1 July 2020

Al Yates
Chief Executive, Ecotricity

By email: alyates@ecotricity.co.nz

Dear Al

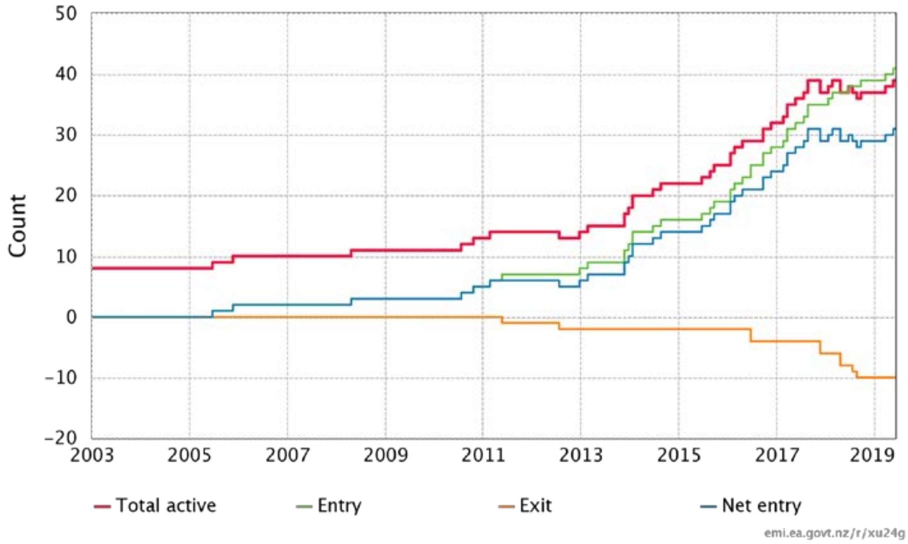
RE: Urgent interim solution required for Spot and ASX markets

I am taking this opportunity to respond to some of the claims and statements you made in your email dated 19 June 2020 to the Minister of Energy and Resources where you raise concerns about recent regulatory activities and outcomes in electricity markets. I attach your most recent correspondence for reference. Your statements reflect very similar claims being levelled at the Authority in recent weeks by other non-integrated retailers. I think it is useful to provide a comprehensive reply and point to the large number of areas where the Electricity Authority is acting to promote the long-term interests of consumers through providing the settings for thriving competition. These claims come at a time when market making has sustained record levels of trading on the ASX.

I also want to reiterate the point that the Authority is not responsible for the business decisions of individual firms. In general, it also has no role in dictating business strategy for how firms should arrange themselves, invest, or manage risk.

The Authority welcomes exit and entry into the competitive parts of the industry

The Authority's focus is the long-term benefit of consumers. Thriving competition is a means of ensuring that consumers receive the benefit from any gains in efficiency. The Authority is not concerned with the outcomes for individual competitors in the process, except to the extent that it impacts on the long-term benefit of consumers. A common feature of competitive markets is the entry and exit of participants as entrepreneurs compete to offer customers products that best meet consumers' needs over time. This market tension is reflected in the data we monitor on the number of retailers, which is an indicator that shows strong competition is occurring.



The graph above shows a clear trend of solid growth in retailer numbers from 2013 to 2018, followed by a period of relative stability in retailer numbers over the past two years. This pattern coincides with a period of generation surplus, followed by a recent period of elevated wholesale prices that have stimulated new generation investment. There is currently ~450MW of new renewable and low-emissions generation committed or under construction in New Zealand. This is an order of magnitude more than was built in the previous five years.

Of greater significance, recent thriving retail competition is driving better outcomes for consumers. Contrary to your claims of huge consumer price increases across the board, recently released data from MBIE shows a sustained downwards trend in retail tariffs over the past five years, including a decline in the energy component of tariffs.[1] For example, the real residential cost of electricity for the year ending March 2020 was 29.11c/kWh (down from 30.54c/kWh in 2015) and the 'energy and other' component was 16.77c/kWh (down from 17.73c/kWh in 2015).

Competition in the retail sector is robust and, as is expected, not all firms compete effectively. EnergyclubNZ recently sold its customer base to Contact Energy, stating '*Contact is the best retailer to look after our customers in terms of service, pricing and stability*'.

In your letter to the Minister, you appear to link Covid-19 to EnergyclubNZ's exit. The Authority has no evidence to suggest EnergyclubNZ's exit from the market was caused by New Zealanders facing difficulty paying their bills because of the Covid-19 pandemic. The Authority's interest is focused on consumer outcomes. We are working with Contact Energy and EnergyclubNZ to ensure the transition of customers to Contact Energy will not result in any disruption to their supply of electricity and that EnergyclubNZ meets all its obligations to the market.

The Authority acts to protect competition, not competitors

The Authority has faced relatively frequent demands for urgent intervention to support independent retailers over the previous six months. We encourage participants to identify potential issues with the design of and conduct in the market. We are sensitive to different challenges faced by different participants and actively monitor the performance of markets on a day-to-day basis.

At the same time, the Authority's focus is on ensuring competition results in long-term benefit to consumers - not on promoting good outcomes for individual industry participants or interfering in the market in a way that subsidises or tilts favour towards one participant over another to the detriment of consumer outcomes or competition.

Nonetheless, the Authority recognises that a mass exit of a segment of the retail sector could materially reduce competition to the long-term detriment of consumers. This is why the Authority acted quickly in response to calls from retailers that there was widespread risk of default in response to possible consumer hardship as a result of Covid-19. The Authority convened a forum for all sector participants to come together in the interest of consumers to ensure that there was a careful, proportionate and timely response from industry to protect consumers. The Authority also moved urgently to introduce a temporary scheme designed to allow qualifying retailers time to recover from temporary but acute wholesale payment issues linked to consumer hardship. This was an intervention targeted specifically at smaller non-integrated retailers; the large generator-retailers and other retail participants backed by large balance sheets were expected to manage their own debt positions.

1 https://www.mbie.govt.nz/assets/Data-Files/Energy/nz-energy-quarterly-and-energy-in-nz/QRSS_March_2020.xlsx.

To date, the Authority has received no formal applications to access this scheme and all retailers have consistently met their obligations to the clearing manager. It is difficult to reconcile the repeated warnings of mass exit with this outcome and the reality that retailer numbers have remained stable over the past two years.

On a related point, during the Covid-19 lock-down period the Authority supported ASX's move to provide additional flexibility to market makers to help address the disruptions they faced as they transitioned to the lock-down. The Authority supported the ASX's decision because it was a pragmatic response that ensured the safety and well-being of people (and their families) within the market makers - without additional flexibility it is possible that market makers could face the unreasonable choice of placing their people at risk, or breaching their market making obligations in a non-material way. This approach aligned with the Government's wider approach to Covid-19 restrictions to protect New Zealanders and their families.

The Authority was committed to ensuring that market making continued during the lock-down period and that all participants – including small non-integrated retailers – could access risk management tools during the significant uncertainty presented by Covid-19. The additional flexibility covered the sort of disruption that could be expected by a sudden move to home based IT and broadband - such as market makers being seconds late to the start of a trading session, or temporarily disconnecting and dropping out of a trading session. An alternative was the very real possibility that all market making services were withdrawn.

The Authority takes its compliance and monitoring responsibilities extremely seriously. The Authority monitored trading activity and market maker performance even closer during the Covid-19 lock-down. When we saw that some market makers did not appear to be taking a best endeavours approach to meeting their obligations, we moved quickly to clarify our expectations and tighten any discretionary judgements around performance.

Despite claims from some non-integrated participants and futures speculators at the time that the Authority was 'withdrawing liquidity' or adding costs for non-market makers, our interventions in March 2020 coincided with the highest ever levels of exchange traded futures activity. There was no shortage of volume available. Further, in response to un-founded claims made by a speculator at the time, there is simply no evidence that trading costs increased.

I was however alarmed by comments we received from some non-integrated retailers (other than Ecotricity) and futures speculators during the Covid-19 lock-down to the effect that the human health and welfare of the people working within market makers should not be a relevant factor in the Authority's response to Covid-19. This sort of commentary detracts from sector-wide efforts to work together during a crisis for the long-term interests of New Zealanders.

The Authority will continue to make timely and robust responses to the Electricity Price Review's (EPR) recommendations

Your email demands urgent intervention beyond the scope of any recommendation of the EPR. Your letter also demands that the priority assigned by the Minister and the Authority to the EPR recommendations be reset midway through delivering complex and important reviews of key markets. Non-integrated retailers were influential in setting those priorities at the time. However, I note that Ecotricity is not alone in now demanding that the Authority stop some of those EPR activities that at the time were considered urgent and pressing, in favour of starting others afresh. The Authority is committed to seeing through EPR priorities and delivering benefits for consumers in a consistent, transparent and sequenced way. Reactionary and alarmist changes in direction are likely to work against the long-term benefit of consumers. A lack of transparency and consistency in regulation will deter the investments New Zealand needs to transition to a low-carbon future.

The Authority has no plans to require vertical separation

The EPR found that vertical integration can provide significant benefit to consumers, and supports new generation being built to support New Zealand's low carbon future. The Electricity Authority would not work to undermine these positive outcomes for consumers for the private benefit of some retail firms and speculators.

Your email draws a link between the vertical integration trend reported on emi.gov.nz and competition. The report you reference shows a consistent trend of 80% - 90% 'vertical integration' over the past 15 years.[2] The trend of vertical integration over time does not correlate with the significant new entry and competition in the retail market over the same period – over that same period the market share of small and medium retailers has grown from ~2% to ~15%.[3] The report you reference does not support the position that vertical integration harms retail competition. Further, a focus on national level statistics reflects a lack of understanding of the nature of the retail market in New Zealand and is misleading about changes in levels of competition among retailers over the last 10 years. Retailing is a regionally based activity, and regional changes in market share have been dramatic. Concentration indicators have declined significantly, and near constantly, across every region over the past ~20 years.[4] For example, Eastern Bay of Plenty was the most concentrated region in 2004 with an HHI score of 9,644 – in May this year it was 2,277.

The Authority, EPR Panel, and Minister have not supported your and other non-integrated retailers and speculators demands for vertical separation – either by forcing the separation of retailing and generating, or by imposing a single business model across the sector that requires all participants to hedge through or sell generation on a single platform. The Authority's role is to promote competition for the long-term benefit of consumers – it is not to stifle opportunities for new and innovative business models or tell firms how they should manage their risks and investments. These sorts of choices are best left for entrepreneurs, and are not matters for a regulator to dictate in an open and competitive market.

For instance, your suggestion to force participants to sell all generation though the ASX would prevent innovation from flourishing and potentially undermine previous innovations. It is unclear how forced sale of generation through an anonymous overseas platform would allow for business models that provided consumers with low carbon certification and assurance that their energy was not generated through thermal plant. Similarly, it is unclear how such a model would allow for a retail offering that gave consumers the choice to access spot markets. Restricting how and where generation can be sold is also likely to increase risks (and consequently costs) of new generation investment, and work against government priorities for the electrification of the economy.

The Authority has prioritised its EPR responses in accordance with feedback from stakeholders

The Authority has made significant progress on its review of market making arrangements, and the Authority's Board will make a high-level decision in August 2020. The Authority's Board will consider all feedback and proposals it receives, including from industry groups. This is ahead of EPR timeframes, and is in addition to the work we have already done to bolster market making. The Authority has tripled the amount of volume available on ASX futures markets across the

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2 emi.ea.govt.nz/r/5zw1w.

3 emi.ea.govt.nz/r/ffhkx.

4 See for example the EMI report on HHI by region (emi.ea.govt.nz/r/jk4lo) or the report on C2 concentration ratios (emi.ea.govt.nz/r/ejmny).

first six months, significantly tightened the required bid-ask spread from 5 to 3 percent and introduced an urgent mandatory backstop Code amendment.

The EPR recommendation to review market making arrangements was noted as the highest priority by non-integrated retailers at the time it was made and we progressed work in this area at pace. The Authority will not be acting on recent feedback that hedge market reform now be stopped in favour of progressing work explicitly excluded by the EPR.

Despite placing a high priority on its review of market making arrangements, the Authority has also made significant progress on other EPR recommendations in the wholesale market.

The Authority has already delivered significant EPR recommendations, and is investing resource to deliver more

The Authority continues to make progress on the delivery of other EPR initiatives and while there have been some minor impacts to the delivery timeframes we set ourselves, we are now back to operating in more of a pre-Covid-19 state. Significant deliveries to date include:

- banning saves and win-backs in February 2020;
- facilitating an industry forum to prepare an incentivised market making proposal, as recommended by the EPR Panel; and
- publishing the Authority's Default Distributor Agreement decision in June 2020.

The Authority has invested resource to ensure it continues to make significant progress, including:

- finalising the Powerswitch contract with Consumer NZ by the end of June 2020;
- deciding next steps with the Utilities Disputes and Powerswitch messaging on retailer bills in August 2020;
- implementing the first stage of the ACCES consumption data project and the Authority's saves and win-backs decision by August 2020;
- consulting with industry on improvements to wholesale market information disclosure in July 2020; and
- prioritising and assigning resource to the remaining retail competition EPR initiatives.

Outcomes in the spot and hedge markets are consistent with a healthy and efficient market supporting the long-term benefit of consumers

The Authority knows what is happening in the spot and hedge markets because it constantly monitors them. The Authority has recently increased the quantity and frequency of monitoring that it publishes – including in relation to recent high spot prices, to improve transparency of market performance.[5]

Spot prices have been elevated during May and June 2020. There are two primary causes of this: low inflows and planned outages happening later in the year than usual. Both causes are outside of the control of industry participants, and to suggest otherwise shows a clear lack of understanding about the operation of the market.

North Island controlled inflows are the second lowest on record. They are in the bottom one percent of inflow sequences since records began. This means that North Island controlled

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5 https://www.ea.govt.nz/about-us/media-and-publications/market-commentary/market-insights/an-update-on-wholesale-electricity-prices/.

storage is very low. South Island storage is also low and concentrated in Lake Tekapo. Lake Pukaki storage is in the lowest three percent of storage levels since records began.

The HVDC outage and the subsequent Covid-19 lockdown has meant that generation outages were postponed and are now occurring later than usual. This has affected North Island thermal plant. Some of this plant has recently returned to service and prices have fallen off their peaks in the second week in June. It is notable also that the highest prices coincide with all available thermal generation running, including Whirinaki. This is indicative of our system right now, with water having a high value and being conserved by generators, while thermal substitutes for water's relative scarcity.

An increase in price in response to scarce resources is exactly what is required at all times for the market to deliver beneficial outcomes for consumers. This price response is the incentive for thermal generation to run when water is scarce, for demand response to occur, and signals when new generation investment is desirable (as is occurring now). During the 2000s New Zealand had three instances when consumers were forced to conserve electricity. This provided retailers with a costless hedge in the sense that consumers reduced their consumption to limit the retailers' exposure to spot prices. In my view, this sort of interference in the market to protect the private interests of retailers and support higher prices at the expense of consumer outcomes is contrary to the purpose of the Electricity Industry Act.

Far from price gouging, generators appear to be pricing efficiently. There is no information in the market right now to suggest prices should be low: storage is historically low, there are more outages than usual, and cold weather and high demand are strongly correlated with high spot prices. During the lockdown, prices were low because the opposite situation existed: storage was healthy, demand was low, and outages were on hold.

Under both these sets of conditions, the spot market did exactly what it was supposed to do: it priced electricity to efficiently balance supply and demand.

Similarly, the forward market has been signalling high prices for this winter for over a year. The chart below shows the forward prices for the current quarter and the subsequent three quarters. It shows how the increased risk of gas supply was priced into the forward price during the Pohokura outage in late 2018. It also shows that price expectations increased throughout 2019.

The Authority has a history of market reforms to support independent retailers for the long-term benefit of consumers

I also want to reiterate the succession of developments the Authority has introduced to enable the development of competition and accessibility of business opportunities for independent and new entrant retailers, as well as independent generators. Examples include:

- What's My Number Campaign – introducing and developing the campaign which specifically delivers benefits to new retailers and is active in encouraging consumers to shop around and be open to new firms offering services.
- More efficient switching and registry management.
- Retailer default programme – these arrangements are largely for the benefit of independent retailers. Established generator retailers face the substantive risk in the event of defaulting new entrants.
- Prudential reform – the current settings, which impose significantly lower financial requirements than the Authority inherited, strike a balance between certainty for new entrants and exposure to market conditions.
- Official Conservation Campaigns – the Code contains allowances specific to the interests of non-integrated retailers. For example, they can negotiate alternative conditions with customers and spot exposed customers bear the risk of OCCs, not their retailer.

These are just some of the market initiatives the Authority has undertaken to improve the market settings in a way that encourages new entrants and independent retailers and generators. The Authority has also avoided changes that would act against greater diversity of participants in the market. For example, the Authority has avoided introducing specific mechanisms, which are standard in other jurisdictions, such as a licencing regime, setting minimum capitalisation rules, imposing retail tariff conditions or having a fit and proper person test on participants dealing with the public.

The Authority has taken these decisions due to its position that such mechanisms are associated with reduced sector innovation and tend to reward or advantage incumbents and major players. Such a move runs counter to the Authority's commitment to a market that provides efficient prices through competition for the long-term benefits of consumers.

Yours sincerely

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