer could earn a fair return by deploying a prudent hedging strategy in this market. We believe over the last 18 months, the answer is no. The Authority could also measure when there is at least 3 MW bid and offered on the close at a spread of less than 5% to obtain a measure of when a minimum viable level of liquidity exists.

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[16] Genesis, Submission on Hedge Market Development, 20 July 2015.

Trading volumes are largely flat, open interest measures don't reflect improving volumes

Regarding the Authority's data on open interest in section 4.3, we do not believe this is representative of a market where market liquidity has materially increased over the past 5 years. When futures trading was introduced open interest was initially zero. It then increased as a relatively constant level of trading happened over a 3 year horizon from inception until 2015. Since then trading has continued at roughly the same rate and we don't believe there has been any material change in underlying open interest. Open interest at the exchange is a measure of the open positions held by clearing members. When New Zealand electricity futures were listed clearing was dominated by Macquarie, since then other clearers have entered and taken market share and this has led to less internal matching within the clearing members and incrementally more reported open interest at the exchange. We believe the improvement from 2015 to 2019 is down to this effect. This description of largely static open interest marries with the volumes traded on exchange over the past 5 years, which is broadly flat.

It is worth comparing incumbent retailer market performance in areas where there is strong geographical alignment of its generation and retail customers against areas where they are non-aligned

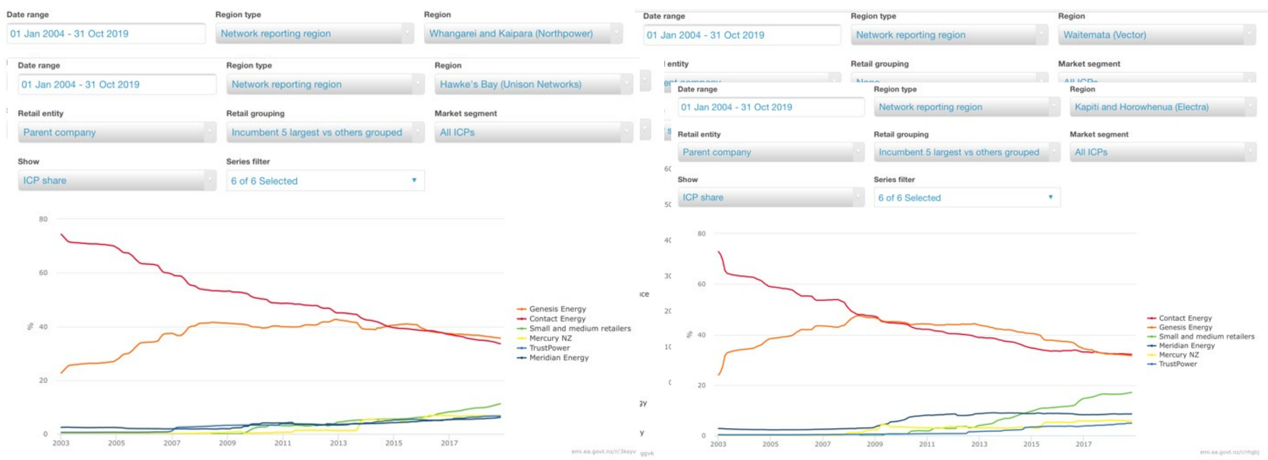
One way to indirectly observe the impact of vertical-integration on the electricity retail market is to look at local retail markets where the incumbent retailer is no longer the largest retailer. There are only a limited number of local retail markets where this has happened: 8 out of 39 network reporting regions.[17]

In ALL the local retail markets where the incumbent retailer is no longer the largest retailer, the incumbent either had relatively weak geographic vertical-integration (its retail customer base is not backed by matching generation capacity in the same area), or the overtaking retailer had stronger geographic vertical-integration (ability to match the retail customer base with regional generation capacity). For example, Genesis Energy overtook Meridian in the Whangarei and Kaipara in 2014.

Similar effects can be seen by looking at the impact of the Genesis-Meridian physical asset swap which disrupted the (hedge) extent to which their generation and retail operations were physically matched.[18]

This provides evidence retail competition would be substantially stronger, with much lower HHI and Concentration Ratios and incumbency advantage, if hedge market arrangements offered independent and other retailers a level-playing field (same wholesale input costs) on which to compete.

Figure 6: Incumbent retailer market share trends in areas with weaker geographic vertical-integration



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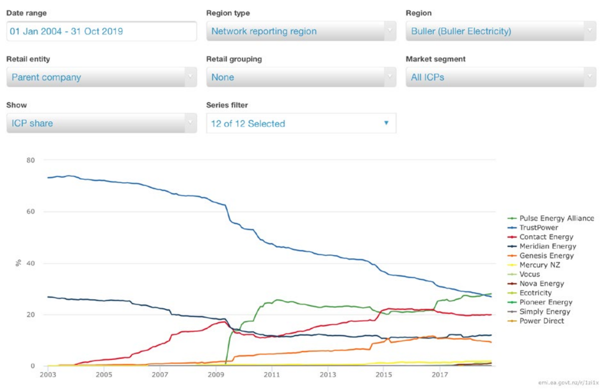
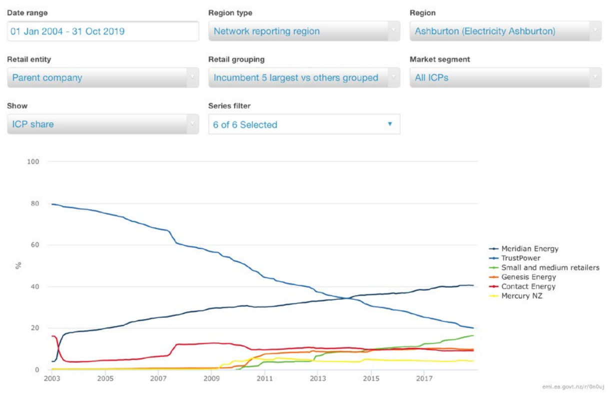
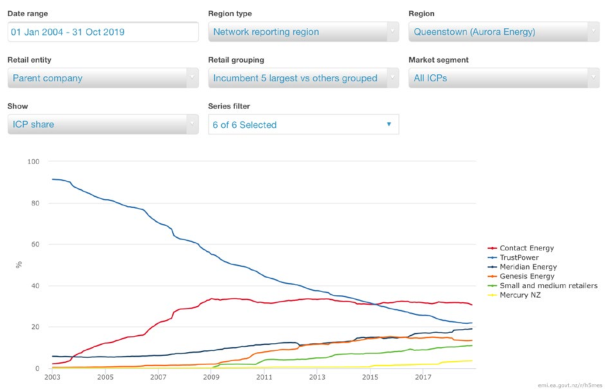
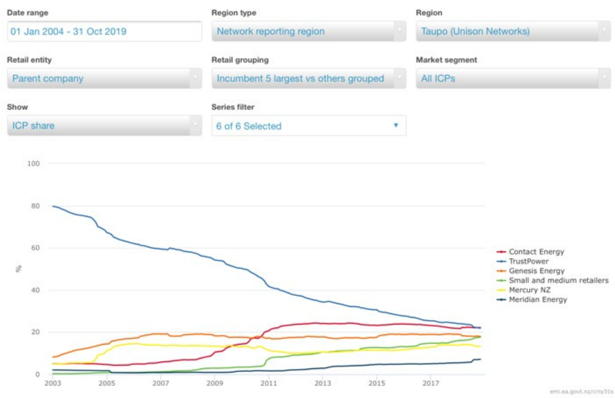
[17] Mercury came close to overtaking Genesis in Waitemata around 2009.
[18] Entrust detailed this impact in submission to the EPR Panel Entrust, Electricity Price Review submission including consumer concerns about retailer's power pricing, Appendix 4.









The Authority can use Meridian's trading conduct as evidence of issues with adequacy of hedge market arrangements

It has been common practice for Meridian to use transitory market power (resulting from being net pivotal) to manage wholesale market price risk.

The Authority should consider why Meridian has considered (and defended) mis-using its market power the best way to manage wholesale market risk rather than relying on hedge market and other risk management tools. The Authority should also consider what the impact of relying on mis-use of market power to manage risk has been on the liquidity and functioning of the hedge market. It is relevant that when the Authority rejected Electric Kiwi's UTS complaint against Meridian, it "acknowledge[d] that limitations in the markets for financial instruments may mean that these types of instruments may not always be able to fully cover a risk position".[19]

The Authority's bias against regulatory intervention delivers regulatory inaction and not "Regulatory best practice"

The Authority has detailed what it purports to be "Regulatory best practice" in Appendix A of the Hedge Paper. We consider this Appendix should be revised as part of the Authority's strategic development reset. Elements of the "Regulatory best practice" that relate to the Consultation Charter were consulted on prior to most electricity retailers (other than the incumbent retailers) entering into the electricity market.

We have the following observations about the Authority's view on "Regulatory best practice":

[19] Electricity Authority, Final Decision, The Authority's decision on claim of an undesirable trading situation Electric Kiwi's claim in relation to trading periods on 2 June 2016, 16 August 2016.

- If the Authority applied the "Regulatory best practice" principles to the TPM review it would reject its own proposal. The Authority's TPM proposal (and previous versions) doesn't comply with any of the principles.

- Concern about the goodwill of market-makers is more likely to reflect 'regulatory capture' than good regulatory practice. Electric Kiwi and Haast do not care about the "goodwill" of current market-makers. We care about the interests and well-being of our customers and other Kiwi consumers. The Authority's statutory objective is to promote competition for the long-term benefit of Kiwi consumers.

- The Authority's position that "Less regulatory intervention is better" and "In principle, we prefer options with a low level of regulatory intervention" creates an inbuilt bias against regulatory intervention. On matters relating to promotion of competition, the Authority has been notable for its pusillanimity.

- The Authority is incorrect to assume "less intervention results in less risk of unintended consequences". The Authority has ignored the risk of unintended consequences from doing nothing or delay in intervention. The joint submission by ecotricity, Electric Kiwi, energyclubnz, Flick Electric, Pulse and Vocus in response to the Authority's 2020/21 Appropriations consultation details our views on risk of unintended consequences, including that there is risk of unintended consequences and outcomes from inertia and not responding to changing market circumstances quickly enough.

- To the extent it is the case that "market making arrangements that are fit-for-purpose in today's market may not be fit-for-purpose in the future" this highlights the need for the Authority to be nimble and act with pace to make changes to existing settings.

- The Authority considers "A less risky option is better". We consider mandatory market-making arrangements have substantially lower risk for market participants and consumers.

- We consider introduction of urgent Code provisions to mandate market-making as an interim solution is consistent with the principle that "Options that can be implemented in stages are better".

Our preferred (longer-term) solution

Electric Kiwi and Haast recommend the Electricity Authority develop mandatory market-making provisions which have the following features:

- Mandate market-making for largest 5 vertically-integrated utilities (Contact, Genesis, Mercury, Meridian and Trustpower).

- No portfolio stress or opt out mechanisms.

- Spreads of 1%.

- Covers baseload quarterly out 3 years, baseload monthly out 6 months, and peakload quarterly contracts out 3 years.

- 3 MW on the bid and offer for all contracts with 3 reloads of 3 MW each.

The Singapore example

Singapore has a market making scheme with spreads of 1%. Since the scheme was launched the spot and futures markets have been volatile, at times approaching the levels seen recently in New Zealand. The scheme has proved durable despite the narrower spreads and no portfolio stress or opt out mechanism. The Authority should be wary about arguments saying that New Zealand is somehow unique and what has worked offshore won't work here. Since the creation of the market making scheme Singapore has seen its independent retailer sector grow 10x faster than in New Zealand, and hedge market volumes have increased by a factor of 3x. Retail prices in Singapore are falling.

Concluding remarks

Given the large body of previous work in this area, and the Minister's instruction that backstop legislation is being prepared in the event the Authority doesn't introduce a comprehensive solution in a timely manner, it is very disappointing the Authority's Hedge Paper effectively consults further on a problem definition, and appears to have a bias that no problem exists. There is absolutely no reason the Hedge Paper couldn't have been consulted on early this year, when the Authority indicated it was planning on completing hedge market reform before Christmas.

The EPR Panel rightly highlighted vertical-integration as root cause of low hedge market liquidity, but the Authority seems allergic to acknowledging this. Electric Kiwi submitted to the Authority in 2015 that "… the high level of vertical integration in the NZ market is the primary obstacle to a liquid hedge market developing without regulation. This has costs for consumers. The level of vertical integration should either be reduced, or the vertically integrated utilities should bear the costs of market making to provide liquid wholesale access across a range of products to non-vertically integrated participants".[20]

The only mention of vertical-integration in the Hedge paper is in reference to the EPR report.

The Authority also seems to be trying to place the burden of proof on submitters (independent retailers) that there is a problem. While we, and other stakeholders, have provided substantial evidence in various submissions and fora, it is ultimately the Authority's responsibility (with support from submissions). Much of the information required to determine the problem is commercially-sensitive information held by the gentailers i.e. evidence of discriminatory practices and price squeezes. It is the Authority that has the information gathering powers to obtain this information.

The Authority does not appear to have had regard to the numerous submissions and evidence it has already been provided, including in relation to the UTS and EPR. It instead attempts to downplay such submissions by depicting them as "identif[ying] high level concerns with the current market making arrangements".

Yours sincerely,

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[20] Electric Kiwi, Consultation – Hedge Market Development: Enhancing trading of hedge products, 14 July 2015.