

18 May 2021

Tom Georg
Manager Wholesale Markets
Electricity Authority
P O Box 10041
Wellington 6143

By e-mail: wholesaleconsultation@ea.govt.nz

Dear Tom

The independents support wholesale-retail transfer price and segmented financial disclosures

Electric Kiwi, Flick Electric and Vocus support requirements for vertically-integrated incumbent suppliers to publish wholesale-retail transfer prices (\$/MWh), Internal Transfer Price (ITP) methodologies, and segmented financial reports and profitability measures. We welcome that “the Government places a high priority on this”¹ and the Authority has now “prioritised disclosure of internal pricing of electricity by large generator-retailers and retail segment profitability”.

Responses to the Authority’s consultation questions are provided in the Appendix.

The Authority should include cross-submissions in the process

While there is near universal support amongst market participants to require vertically-integrated suppliers to disclose segmented retail financial profits, there are a number of elements of the Authority’s consultation which are likely to be contentious, particularly given the focus on discriminatory practices and the extent to which vertical-integration is a barrier to competition. We consider inclusion of cross-submissions to be good regulatory practice. The Authority should add a cross-submission step to its consultation process.²

Other EPR submissions are relevant, not just the independent retailer views

In our 2021/22 appropriations submission, we suggested the Authority look at submissions to the Electricity Price Review (EPR) on this topic. Segmented profit disclosure, along with removal of the low fixed charge regulations, were two topics which gained near universal support from market participants.³ ENA, Genesis, Trustpower, Vector and others made substantive submissions that should assist the Authority and merit reference, yet no stakeholder views other than those

¹ Electricity Price Review: Government Response to Final Report, 3 October 2019 at <https://www.mbie.govt.nz/assets/electricity-price-review-government-response-to-final-report.pdf>.

² We raised this suggestion in advance in e-mail to the Authority.

³ Based on our assessment of submissions to the EPR, the total list of supporters consisted of Buller, Business NZ, Conumer NZ, Contact Energy, Counties Power, Counties Power Consumer Trust, ecotricity, Electric Kiwi, ENA, Entrust, Flick Electric, Fonterra, Genesis, Grey Power, independent retailers, The Lines Company, Lines Trust South Canterbury, Mercury, Meridian/Powershop, Network Waitaki, Northpower/Top Energy, NZ Steel, Orion, Pioneer Energy, Pulse, Trustpower, Vector, Vocus, and Wellington Electricity.

The only electricity retailer (or vertically-integrated supplier) that opposed financial separation requirements was Nova.

attributed to independent retailers are discussed in the consultation paper. The Authority does not need to rely solely on its interpretation of independent retailer views.

The focus on the efficiency of current ITP and discriminatory hedging practices is out of scope for development of financial disclosure requirements

The consultation paper contains a lengthy discussion defending current incumbent ITP and discriminatory hedging arrangements, despite the Authority stating “The efficiency of wholesale pricing and hedge markets are outside the scope of this investigation”.

These issues have wider potential implications for the Authority’s work programme and achievement of “thriving competition”, but it is not obvious they are relevant to the design of the proposed financial disclosure regime. Authority staff have not been able to clarify this in the discussions we have had.

The consultation paper omits the role of segmented financial disclosure in identifying excessive profits

While the consultation paper focussed on vertical-integration competition issues, one of the principal purposes of profitability disclosure is to identify excessive profits. This can be seen from the approach to ITP and profitability disclosures in other jurisdictions.

The consultation paper omits any mention of the role of profit reporting in identifying excess returns despite the useful discussion in the Authority’s Market Monitoring: Competition Information Paper⁴ and the Government being clear in its EPR decision “ongoing questions about whether integrated generator-retailers are making excessive profits risks undermining confidence in the electricity market”.⁵

One of the problems with looking at retail gross margins only is that low margins could simply reflect high (undisclosed) generation profits and hide that electricity retail prices are higher than they should be in a workably competitive market. Retail margin or profit disclosure only tells half the story.

Parallel sets of Internal Transfer Prices for accounting and pricing

We agree with the Authority, to the extent ITPs used for accounting practices differ from the wholesale input cost used for retail pricing, “ITPs are not a particularly strong mechanism for mitigating potential anti-competitive practices by generator-retailers”. The Authority’s analysis shows incumbent vertically-integrated suppliers are effectively running two sets of books with two sets of Internal Transfer Prices; one for accounting purposes and one for retail pricing purposes.

Our interest is (obviously) in the Internal Transfer Prices used for retail pricing purposes. As discussed in the body of our submission, we recommend the retail ITP be based at Otahuhu (OTA) and Benmore (BEN) and is disclosed at the start of each financial year (for the year to come), and whenever they are updated or changed.

⁴ Electricity Authority, Industry and market monitoring: Competition Information paper, 31 August 2011.

⁵ Electricity Price Review: Government Response to Final Report, 3 October 2019 at <https://www.mbie.govt.nz/assets/electricity-price-review-government-response-to-final-report.pdf>.

The Authority should draw on international precedent and apply orthodox vertical price squeeze and discrimination tests

In our 11 June 2020 submission on hedge market reform, we commented “The Vocus’ December submission detailed the type of “Equivalence of Input” testing the Authority could undertake to determine whether market makers are using vertical-integration to impose price barriers.”^{6,7} The examples Vocus provided are standard competition tests used by the Commerce Commission and regulators in other jurisdictions.

We are not aware of any other regulator adopting the type of test the Authority has used to attempt to dismiss “perceptions of impediments to competition facing independent retailers” (comparison of the vertical-suppliers’ ITPs against the Authority’s assessment of hedge prices they could obtain externally). The test is novel and ignores whether independent retailers could obtain the same prices. The Authority’s analysis also contains basic and rudimentary errors. When the errors are corrected the analysis shows the opposite to that purported in the consultation.

In order for the Figure 2 Internal Transfer Prices benchmarks to be useful they need to compare the prices available to the incumbent vertical-suppliers (which include FPVV) with prices that would be reasonably feasible (not just “plausible”) for a prudent and efficient (or, using the Authority wording, “financially credible”) independent retailer i.e. equivalence/non-discrimination testing.

Relevance of the accounting ITPs

While the ITP is still relevant, it cannot be used to test for vertical price squeezes or whether vertical-integration results in barriers to competition. The Business Plan ITP is a known price on which other business decisions are made which all contribute to long term performance. The ITP might not be directly linked to the absolute level of retail pricing, but it is likely to be linked to decisions made about any percentage change in retail pricing. We suspect (unverified) that there is some type of interlinkage between the accounting and pricing ITPs such that Meridian (Mercury) having the lowest (highest) accounting ITP most likely corresponds with Meridian (Mercury) having the lowest (highest) pricing ITP.

The Authority has identified that the ‘accounting purpose’ ITP creates a financial position for the vertical-suppliers’ retail businesses on which business decisions are made:

“The Authority were advised by a number of generator-retailers that the ITP’s primary use is to support the measurement of the retail and generation groups’ longer-term performance, to inform decisions about whether to grow or shrink these business lines, and explain continued investment to shareholders.”

An integral part of the long-term performance of a generator-retailer will depend on how they recover costs – such as the internal ‘accounting’ hedge cost for electricity – from their customer base.

Requirements for building trust and confidence

We agree disclosure should be used to help establish whether vertically-integrated incumbents “are compromising competition in the sector by: (a) providing their retail arms with electricity on favourable terms” and/or “(b) employing anti-competitive retail pricing practices or providing subsidies to their retail business”.

⁶ <https://www.ea.govt.nz/assets/dms-assets/26/26944Independent-retailers-HME-Consultation-Submission-11-06-2020.pdf>

⁷ Refer, for example, to Vocus submission, Hedge Market Enhancements (market making) – Discussion Paper, 2 December 2019, available at: <https://www.ea.govt.nz/assets/dms-assets/26/26535Vocus-Hedge-Market-Enhancements-submission.pdf>.

Building trust and confidence requires putting in processes and systems for identifying whether there are, and the extent of, problems, not just trying to convince stakeholders there isn't anything wrong with current regulatory and market arrangements (or, as the Authority expresses it, "instil confidence that large generator-retailers are pricing internal electricity sales appropriately").

Independent and entrant retailers will base competitive market strategies on their 'on the ground' and lived-experience, not the perceptions of the Authority about how well it has promoted competition over the last 10 years and whether or not it thinks independent retailers face barriers to competition and growth.

Recommendations

Our recommendations in response to the Authority's proposals include the following:

| |
|--|
| <ul style="list-style-type: none"> Implement the ITP and segmented profitability disclosures as a two-phase project: Implement Internal Transfer Price and retail gross margin disclosure as an immediate priority, and work on full wholesale-retail financial separation and profitability disclosure as a second phase of the project. Phase 1 should take effect from 1 July 2021, with enhanced market monitoring and reporting taking immediate effect. Phase 2 should be completed within the 2021/22 financial year. Figure 2 Internal transfer prices replicability benchmarks: If the Authority is going to rely on this analysis, it should: (i) base the replicability benchmarks on prices that would be feasible for an existing prudent and efficient independent retailer (the current benchmarks are based on FPVV hedging arrangements which are not available to independent retailers); (ii) the same analysis again but entirely forward-looking for a potential new entrant retailer; (iii) undertake the analysis on the basis of residential only (to overcome inconsistencies with mass market which is based on size or meter type); (iv) repeat the exercise using up-to-date information including for 2020/21⁸ and 2021/22 (most or all vertical-suppliers will have their ITPs set for this period); and (v) undertake the analysis based on the wholesale input costs the vertical-suppliers have actually used to set retail prices (where this differs from the ITPs used for accounting purposes). |
| <ul style="list-style-type: none"> Market participants that should be subject to the disclosure requirements: The criteria for determining who should be subject to the disclosure requirements should be based on whether the supplier: (i) is vertically-integrated; and (ii) has market power in the wholesale or retail market. The requirements should apply to Contact, Genesis, Mercury, Meridian, Nova and Trustpower, and not vertically-integrated suppliers with 5% market share (ITP disclosure) or retailers with 1% market share (retail gross margin disclosure). Quality assurance: The disclosure requirements should include independent audit and director certification requirements (following OFGEM/Commerce Commission precedent). |
| Phase I implementation |
| <ul style="list-style-type: none"> Transfer price disclosure: Where the Internal Transfer Prices for financial reporting differ from those provided for retail pricing both sets of payments and methodologies should be disclosed. |

⁸ The consultation paper Figure 2 states that it includes 2020/21 but this reflects errors in the Authority modelling.

- Require that Internal Transfer Prices disclosure also includes a reference node (e.g. Otahuhu and Benmore equivalent) to recognise the difference in each of the integrated suppliers retail-generation portfolios and enable a more ‘apples with apples’ comparison.
- Require Internal Transfer Prices to be disclosed whenever they are updated or changed.
- Require disclosure of the Internal Transfer Price methodology and the reasons justifying the methodology that was adopted and the reasons for any changes to the methodology, to a level of specificity that a reasonable person would understand why the supplier has adopted the method, including the extent to which the supplier considers it to be “a fair reflection of the cost of electricity”.
- The Commerce Commission’s Information Disclosure Requirements for disclosure of pricing methodologies provides some useful precedent⁹ for the drafting of the methodology disclosure requirements e.g.:
 - “Describes any changes in the price”
 - “Any change in the pricing methodology or adoption of a different pricing methodology, must be publicly disclosed at least 20 working days before prices determined in accordance with the change or the different pricing methodology take effect” [this should apply to the methodology used for determining the wholesale cost used for retail pricing purposes if this differs from the ITP used for financial segmentation purposes]
 - “must ... Include sufficient information and commentary to enable interested persons to understand how prices were set”
 - “must ... Demonstrate the extent to which the pricing methodology is consistent with the pricing principles and explain the reasons for any inconsistency between the pricing methodology and the pricing principles” [this could be reworked into an “obligation to [demonstrate] ITP transfer prices are a fair reflection of the cost of electricity”]
 - “must If prices have changed from prices disclosed for the immediately preceding disclosure year, explain the reasons for changes, and quantify the difference in respect of each of those reasons”
 - “If the pricing strategy has changed from the preceding disclosure year, identify the changes and explain the reasons for the changes.” [This should apply with “ITP” substituted for “pricing strategy”].

- **Retail Gross Margin disclosure:** Require disclosure of retail gross margins, including segmentation between residential/non-residential.¹⁰
- **Gross margins should be disclosed using the separate categories as defined in the consultation paper** – electricity revenue minus cost of electricity, distribution and transmission costs, metering costs, and levies.

Phase II implementation

- **Financial separation:** Require the vertically-integrated incumbent suppliers to disclose segmented financial accounts and profitability measures for their retail and wholesale

⁹ https://comcom.govt.nz/_data/assets/pdf_file/0025/78703/Electricity-distribution-information-disclosure-determination-2012-consolidated-3-April-2018.pdf

¹⁰ The requirement to disclose individual components of the gross margin (individual cost components and revenue) will also enable the Authority and other stakeholders to use alternative wholesale input costs to ensure comparability and to apply different types of equivalence/price squeeze/discrimination tests etc.

businesses, including break-down of residential/non-residential (including commercial and industrial) retail profitability.

- The profitability disclosure requirements should include full financial segmentation of wholesale and retail to the EBITDAF level (not just gross margin disclosure).

- **Comparability:** Introduce standardised cost allocation rules for financial separation.

Market Monitoring

- The Authority to undertake price-squeeze/discrimination testing as part of its market monitoring. This should include, by way of example, monitoring of the incumbent retailers' self-supply prices and the actual prices available to independents;
- The Authority should monitor that hedge arrangements provided by each of the incumbent suppliers to third parties/independent retailers, including volumes and price;
- Adopt the type of profitability/margin reporting/monitoring that was envisaged in the Competition Information Paper to determine whether suppliers are making ongoing supranormal-normal profits e.g. indicators such as cost to income ratios; net revenue benchmark analysis; return on investment; return on equity;
- Further improve the EMI website to include cost/profitability/residential savings information, including the type of financial segmentation information provided in OFGEM reporting;¹¹
- Reintroduce monitoring of residential savings/loyalty taxes (potential savings from changing supplier);¹² and
- Include wholesale HHI and Concentration statistics (in addition to existing retail) on EMI. The Authority has previously said that this will be introduced as part of an upgrade of EMI but is yet to do so.

¹¹ <https://www.ofgem.gov.uk/electricity/retail-market/retail-market-monitoring/understanding-profits-large-energy-suppliers>.

¹² This was discontinued after 2017.

Table of Contents

| | |
|--|----|
| Table of Contents | 7 |
| Summary of the independent retailers' views | 8 |
| Requirements for building trust and confidence | 10 |
| Trying to discredit legitimate and orthodox concerns about vertical-integration will not build “trust and confidence” | 10 |
| Near industry-consensus support for segmented profitability disclosure | 12 |
| Gross retail margin reporting would not be onerous | 12 |
| Standardised reporting rules would be beneficial for financial segmentation | 13 |
| Transparency is important for checking the health of competition..... | 15 |
| Nature of the market failures in the electricity market | 16 |
| Market power in one market can manifest in downstream markets | 18 |
| Application of the Industry and market monitoring: Competition Information Paper..... | 19 |
| Case study: the market study into the retail fuel sector..... | 21 |
| OFGEM provides useful precedent | 22 |
| Concluding remarks and recommendations | 23 |
| Recommendations | 24 |
| Appendix: Responses to the Electricity Authority consultation questions | 28 |

Summary of the independent retailers' views

- **The electricity retail and wholesale markets are both highly concentrated.** We agree with the Authority "... integrated generator-retailers' controlling the bulk of electricity generation can raise competition concerns" and "Confidence in the industry, and the regulation of the industry by the Authority, may be undermined by dominant vertically integrated generator-retailers behaving strategically to increase the costs of rivals, thereby limiting competition and increasing their own profitability".

The European Union has observed "One of the main obstacles to the development of a true level playing field for access seekers ... is the preferential treatment of the downstream businesses, for example the retail arm, of a vertically integrated operator with significant market power (SMP operator) through price and non-price discrimination ..."¹³

- **ITP and profitability disclosure should be implemented as a two stage project:** Given the Authority has developed draft Code for Internal Transfer Prices and retail gross margin disclosure; our preference is for the Authority to implement this without further delay. The full wholesale-retail financial separation and profitability disclosure included in the Government's EPR reforms could be developed as a second phase of the project to be completed within the 2021/22 financial year.
- **ITP disclosure should be mandatory:** We agree with the Authority "The current voluntary disclosure arrangements have not provided sufficient details on the methodologies used and the composition of the ITP to enable third parties to understand why ITP vary from year-to-year, vary across generator-retailers and vary relative to past and present forward or spot prices."

We also agree "There should be a positive obligation on large generator-retailers to disclose the material details of their approach, to demonstrate [whether] their ITP are a fair reflection of the cost of electricity" and "These disclosures ought to enable a reconciliation". This disclosure requirement could be enhanced by requiring explanation of the reasons for the method adopted as well as the methodology.

- **The reporting/methodological requirements should be standardised:** We agree with Trustpower that "segmented reporting requirements for all generator-retailers should be ... standardised and made mandatory ...".¹⁴
- **Independent audit and director certification requirements are critical to the integrity of the disclosures:** The financial separation requirements should include independent audit and director certification requirements to ensure the integrity of the information (following OFGEM/Commerce Commission precedent).
- **Disclosure requirements should only apply to suppliers with market power:** Contact, Genesis, Mercury, Meridian, Nova and Trustpower. As the Authority noted: "Confidence in the industry, and the regulation of the industry by the Authority, may be undermined by dominant vertically integrated generator-retailers behaving strategically to increase the costs of rivals, thereby limiting competition and increasing their own profitability" [emphasis added].

¹³ Article 14(3) of Directive 2002/21/EC: <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32002L0021>

¹⁴ Trustpower, TRUSTPOWER SUBMISSION: ELECTRICITY PRICE REVIEW'S OPTIONS PAPER, 22 March 2019, at: <https://www.mbie.govt.nz/dmsdocument/4926-trustpower-submission-electricity-price-review-options-paper-pdf>.

We are surprised the Authority considers 5% to be “of a size that could raise competition concerns”. It would be unusual to regulate suppliers that do not have market power e.g. vertically-integrated suppliers with a market share of 5%, or retailers with market share of 1%. If the Authority requires small retailers to disclose revenue/margin information, it should use this to extend its EMI market concentration statistics to include the GINI coefficient and Lerner Curve.

- **ITPs should be disclosed at BEN and OTA and be disclosed annually/ whenever they are updated or changed.** Most of the gentailers already disclose this information in their quarterly operational reports and six monthly financial statements. An annual ITP does not provide a comparison of the prices available to incumbents through self-supply with the prices reasonably available to independents (who will be in the market daily, weekly, monthly ...).
- Further, the Internal Transfer Prices disclosure should also include a reference node (e.g. Otahuhu equivalent) to recognise the difference in each of the integrated suppliers’ retail-generation portfolios and enable a more ‘apples with apples’ comparison.
- **The disclosure requirements should be specified to enable identification of barriers to competition:**¹⁵ For example, a lack of economic replicability exists if a vertically-integrated supplier’s downstream retail arm could not trade profitably on the basis of the upstream wholesale electricity prices charged to (/faced by) its competitors. BEREC have noted “By setting either wholesale or retail prices (or both), ... vertically integrated firms ... can define the space (margin) between the wholesale and the retail price level. By setting the margin too small, the [vertically-integrated] operator could potentially squeeze other operators out of the market”.¹⁶
- We are concerned the Authority has instead deflected concerns about operation of the wholesale market and undertaken a backward-looking analysis which omits the current and prospective problems faced by independent retailers or potential new entrants.
- **Transparency of vertically-integrated suppliers’ profitability is important for checking on the health of competition:** We agree with ENA “It is currently difficult to assess generator and retail profitability given the current lack of transparency and disclosure by vertically-integrated incumbents”.¹⁷ The level of incumbent profitability is a useful gauge for the health of competition, complementing measures such as HHI, Concentration Ratios and SSNIP tests.¹⁸
- We have particular concerns about the wholesale market, given the high market share (hydro capacity) of Meridian, and market concentration has changed very little over the last decade (with HHI fluctuating around the 2,000 mark). Low gross retail margins could simply hide excessive generation profits and that retail prices are higher than they should be.
- **There is precedent the Authority can draw on:** The Authority doesn’t need to ‘reinvent the wheel’ and can draw on, for example, the Commerce Commission financial separation/transfer payment requirements under Part 4 Commerce Act, Commerce Commission investigations such

¹⁵ From Vocus, Hedge Market Enhancements (market making) – Discussion Paper, Submission to Electricity Authority, 2 December 2019, at <https://www.ea.govt.nz/assets/dms-assets/26/26535Vocus-Hedge-Market-Enhancements-submission.pdf>.

¹⁶ https://berec.europa.eu/eng/document_register/subject_matter/berec/regulatory_best_practices/guidelines/4782-berec-guidance-on-the-regulatory-accounting-approach-to-the-economic-replicability-test-ie-ex-antesector-specific-margin-squeeze-tests

¹⁷ ENA, Electricity Price Review Options Paper, Submission to the EPR Panel, 22 March 2019, at: <https://www.mbie.govt.nz/dmsdocument/4842-electricity-networks-association-submission-electricity-price-review-options-paper-pdf#page14>.

¹⁸ Small but significant and non-transitory price increases.

as into the petrol and grocery markets, and the OFGEM wholesale-retail financial separation rules.¹⁹ Mercury has submitted it “supports greater consultation with regulatory agencies to provide guidance on the form and content of a consistent regulatory reporting regime that might apply”.²⁰

Requirements for building trust and confidence

We agree with the Authority that “Integrated generator-retailers influence over the pricing and supply of electricity, without sufficient transparency and other assurances, could adversely affect market confidence and retail competition outcomes”. The Authority has put a lot of emphasis on building “trust and confidence”, with 52 references to “trust and confidence” or “confidence” in the consultation paper, though its other relevant strategic goal of “thriving competition” is not mentioned.²¹

In our view, the necessary building blocks for trust and confidence include that:

- (i) the disclosure requirements are suitable for identifying and measuring the extent of any competition issues, and
- (ii) the Authority acts on this information to address any problems/market failures that may be identified. This is most directly reflected in the consultation paper by the Authority’s statement “If this monitoring were to identify a misuse of a market power by large generator-retailers when pricing and supplying electricity to internal or independent parties, the Authority would consider appropriate penalties and policy responses”.

These building blocks are well articulated in the Authority’s market monitoring: Competition Information Paper e.g.:

Transparency and access to quality information Market monitoring can improve competition in and of itself by increasing transparency about market events and by improving access to quality information. The Electricity Authority, market participants, and ultimately consumers will benefit from open information on the state of the market and explanations and explications of unusual events.

Improving access to quality information means ensuring that all industry participants have reasonable access to meaningful and reliable market information and analysis. This means information which is: timely, relevant, credible, and useful for decision making.

Accurate and timely information can help build confidence that the market governance arrangements are engendering outcomes that contribute to the long-term benefit of consumers.

Trying to discredit legitimate and orthodox concerns about vertical-integration will not build “trust and confidence”

The approach to “trust and confidence” taken in the consultation paper is to claim vertical-integration and discriminatory practices are not the cause of competition problems, and to justify current incumbent discriminatory practices. Concerns about vertical-integration have not just been raised by independent retailers. They have been raised by Trustpower (who considers ownership separation to be the “gold-standard”), the EPR, a wide range of stakeholders in response to the EPR, and by various industry regulators such as ACCC and OFGEM. The concerns reflect orthodox

¹⁹ We have referenced various relevant documents etc the Authority can draw on in this submission.

²⁰ <https://www.mbie.govt.nz/dmsdocument/4884-mercury-submission-electricity-price-review-options-paper-pdf>

²¹ There are 6 references to “trust and confidence” in the 2 page Executive Summary alone.

competition policy and not just a “perception that dominant generator-retailers may increase cost of rivals, limiting competition and increasing their own profitability”.

The Authority dismissed concerns about vertical-integration settings, on the basis “The Electricity Authority’s own analysis does not support these claims” even though the Authority’s analysis was based on incumbents’ ITPs and the Authority was clear “ITP is primarily an accounting concept for allocating costs across two business units and has limited application in commercial decision making, such as pricing new business”.²²

It is also notable that while the Authority compared the incumbents ITPs against prices that they could obtain, rather than comparing the prices available to incumbents versus independents, the Authority analysis showed the incumbent ITPs, except for Mercury, were either below or at the bottom of the “plausible” range.

The analysis also includes rudimentary errors such as that Figure 2 maps the wrong years and the benchmarks only use ASX prices which were not adjusted for location, seasonability, and load etc.²³

In order to test whether vertical-integration is a problem, the Authority needs to undertake orthodox vertical price squeeze and discrimination testing that is common internationally rather than the bespoke and novel approach applied in the Figure 2 analysis. The testing should include, for example, a comparison of the prices available to incumbents through self-supply versus the prices reasonable available to: (i) an existing prudent and efficient independent retailer (which would include a backward looking element); and (ii) a prospective new entrant retailer (which would be entirely forward-looking). The extent to which the independent/new entrant can access the prices available to the incumbents would help inform whether there are barriers to competition.

Dismissing our and other stakeholders’ serious and substantive concerns, over matters that impact the level of competition in the market, based on flawed and limited analysis, does not “make it easier for investors, and small and prospective retailers to assess risks of both market entry and expansion strategies” or increase our trust and confidence such that “Consumers benefit ... through increased competition”.

The Authority’s narrative on current ITPs (which the Authority agrees with the gentailers is for accounting purposes) and hedging arrangements creates a juxtaposition where the Authority considers disclosure is required to build trust and confidence, but there is no problem and the market is operating in the way the Authority thinks it should.²⁴ This analysis takes up a sizeable portion of the consultation paper, despite the Authority saying “The efficiency of wholesale pricing and hedge markets are outside the scope of this investigation”.

²² If the Authority wants to test the extent to which vertical-integration results in barriers to competition there are various tests it could conduct such as comparing the prices vertically-integrated suppliers are able to obtain (including via FPVV) with the prices that a prudent and efficient independent retailer could obtain, testing whether the vertically-integrated suppliers’ retail businesses would be economic based on the prices available to independent retailers, and undertaking imputation type testing based on the wholesale input costs the vertically-integrated suppliers use for setting retail prices (as opposed to the ITPs for accounting purposes) etc.

²³ The ITPs are supposed to be for 2018/19, 2019/20 and 2020/21 but are, in actual fact, for 2017/18, 2018/19, and 2019/20.

²⁴ For the avoidance of doubt, we do not consider the consultation paper provides sound basis for the statement: “the Authority’s investigation did not find evidence to support non-integrated retailers’ concerns ITPs were too low”.

Near industry-consensus support for segmented profitability disclosure

The EPR received near universal support for its proposal:

D3: Make generator-retailers release information about the profitability of their retailing activities

New information disclosure rules developed by the Electricity Authority would require generator-retailers to report separately on the financial performance of their generation and retailing operations.

in submissions to the EPR. Notably, this included support from all the large vertically-integrated incumbent suppliers; Contact, Genesis, Mercury, Meridian/Powershop and Trustpower (subject to adopting standardised cost allocation rules).

For example, Genesis submitted:

Genesis would be open to a requirement to disclose segment contributions from its generation / wholesale operations, as well as performance from its residential and business operations. This is a level of transparency not currently in the market and would need to be carefully coordinated by an independent and external agency to ensure consistency.

Genesis already reports the transfer price between our generation and retail segments in our annual report. We would be willing to share this more widely along with our methodology to aid in comparison with other generator-retailers and ASX traded products²⁵

We further support requiring gentailers to disclose information about the financial performance of their generation and retailing activities (D3) and we support contract prices and generation costs being monitored periodically (D4). Genesis already provides segmented reporting and discloses the transfer price of energy sales in its Annual Report and is willing to do so in an appropriately standardised, disaggregated format that is consistent with agreed accounting standards.²⁶

Based on our assessment of submissions to the EPR, the total list of supporters consisted of Buller, Business NZ, Conumer NZ, Contact Energy, Counties Power, Counties Power Consumer Trust, ecotricity, Electric Kiwi, ENA, Entrust, Flick Electric, Fonterra, Genesis, Grey Power, Haast, independent retailers (jointly), The Lines Company, Lines Trust South Canterbury, Mercury, Meridian/Powershop, Network Waitaki, Northpower/Top Energy, NZ Steel, Orion, Pioneer Energy, Pulse, Trustpower, Vector, Vocus, and Wellington Electricity.

The only electricity retailer (or vertically-integrated supplier) that opposed financial separation requirements was Nova.²⁷

Gross retail margin reporting would not be onerous

We suggest the proposal for gross margin reporting will not be that onerous on the vertically-integrated suppliers. The following table demonstrates that a number of the data components are already published by these companies.

The most important change is to ensure the five companies are using the same definition of customer segment – which we submit should be residential / non-residential for retail segment

²⁵ <https://www.mbie.govt.nz/dmsdocument/4174-genesis-energy-electricity-price-review-first-report-submission>

²⁶ <https://www.mbie.govt.nz/dmsdocument/4859-genesis-energy-submission-electricity-price-review-options-paper-pdf>

²⁷ The Authority, MEUG and Nova were the only stakeholders that submitted in opposition. ERANZ did not have a view on the matter.

reporting. The definition of the wholesale segment is included below as it provides clarity about what is not currently included in the retail segment reporting.

| Gross Margin calculation | Mercury | Genesis | Contact | Meridian | Trustpower |
|--|--|------------------------------|---|---|--|
| Definition of electricity customer segments | mass market | all customers | mass market (incl SME) | residential, business & industrial | all customers |
| Electricity revenue | Yes | Yes | Yes | No - electricity revenue is net of distribution costs | Yes (with mass market \$m separately disclosed) |
| Cost of electricity supplied internally (IIP) Cost of electricity supplied from other sources | combined | combined | combined | combined | combined |
| Transmission and distribution costs | Yes | combined | combined | not separately identified | Yes |
| Metering costs | Yes (3rd party metering) | | | Yes | Yes |
| Levies | included in 'Other direct costs' | | | not separately identified | not separately identified |
| MWhs sales to same customer segment | Yes | Yes | Yes (with residential & SME MWh separately disclosed) | | Yes (with mass market MWhs separately disclosed) |
| Number of Customers for same customer segment | No | Yes | Yes (with residential & SME cust. Nos separately disclosed) | Yes | Yes |
| Definition of Wholesale segment | includes commercial and industrial customers | includes wholesale customers | includes commercial and industrial customers | includes large industrial customers & NZAS | Generation (+sale of water to irrigators) |

Standardised reporting rules would be beneficial for financial segmentation

We agree with Trustpower that “segmented reporting requirements for all generator-retailers should be:

- standardised and made mandatory within the Code ... ; and
- complemented by additional disclosure obligations around internal mass market transfer pricing for vertically integrated firms (consolidated with their subsidiaries) to ensure complete transparency of transfer prices.” [footnote removed]²⁸

We also agree with Trustpower that “unless requirements for segmented reporting are standardised there is a risk that each generator-retailer will report differently, making it difficult to use the information to:

- identify whether cross-subsidisation is occurring within vertically integrated parties; ... and
- enable interested parties to more accurately determine the value contributed from each segment within a vertically integrated business”.²⁹

²⁸ Trustpower, TRUSTPOWER SUBMISSION: ELECTRICITY PRICE REVIEW'S OPTIONS PAPER, 22 March 2019, at: <https://www.mbie.govt.nz/dmsdocument/4926-trustpower-submission-electricity-price-review-options-paper-pdf>.

²⁹ Trustpower, TRUSTPOWER SUBMISSION: ELECTRICITY PRICE REVIEW'S OPTIONS PAPER, 22 March 2019, at: <https://www.mbie.govt.nz/dmsdocument/4926-trustpower-submission-electricity-price-review-options-paper-pdf>.

Vector similarly submitted “Regulated segmented accounts should be required to display revenue, cost and profitability metrics for the generation and retail arms separately, calculated on a consistent basis across all vertically integrated companies. Businesses should also be required to disclose the transfer prices that have been applied between their generation and retail segments when calculating revenues and profits. Those transfer prices should be derived using a consistent methodology set out in regulation”.³⁰

Flick submitted, by way of example also: “It will be important to ensure robust rules for cost allocation and related party transfers (RTP), to ensure that cost allocation isn’t used to mask profitability and/or cross-subsidies”.³¹

We have also jointly submitted previously that:³²

It will be important to ensure robust rules for cost allocation and related party transfers (RTP), to ensure that cost allocation isn’t used to mask profitability and/or cross-subsidies.

The views expressed by ERANZ and the incumbent gentailers in their submissions to the Commerce Commission during its statutory review of the Input Methodologies under Part 4 of the Commerce Act - in relation to new technology, and cost allocation and RTP rules for EDBs - are directly relevant to the issue of gentailer disclosure.

We consider it will be useful to review these submissions when considering the type of financial reporting and disclosure requirements that should be introduced, particularly in relation to the incumbent retailers’ concerns about the need for tight rules (which minimise the suppliers’ ability to manipulate its cost allocations), and concerns about particular types of cost allocation methodologies.

The principal focus needs to be on determining the boundaries between retail and wholesale (so wholesale costs are not used to inflate retail costs/suppress disclosures retail profitability), the size of shared and common costs and how they are allocated and the methodolog(ies) applied in setting Transfer prices between wholesale and retail.^{33,34} We recognise segmented profit disclosure won’t be perfect and there are cost allocation issues, but imperfect information is better than no information at all. Further, other regulators have addressed these types of issues, and there is far more complexity, by way of example, with the segmentation required by the TPM Guidelines (which require separate segmentation of “covered costs” for each benefit-based investment which could run into the hundreds).

While some vertically-integrated suppliers opposed standardised rules for segment reporting,³⁵ their submissions to the Commerce Commission highlight the risks financial disclosures will not reliably identify business unit profitability and/or cross-subsidies and could be gamed by suppliers. The submissions advocated tightening cost allocation and related party transaction rules, as well as arms-length rules.³⁶

³⁰ Vector, Electricity Price Review – Options Paper, 22 March 2019, at: <https://www.mbie.govt.nz/dmsdocument/4930-vector-submission-electricity-price-review-options-paper-pdf>.

³¹ <https://www.mbie.govt.nz/dmsdocument/4853-flick-energy-submission-electricity-price-review-options-paper-pdf>

³² <https://www.mbie.govt.nz/dmsdocument/4868-independent-retailers-submission-electricity-price-review-options-paper-pdf>

³³ The rules for allocating shared and common costs and for setting Transfer prices were particular areas of attention in the Commerce Commission’s review of the Part 4 Commerce Act Input Methodologies’ cost allocation rules.

³⁴ There are bounds on the level of imprecision and sensitivity of segmented profitability disclosure to cost allocation as significant elements of wholesale-retail costs are directly attributable to the respective businesses, including costs relating to generation plant, wholesale electricity payments and line charges which would represent the bulk of the vertically-integrated suppliers’ costs.

³⁵ For example, Contact submitted “Contact is concerned that having a set of detailed rules on segment reporting and how common costs must be allocated will simply add unnecessary costs to the business with no benefit to customers”. Source: Contact, Contact Energy submission on the Electricity Pricing Review Options Paper, 22 March 2019 at: <https://www.mbie.govt.nz/dmsdocument/4824-contact-energy-submission-electricity-price-review-options-paper-pdf>.

³⁶ See, for example: ERANZ, SUBMISSION TO THE COMMERCE COMMISSION ON UPDATED DECISION ON COST ALLOCATION FOR ELECTRICITY DISTRIBUTION BUSINESSES, 13 OCTOBER 2016, at: https://comcom.govt.nz/_data/assets/pdf_file/0025/60199/ERANZ-Submission-on-further-consultation-paper-on-cost-allocation-for-electricity-and-gas-businesses-13-October-2016.PDF

Contact, for example, raised the need “to avoid the potential for cross subsidisation”, and to ensure “operat[ion] on an arm’s length basis ... to provide an open and level playing field in the market for energy services”.³⁷ Similarly, Mercury warned against the risks of providing flexibility in cost allocation rules:³⁸

...providing greater flexibility potential[ly] runs the risk of restricting competition for the provision of such technologies by providing a regulated cost advantage which is not in the long term interests of consumers.

The EPR also noted “We support the suggestion of independent retailers and Vector that the design of disclosure arrangements draw on experience from the distribution sector regime overseen by the Commerce Commission”.³⁹

Transparency is important for checking the health of competition

The Government EPR decision noted, in relation to segmented financial reporting, that “There are ongoing questions about whether generators are making excessive profits at the expense of consumers. This risks undermining confidence in the wholesale market” and requiring “vertically integrated companies to report separately on the financial performance of their retail and generation operations using a common set of rules ... will assist market participants and others assess whether generators are making excessive profits”.⁴⁰

Wholesale-retail ITP and profitability disclosures should help ensure there is better information about the competitive performance of the electricity market and for identifying potential problems, including problems relating to vertical-integration of the incumbent wholesale-retail operators. No measure of the level of competition is perfect so it would be useful to understand the extent, or whether, high levels of market concentration manifest in persistent and enduring monopoly or supra-normal profits and excessive prices for consumers.

We agree with the EPR “At a minimum, expanded reporting will fill the information gap that fosters suspicion and undermines market confidence. If there is a real competition problem that requires correcting, separate reporting should help uncover it” and “More accurate disclosure of transfer prices will enable a much clearer assessment of the extent of any competition problems, triggering further action if justified”.⁴¹

We also agree with OFGEM that “Transparency of [large] energy company profits matters. It is important for consumer confidence, and for new firms thinking to enter the energy market. Robust data also allows us to monitor and assess how well the market is working for consumers”.⁴² OFGEM stated a benefit of this disclosure was to “make it easier for potential entrants to assess market opportunities at each point along the value chain”.

In a letter to energy suppliers describing the decisions OFGEM had made⁴³ it states:

³⁷ Contact Energy, “Cross submissions on the Commission’s invitation to contribute to problem definition”, 4 September 2015, section 1.

³⁸ Mighty River Power, “Input Methodologies Review: Cross-submission on invitation to contribute to problem definition”, 4 September 2015.

³⁹ Electricity Price Review, FINAL REPORT, 21 May 2019.

⁴⁰ <https://www.mbie.govt.nz/assets/electricity-price-review-recommendations-from-final-report.pdf>

⁴¹ Electricity Price Review, FINAL REPORT, 21 May 2019.

⁴² https://www.ofgem.gov.uk/sites/default/files/docs/2014/02/actions_to_improve_the_transparency_of_energy_company_profits.pdf

⁴³ <https://www.ofgem.gov.uk/ofgem-publications/86388/actionstoimprovethe Transparency of energy company profits.pdf>

“Regarding transparency of profits, we aim to provide meaningful and robust information in a way that can be clearly understood. We want to inform the debate on energy company profits and the link to the functioning of the market. There should not be disagreements over facts.”

And in a 2014 consultation paper to extend the reporting obligations⁴⁴, OFGEM states:

“Large energy companies’ profits continue to attract significant public interest. Rising domestic supply prices and profits over the last five years have resulted in concerns about the effectiveness of competition. This has been coupled with distrust over the profits that the large companies have reported for their generation and supply businesses.”

Proposal: tighten scrutiny of companies’ transfer pricing policies

We propose to require companies to keep, appropriate and effective transfer pricing policies for their specific individual circumstances, like business models. This must be done by, among other appropriate actions:

- keeping transfer pricing policies under review as the market changes, for example by ensuring that supporting comparable data underpinning their transfer prices remains appropriate, and
- ensuring that transfer pricing policies and procedures are subject to internal audit.

The potential benefits we consider most relevant for this assessment include:

- enhancing transparency on the profitability of different energy companies
- facilitating potential new entrants assessing opportunities to enter the market
- helping increase assurance of the information that vertically-integrated companies publish by providing comparator data
- helping government gather a broader evidence base on the impact of its policies on company costs
- exerting downward pressure on the cost of capital by reducing information risk

Nature of the market failures in the electricity market

The electricity retail and wholesale markets are both highly concentrated. They have strong oligopolistic characteristics with abnormal levels of vertical-integration. Information Disclosure should help develop a better understanding of the impact of market concentration in both wholesale and retail coupled with the high levels of vertical-integration.

The Commerce Commission defines a “concentrated market” as a market where three firms have a total of 70% or more of the relevant market. Under this definition, the wholesale electricity market is concentrated (CR3 = 70.23% over the last 12 months)⁴⁵ and 18 out of 39 electricity retail markets on a network reporting region basis are concentrated (with another 10 within 5% of the Commerce Commission threshold).

The UK Competition and Markets Authority uses a stricter definition under which an HHI of 2,000 is the boundary between concentrated and highly concentrated. This puts the wholesale electricity market on the cusp between concentrated and highly concentrated. 16 out of 39 of the electricity retail markets on a network reporting region basis are concentrated and the remaining 23 highly concentrated.

The U.S. Department of Justice considers a market with a HHI of less than 1,500 to be a competitive marketplace, a HHI of 1,500 to 2,500 to be a moderately concentrated marketplace, and an HHI of 2,500 or greater to be a highly concentrated marketplace.⁴⁶ Using the US definition the NZ wholesale electricity market is moderately concentrated, and 5 of the 39 retail markets are highly concentrated and 2 are competitive.

⁴⁴ <https://www.ofgem.gov.uk/ofgem-publications/90703/transparencyconsultationpdf>

⁴⁵ Up to 31 January 2021.

⁴⁶ The same measure is also used by other regulators e.g. Economic Regulation Authority Western Australia, Report on the effectiveness of the Wholesale Electricity Market 2020, 28 August 2020 at: <https://www.erawa.com.au/cproot/21468/2/WEM-Report---Final---2020-v4.1-Redacted-further-for-Publication.PDF>.

The HHI market concentration levels in the electricity wholesale and retail markets are shown in figures 1 – 2 below.

Figure 1: Wholesale electricity market HHI trend (12 month rolling average)⁴⁷

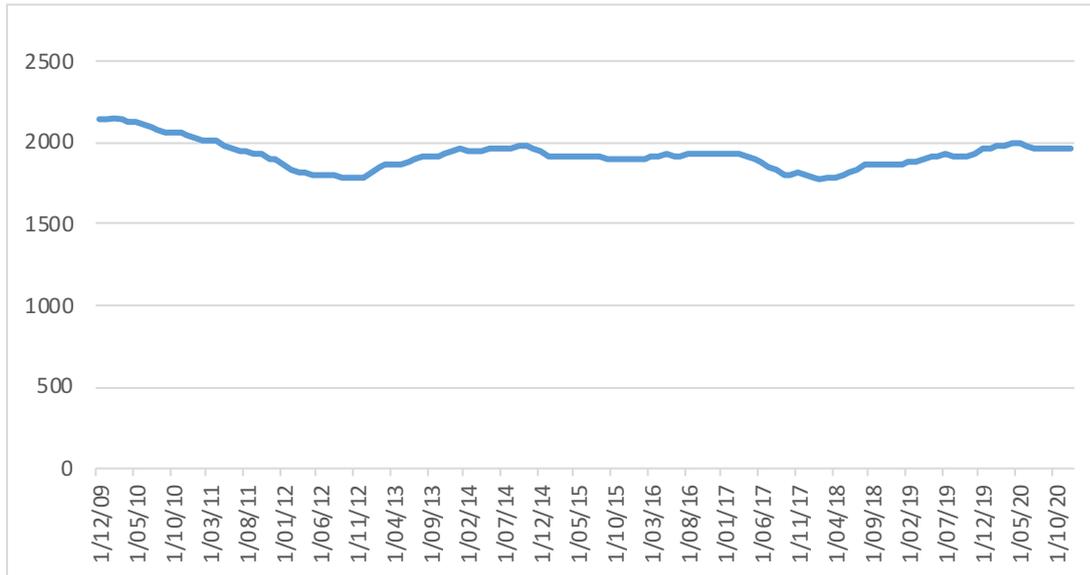
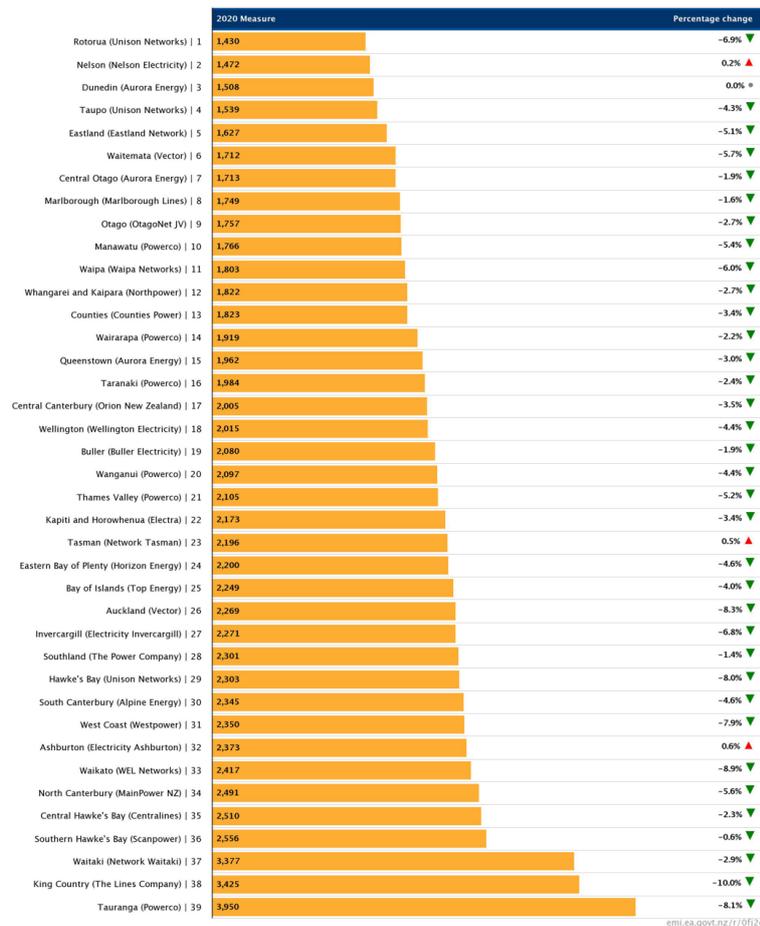


Figure 2: Electricity retail market HHIs 2020⁴⁸



⁴⁷ Extracted from <https://www.emi.ea.govt.nz> data.

⁴⁸ https://www.emi.ea.govt.nz/Retail/Reports/IE31BN?RegionType=NWK_REPORTING_REGION&si=v|3

When the Commerce Commission investigated the electricity sector in 2009 it found “each of the four largest gentailers - Contact, Genesis, Meridian and Mighty River Power - is likely to have held substantial market power on a recurring basis, particularly during dry years ... Each of these companies has the ability and incentive unilaterally to exercise market power and increase wholesale prices during certain periods. The price increases in dry periods are well above any increases in input costs, including the higher opportunity cost of water when hydro storage is low”.⁴⁹ The level of market concentration in the wholesale electricity market has changed little since the Commerce Commission assessed the level of market power.

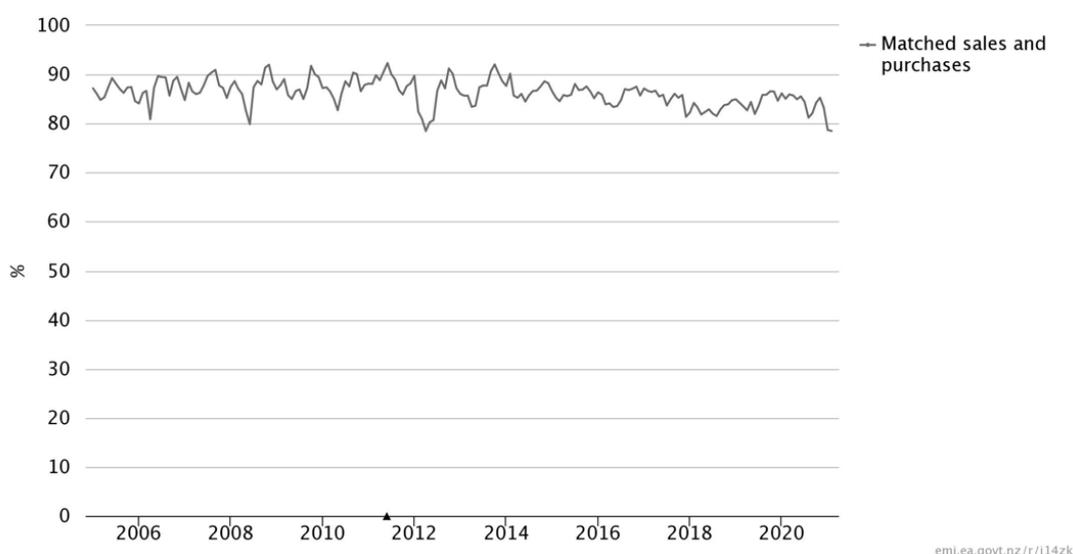
Consistent with the Commerce Commission findings, the EPR observed “generators have exercised market power by, for example, sharply raising prices in the spot market for brief spells”. The Brattle Group, on behalf of Meridian, has also acknowledged the wholesale electricity market is concentrated allowing exercise of market power:⁵⁰

The concentrated structure of the New Zealand market means that many generators are potentially price-setting, resulting in prices deviating from SRMC depending on prevailing market circumstances and economic trading strategies.

Market power in one market can manifest in downstream markets

We agree with the Authority that one indicator of barriers to entry is the “degree of vertical integration e.g. retail sales as % of own generation”.^{51,52} Figure 3 details the level of wholesale-retail vertical-integration.

Figure 3: Wholesale-retail vertical-integration trends⁵³



Given the high levels of vertical-integration in the wholesale-retail markets, it is important to recognise market power in one market can manifest itself in other markets.

⁴⁹ Commerce Commission, media release, Commerce Commission finds that electricity companies have not breached the Commerce Act, 21 May 2009 at: <https://comcom.govt.nz/news-and-media/media-releases/archive/commerce-commission-finds-that-electricity-companies-have-not-breached-the-commerce-act>.

⁵⁰ The Brattle Group, Response to Third Party Submissions Regarding Alleged UTS of 2019, prepared for Meridian Energy, 16 September 2020 at: <https://www.ea.govt.nz/assets/dms-assets/27/27239Meridian-Energy-2019-UTS-Preliminary-Decision-Submission-Brattle-Report.PDF>.

⁵¹ Electricity Authority, Industry and market monitoring: Competition Information paper, 31 August 2011.

⁵² A better measure is the extent of geographic vertical-integration.

⁵³ https://www.emi.ea.govt.nz/Wholesale/Reports/BLKL4U?_si=v|3

We agree with the European Union that “One of the main obstacles to the development of a true level playing field for access seekers ... is the preferential treatment of the downstream businesses, for example the retail arm, of a vertically integrated operator with significant market power (SMP operator) through price and non-price discrimination ...”⁵⁴ The EPR reached similar conclusions e.g. “Vertical integration has costs and benefits ... it 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”.⁵⁵

All of the above evidence confirms the importance / value of accurate and timely wholesale/retail profitability reporting as well as understanding the arrangements for pricing generation between the vertically integrated businesses.

Application of the Industry and market monitoring: Competition Information Paper

We agree with the Authority that “Effective industry and market monitoring will help ... increas[e] transparency about market events and by improving access to quality information”, “The Electricity Authority, market participants, and ultimately consumers will benefit from open information on the state of the market” and “Market monitoring will highlight any deficiencies with current arrangements”.⁵⁶

The Authority’s Competition Information Paper sets out various measures that can be used to determine and monitor the state of competition which would be supported by segmented financial and profitability disclosures e.g.:

| Measure | Why important for competitive pressure in industry | Potential indicators |
|------------------------------------|---|---|
| Price-cost relationship | Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power. | Price-cost margin index; Lerner Index. |
| Revenue and input costs | In a competitive market, if input costs rise then marginal costs and marginal revenue rise by the same amount. | Panzar-Rosse H Statistic |
| ... | | |
| Profitability/return on investment | No firm should be able to make supernormal profits on an ongoing basis unless it is linked to innovation and a pushing out of the production efficiency frontier. | Cost to income ratios; Net revenue benchmark analysis; Return on investment; Return on equity |

⁵⁴ Article 14(3) of Directive 2002/21/EC: <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32002L0021>

⁵⁵ Electricity Price Review, FIRST REPORT FOR DISCUSSION, 30 August 2018 at <https://www.mbie.govt.nz/dmsdocument/4334-electricity-price-review-first-report-technical-paper>.

⁵⁶ Electricity Authority, Industry and market monitoring: Competition Information paper, 31 August 2011.

The Authority gives profitability/cost measures medium to high relevance for monitoring the extent of competition across market segments:

Table 4 Application of competition measures across market segments

| | Wholesale | Distribution | Transmission | Ancillary | Hedge | Retail |
|--------------------------------------|-----------|--------------|--------------|-----------|-------|--------|
| Economic, Structure | | | | | | |
| Market shares | √√√ | ... | ... | √ | √√ | √√√ |
| Market share concentration ratio | √√√ | ... | ... | √ | √√ | √√√ |
| Herfindahl-Hirschman Index | √√√ | ... | ... | √ | √√ | √√√ |
| Pivotal supplier indicator | √√√ | ... | ... | √ | √√ | √ |
| Residual supply index | √√√ | ... | ... | √ | √√ | √ |
| Residual demand analysis | √√ | ... | ... | √ | √ | √ |
| Homogeneity of products and services | √√ | √√ | ... | ... | √√ | √√ |
| Barriers to entry | √√√ | ... | ... | ... | √√√ | √√√ |
| Economic, Conduct | | | | | | |
| Price-cost margin index | √√ | √√ | √√ | √√ | √√ | √√ |
| Lerner Index | √√ | √√ | √√ | √√ | √√ | √√ |
| Panzar-Rosse H Statistic | √√ | √√ | √√ | √ | √√ | √√ |
| Economic withholding analysis | √√ | ... | ... | √√ | √√ | √ |
| Physical withholding analysis | √√ | ... | ... | √√ | √ | √ |
| Curious offers and bids | √√√ | ... | √ | √ | √√√ | √ |
| Availability of market information | √ | √√ | ... | ... | √ | √√√ |
| Ease of switching suppliers | √ | ... | ... | √ | √ | √√√ |
| Conditions for collusion | √√ | √ | ... | √ | √√ | √√ |
| Economic, Performance | | | | | | |
| Presence of excess capacity | √√ | √√√ | √√√ | ... | ... | ... |
| Single factor efficiency ratios | √√√ | √√√ | √√√ | √ | ... | √ |
| Total factor productivity | √√√ | √√√ | √√√ | √ | ... | √√ |
| Price monitoring | √√√ | √√√ | √ | √√√ | √√√ | √√√ |
| Cost to income ratios | √√√ | √√√ | √ | √√ | ... | √√√ |
| Net revenue benchmark analysis | √√√ | √√√ | √ | √√ | ... | √√√ |
| Return on investment | √√√ | √√√ | √√√ | √ | ... | √√√ |
| Return on equity | √√√ | √√√ | √√√ | √ | ... | √√√ |

Notes: (1) Applicability/relevance scale: ... = not at all applicable; √ = Low; √√ = Medium; √√√ = High.

Source: NZIER

Case study: the market study into the retail fuel sector

The Commerce Commission's market study into the retail fuel sector is a useful illustration of the role and benefits of segmented profitability reporting.⁵⁷

The Minister of Commerce and Consumer Affairs, pursuant to section 51(1) in Part 3A of the Commerce Act 1986, required the Commerce Commission to carry out a competition study into any factors that may affect competition for the supply of retail petrol and diesel used for land transport throughout New Zealand. The terms of reference provided by the Minister directed the Commission to consider a series of issues that would be expected of any study into the competitiveness of an oligopolistic market with high levels of vertical-integration between wholesale and retail:⁵⁸

Matters to be considered in the study may include, but are not restricted to:

1. the structure of the industry;
2. the extent of competition at the refinery, wholesale and retail levels, including the role of imports;
3. any factors that may hinder competition between industry participants;
4. the conditions for entry by potential competitors, including independent suppliers, and/or the conditions for expansion;
5. whether wholesale and retail price and service offerings of petrol and diesel are consistent with those expected in workably competitive markets; and
6. features of retail petrol and diesel markets that are not in the long-term interests of consumers.

The study was based on the premise that what matters when considering workably competitive markets, is their tendency over time to move towards the outcomes that would be expected in strongly competitive markets⁵⁹ and:

"one important outcome that can be expected over the long run in a workably competitive market is that firms will tend to earn normal rates of return and prices will reflect efficient costs".

"... longer term profits if they are persistently greater than a normal level of return, generally indicate a competition problem as competition is not eroding them."

"Persistent excess levels of profitability are an indicator that competition is ineffective"

"... assessing profitability may help identify the factors affecting competition ..."

The Commerce Commission noted the High Court has elaborated upon this as follows:⁶⁰

... what matters is that workably competitive markets have a tendency towards generating certain outcomes. These outcomes include the earning by firms of normal rates of return, and the existence of prices that reflect such normal rates of return, after covering the firms' efficient costs ...

Consequently, a core element of the investigation into the competitiveness of the retail fuel sector was to assess profitability to determine whether the prices for retail fuel were consistent with those expected in a workably competitive market. The report provides a useful framework for how to consider profits (with a focus on whether returns were excessive over the long-run) and the

⁵⁷ Commerce Commission, Market study into the retail fuel sector, Final report, 5 December 2019.

⁵⁸ "Terms of reference for competition study into retail fuel markets" (5 December 2018) New Zealand Gazette No 2018-go6158 at <https://gazette.govt.nz/notice/id/2018-go6158>.

⁵⁹ Wellington International Airport Ltd and Others v Commerce Commission [2013] NZHC 3289, paragraphs [20]-[23] at <https://forms.justice.govt.nz/search/Documents/pdf/jdo/53/alfresco/service/api/node/content/workspace/SpacesStore/1c117dea-b8ba-491e-ba1d-d4cd30dbe522/1c117dea-b8ba-491e-ba1d-d4cd30dbe522.pdf>.

⁶⁰ Wellington International Airport Ltd and Others v Commerce Commission [2013] NZHC 3289, paragraphs [18]-[22].

limitations anyone evaluating the competitiveness of a market needs to be mindful of when looking at evidence of profits. For example, the Commission noted:

“Profitability analysis is only one indicator of the level of competition

“Profitability analysis is simply one indicator to assist us in determining whether there are factors affecting competition to the long-term detriment of consumers. That is, an assessment of profits needs to be done in combination with an analysis of the conditions for competition, and the specific factors which may be affecting competition.

“Similarly, evidence that the level of profitability is around normal or competitive levels does not necessarily mean that there are no factors adversely affecting competition in the market.”

The Commerce Commission also acknowledged “techniques for assessing profitability are imperfect”⁶¹ and, given the investigation was one-off, it did not have the luxury of being able to set Part 4 Commerce Act type rules for financial separation/cost allocation to establish information on retail profitability:

... in the context of this study and the available timeframes, and to avoid imposing substantial costs on stakeholders in responding to requests for information that a Part 4-style approach would necessitate, we have instead adopted a pragmatic approach, analysing the information that is more readily available and tailoring our analysis accordingly. This approach also recognises that there are quality, innovation and product differences in the market, and that there are cost implications arising from this.

This is not a problem or limitation the Electricity Authority faces other than it would take longer to establish financial segmentation rules than to establish ITP and retail gross margin disclosure requirements, which is why we have suggested to two stage process for implementing the Government’s EPR financial segmentation requirements.

OFGEM provides useful precedent

As well as drawing on the approach to financial separation the Commerce Commission has adopted in electricity distribution and in other investigations etc, the EPR noted the Authority can draw on “the segmental reporting rules issued by Ofgem in the United Kingdom”.⁶² OFGEM introduced retail-wholesale disclosure requirements in 2009 and considers that “This has improved the transparency of large suppliers’ profits”.⁶³

Since 2009, OFGEM has undertaken various reviews of the disclosures and disclosure requirements in order to improve their quality and ensure they are fit-for-purpose. This has included things like requiring the vertically-integrated suppliers commission external auditors to scrutinise their Consolidated Segmental Statements, tightening of Transfer price rules⁶⁴ and a common methodology for valuing generation assets.

OFGEM “publish[es] a wide range of information on the retail energy markets and how they are working” in order “To increase transparency and improve trust, we publish a wide range of information on the retail energy markets and how they are working”.⁶⁵

We consider OFGEM provides good precedent for the type of information that should be required to be publicly disclosed. For example, the graphs below show the financial separation requirements are not only sufficient to provide a split out of retail-wholesale profitability, but also domestic/non-

⁶¹ Commerce Commission, Market study into the retail fuel sector, Final report, 5 December 2019.

⁶² Electricity Price Review, FINAL REPORT, 21 May 2019.

⁶³ https://www.ofgem.gov.uk/sites/default/files/docs/2013/04/factsheet-understanding-profits_0.pdf

⁶⁴ OFGEM requires the large vertically-integrated suppliers to calculate in the same way the average cost to their supply business of buying the wholesale electricity they need to meet their customers’ needs. This is called ‘weighted average cost of electricity’ (WACOE) in the statements.

⁶⁵ <https://www.ofgem.gov.uk/electricity/retail-market/retail-market-monitoring>.

domestic retail profitability and break-down of the individual components of electricity bills.⁶⁶ This information would naturally fit within the Authority’s EMI website, and their responsibility to promoting thriving competition.



Concluding remarks and recommendations

The introduction of transfer price/segment profitability disclosure requirements should help provide better and more complete information for monitoring the health of competition and identifying potential barriers to competition:

| | Why is it important? |
|--|---|
| <ul style="list-style-type: none"> Financial separation: “The Electricity Authority should require vertically integrated companies to report separately on the financial performance of their retailing and generation/wholesale operations using a common (regulated) set of reporting rules”.⁶⁷ | <p>Identification of problems with the level of competition/market power: Information on the costs and profits of the vertically-integrated incumbent suppliers will help with monitoring of the state of the electricity market and determining whether competition is effective at curbing electricity prices. We agree with the Authority that: “Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power.”⁶⁸</p> |

⁶⁶ <https://www.ofgem.gov.uk/electricity/retail-market/retail-market-monitoring/understanding-profits-large-energy-suppliers>.

⁶⁷ Electricity Price Review, FINAL REPORT, 21 May 2019 at: <https://www.mbie.govt.nz/assets/electricity-price-review-final-report.pdf>.

⁶⁸ Electricity Authority, Industry and market monitoring: Competition Information paper, 31 August 2011 at: <https://www.ea.govt.nz/assets/dms-assets/11/11525Industry-market-monitoring-information-paper.pdf>.

| | |
|--|---|
| | |
| <ul style="list-style-type: none"> • Transfer price disclosure: “How internal transfer prices are treated will, as many submitters noted, be crucial.”⁶⁹ “Generator-retailers would also need to disclose the “transfer prices” of energy sales within their vertically integrated companies. An example would be when they “sell” electricity from their generation arm to their retail arm.”⁷⁰ | <p>Identification of barriers to competition: Information on Internal Transfer Prices (including the methodologies for setting Internal Transfer Prices) of the vertically-integrated suppliers will help identify whether, or the extent to which, there are barriers to competition/market concentration issues e.g. due to vertically-integrated suppliers discriminating between their own retail businesses and independent businesses.</p> |

We agree with the EPR “More accurate disclosure of transfer prices will enable a much clearer assessment of the extent of any competition problems, triggering further action if justified”⁷¹ and with OFGEM that “Transparency of [large] energy company profits matters. It is important for consumer confidence, and for new firms thinking to enter the energy market. Robust data also allows us to monitor and assess how well the market is working for consumers”.⁷²

If the Authority had transfer price/segment profitability disclosure requirements in place now, it could have informed potential quantitative assessment of the benefits of hedge market reform, the extent to which EDB price reductions in 2020 were passed-through to end-consumers, and the Authority’s review of competition in the spot market since the unplanned Pohokura outage in late 2018⁷³ (including whether current very high wholesale electricity prices reflect genuine scarcity issues or also use of market power).

Recommendations

Other than proposing to extend the disclosure requirements to suppliers with no market power, we are unsure of the basis of the unreferenced claim “The proposed amendments address, and indeed go beyond, many of the proposals raised by small and medium-sized retailers with respect to the disclosure of ITP and segment profitability”. Our submissions have advocated full financial separation and both wholesale and retail disclosure, as well as application of various economic replicability tests, which go well beyond the Authority proposals.

Our recommendations in response to the Authority’s proposals include the following:

- | |
|---|
| <ul style="list-style-type: none"> • Implement the ITP and segmented profitability disclosures as a two-phase project: Implement Internal Transfer Price and retail gross margin disclosure as an immediate priority, and work on full wholesale-retail financial separation and profitability disclosure as a second phase of the project. • Phase 1 should take effect from 1 July 2021, with enhanced market monitoring and reporting taking immediate effect. Phase 2 should be completed within the 2021/22 financial year. |
|---|

⁶⁹ Electricity Price Review, FINAL REPORT, 21 May 2019.

⁷⁰ Electricity Price Review, OPTIONS PAPER for discussion, 18 February 2019 at <https://www.mbie.govt.nz/dmsdocument/4578-electricity-price-review-options-paper>.

⁷¹ Electricity Price Review, FINAL REPORT, 21 May 2019.

⁷² https://www.ofgem.gov.uk/sites/default/files/docs/2014/02/actions_to_improve_the_transparency_of_energy_company_profits.pdf

⁷³ <https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/2019-wholesale-market-prices-review/>

- **Figure 2 Internal transfer prices replicability benchmarks:** If the Authority is going to rely on this analysis, it should: (i) base the replicability benchmarks on prices that would be feasible for an existing prudent and efficient independent retailer (the current benchmarks are based on FPVV hedging arrangements which are not available to independent retailers); (ii) the same analysis again but entirely forward-looking for a potential new entrant retailer; (iii) undertake the analysis on the basis of residential only (to overcome inconsistencies with mass market which is based on size or meter type); (iv) repeat the exercise using up-to-date information including for 2020/21⁷⁴ and 2021/22 (most or all vertical-suppliers will have their ITPs set for this period); and (v) undertake the analysis based on the wholesale input costs the vertical-suppliers have actually used to set retail prices (where this differs from the ITPs used for accounting purposes).

- **Market participants that should be subject to the disclosure requirements:** The criteria for determining who should be subject to the disclosure requirements should be based on whether the supplier: (i) is vertically-integrated; and (ii) has market power in the wholesale or retail market. The requirements should apply to Contact, Genesis, Mercury, Meridian, Nova and Trustpower, and not vertically-integrated suppliers with 5% market share (ITP disclosure) or retailers with 1% market share (retail gross margin disclosure).
- **Quality assurance:** The disclosure requirements should include independent audit and director certification requirements (following OFGEM/Commerce Commission precedent).

Phase I implementation

- **Transfer price disclosure:** Where the Internal Transfer Prices for financial reporting differ from those provided for retail pricing both sets of payments and methodologies should be disclosed.
- Require that Internal Transfer Prices disclosure also includes a reference node (e.g. Otahuhu and Benmore equivalent) to recognise the difference in each of the integrated suppliers retail-generation portfolios and enable a more 'apples with apples' comparison.
- Require Internal Transfer Prices to be disclosed whenever they are updated or changed.
- Require disclosure of the Internal Transfer Price methodology and the reasons justifying the methodology that was adopted and the reasons for any changes to the methodology, to a level of specificity that a reasonable person would understand why the supplier has adopted the method, including the extent to which the supplier considers it to be "a fair reflection of the cost of electricity".
- The Commerce Commission's Information Disclosure Requirements for disclosure of pricing methodologies provides some useful precedent⁷⁵ for the drafting of the methodology disclosure requirements e.g.:
 - "Describes any changes in the price"
 - "Any change in the pricing methodology or adoption of a different pricing methodology, must be publicly disclosed at least 20 working days before prices determined in accordance with the change or the different pricing methodology take effect" [this should

⁷⁴ The consultation paper Figure 2 states that it includes 2020/21 but this reflects errors in the Authority modelling.

⁷⁵ https://comcom.govt.nz/_data/assets/pdf_file/0025/78703/Electricity-distribution-information-disclosure-determination-2012-consolidated-3-April-2018.pdf

| |
|--|
| <p>apply to the methodology used for determining the wholesale cost used for retail pricing purposes if this differs from the ITP used for financial segmentation purposes]</p> <ul style="list-style-type: none"> ○ “must ... Include sufficient information and commentary to enable interested persons to understand how prices were set” ○ “must ... Demonstrate the extent to which the pricing methodology is consistent with the pricing principles and explain the reasons for any inconsistency between the pricing methodology and the pricing principles” [this could be reworked into an “obligation to [demonstrate] ITP transfer prices are a fair reflection of the cost of electricity”] ○ “must If prices have changed from prices disclosed for the immediately preceding disclosure year, explain the reasons for changes, and quantify the difference in respect of each of those reasons” ○ “If the pricing strategy has changed from the preceding disclosure year, identify the changes and explain the reasons for the changes.” [This should apply with “ITP” substituted for “pricing strategy”]. |
| <ul style="list-style-type: none"> ● Retail Gross Margin disclosure: Require disclosure of retail gross margins, including segmentation between residential/non-residential.⁷⁶ ● Gross margins should be disclosed using the separate categories as defined in the consultation paper – electricity revenue minus cost of electricity, distribution and transmission costs, metering costs, and levies. |
| <p>Phase II implementation</p> |
| <ul style="list-style-type: none"> ● Financial separation: Require the vertically-integrated incumbent suppliers to disclose segmented financial accounts and profitability measures for their retail and wholesale businesses, including break-down of residential/non-residential (including commercial and industrial) retail profitability. ● The profitability disclosure requirements should include full financial segmentation of wholesale and retail to the EBITDAF level (not just gross margin disclosure). |
| <ul style="list-style-type: none"> ● Comparability: Introduce standardised cost allocation rules for financial separation. |
| <p>Market Monitoring</p> |
| <ul style="list-style-type: none"> ● The Authority to undertake price-squeeze/discrimination testing as part of its market monitoring. This should include, by way of example, monitoring of the incumbent retailers’ self-supply prices and the actual prices available to independents; ● The Authority should monitor that hedge arrangements provided by each of the incumbent suppliers to third parties/independent retailers, including volumes and price; ● Adopt the type of profitability/margin reporting/monitoring that was envisaged in the Competition Information Paper to determine whether suppliers are making ongoing supranormal-normal profits e.g. indicators such as cost to income ratios; net revenue benchmark analysis; return on investment; return on equity; |

⁷⁶ The requirement to disclose individual components of the gross margin (individual cost components and revenue) will also enable the Authority and other stakeholders to use alternative wholesale input costs to ensure comparability and to apply different types of equivalence/price squeeze/discrimination tests etc.

- Further improve the EMI website to include cost/profitability/residential savings information, including the type of financial segmentation information provided in OFGEM reporting;⁷⁷
- Reintroduce monitoring of residential savings/loyalty taxes (potential savings from changing supplier);⁷⁸ and
- Include wholesale HHI and Concentration statistics (in addition to existing retail) on EMI. The Authority has previously said that this will be introduced as part of an upgrade of EMI but is yet to do so.

Yours sincerely,

Luke Blincoe
Chief Executive
luke.blincoe@electrickiwi.co.nz



Steve O'Connor
Chief Executive Officer
steve.oconnor@flickelectric.co.nz



Emily Acland
General Counsel and Regulatory
GM
emily.acland@vocusgroup.co.nz



⁷⁷ <https://www.ofgem.gov.uk/electricity/retail-market/retail-market-monitoring/understanding-profits-large-energy-suppliers>.

⁷⁸ This was discontinued after 2017.

Appendix: Responses to the Electricity Authority consultation questions

| Consultation question | Response |
|---|---|
| <p>Q1. Do you agree the issues identified by the Authority are worthy of attention?</p> | <p>Yes, for the reasons provided at paragraphs 2.26 and 2.27. We support the Authority’s aim “to ensure independent retailers can compete on a level playing field, and that generator-retailers’ pricing of electricity is held in check by competitive pressures”.</p> <p>Additionally, the Government EPR decision noted “ongoing questions about whether integrated generator-retailers are making excessive profits risks undermining confidence in the electricity market”.⁷⁹ While the potential for excess returns or prices to diverge from costs is prominent in the Authority’s Market monitoring: Competition Information Paper, it is not mentioned in the consultation paper.</p> <p>The question of generators profitability is particularly relevant now given the impact of the UTS on wholesale electricity prices, and the ongoing and persistently high wholesale electricity prices since 2018. The Minister has asked the question whether wholesale prices need to be as high as they currently are, but without information on generation profits and margins the Authority simply not in a position to shed any light on whether the prices reflect genuine scarcity only or use of market power.</p> |
| <p>Q2. Do you agree with the objectives of the proposed amendment? If not, why not?</p> | <p>If “The proposed Code amendment for ITP is intended to instil confidence that large generator-retailers are pricing internal electricity sales appropriately, using prices which could have been reasonably achieved by third parties through futures and spot markets” then information needs to be provided on the internal transfer pricing used to set retail prices, rather than for accounting purposes.</p> <p>The objectives should be broader than confidence about internal versus third party cost of energy pricing, with robust disclosures to assist identification of:</p> <ul style="list-style-type: none"> • any factors that may hinder competition between industry participants; |

⁷⁹ Electricity Price Review: Government Response to Final Report, 3 October 2019 at <https://www.mbie.govt.nz/assets/electricity-price-review-government-response-to-final-report.pdf>.

| Consultation question | Response |
|--|---|
| | <ul style="list-style-type: none"> • the conditions for entry by potential competitors, including independent suppliers, and/or the conditions for expansion; and • whether wholesale and retail prices are consistent with those expected in workably competitive markets. |
| <p>Q3. Do you agree that disclosure of ITP by large generator-retailers is important for trust and confidence in electricity markets?</p> | <p>Trust and confidence will be established by ensuring information is provided that can identify competitions problems, which are then acted on.</p> <p>For example, we agree with the Authority that: “If this monitoring were to identify a misuse of a market power by large generator-retailers when pricing and supplying electricity to internal or independent parties, the Authority would consider appropriate penalties and policy responses”.</p> |
| <p>Q4. Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?</p> | <p>Yes. We agree for the reasons provided in the consultation document.</p> |
| <p>Q5. Do you agree that the generator-retailers subject to these provisions should have an obligation to [demonstrate] ITP transfer prices are a fair reflection of the cost of electricity?⁸⁰</p> | <p>The disclosure requirements should be specified to help determine whether the “ITP transfer prices are a fair reflection of the cost of electricity” and/or whether they reflect prices that may result in a price squeeze against 3rd party/independent retailers and/or discriminatory practices. Where the ITP used for financial reporting differs from the wholesale cost used for retail pricing, the disclosure requirements should apply to the methodology used to determine the wholesale cost for pricing purposes.</p> <p>The Authority should add a requirement to disclose the reasons why the methodology was adopted (not just the methodology) and the reasons for any changes to the methodology, to a level of specificity that a reasonable person would understand why the supplier has adopted the method, including the extent to which the supplier considers it to be “a fair reflection of the cost of electricity”. The Code drafting provided in Appendix A covers a requirement to disclose the methodology but no requirement to disclose the reasons justifying the methodology that is used: “an explanation of the methodology the generator retailer used to determine or to assist in determining the retail ITP”.</p> |

⁸⁰ Wording of the question was clarified/amended after e-mail exchange with the Electricity Authority.

| Consultation question | Response |
|--|--|
| | <p>The Commerce Commission’s Information Disclosure Requirements for disclosure of pricing methodologies provides some useful precedent⁸¹ e.g. requirements that the methodology:</p> <ul style="list-style-type: none"> • “Describes any changes in the price” • “Any change in the pricing methodology or adoption of a different pricing methodology, must be publicly disclosed at least 20 working days before prices determined in accordance with the change or the different pricing methodology take effect” [this should apply to the methodology used for determining the wholesale electricity cost used for retail pricing purposes if this differs from the ITP used for financial segmentation purposes] • “must ... Include sufficient information and commentary to enable interested persons to understand how prices were set” • “must ... Demonstrate the extent to which the pricing methodology is consistent with the pricing principles and explain the reasons for any inconsistency between the pricing methodology and the pricing principles” [this could be reworked into an “obligation to [demonstrate] ITP transfer prices are a fair reflection of the cost of electricity”] • “must If prices have changed from prices disclosed for the immediately preceding disclosure year, explain the reasons for changes, and quantify the difference in respect of each of those reasons” • “If the pricing strategy has changed from the preceding disclosure year, identify the changes and explain the reasons for the changes.” [This should apply with “ITP” substituted for “pricing strategy”]. |
| <p>Q6. Do you agree that ITP disclosure requirements should encompass the price, pertinent details of the methodology used, the major component parts which the price comprises, and the terms and conditions?</p> | <p>Yes. For the reasons provided in the consultation document. See also our answer to Q5 about providing the rationale and reasons justifying the methodology.</p> |
| <p>Q7. Do you have any comments on the specifics of the information requirements with</p> | <p>See response to Q5. The Code requirements should include both a requirement to disclose the ITP methodology but also to disclose the rationale and justification for the methodology that</p> |

⁸¹ [https://comcom.govt.nz/ data/assets/pdf file/0025/78703/Electricity-distribution-information-disclosure-determination-2012-consolidated-3-April-2018.pdf](https://comcom.govt.nz/data/assets/pdf_file/0025/78703/Electricity-distribution-information-disclosure-determination-2012-consolidated-3-April-2018.pdf)

| Consultation question | Response |
|--|---|
| respect to the price, methodology, component parts, and terms and conditions? | has been adopted. The frequency of the disclosure should be a minimum of every six months. Most of the gentailers already disclose this information in their quarterly operational reports and six monthly financial statements. |
| Q8. Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements? | <p>No. The criteria for determining who should be subject to the ITP requirements should be based on whether the supplier: (i) is vertically-integrated; and (ii) has market power in the wholesale or retail market.</p> <p>Our position is consistent, for example, with the Authority’s statements that:</p> <ul style="list-style-type: none"> • “Stronger metrics for identifying and mitigating anti-competitive practices will relate to contexts where there is potential for <u>firms with market power</u> to extract value directly from third parties.” • “... <u>integrated generator-retailers’ controlling the bulk of electricity generation</u> can raise competition concerns.” • “The Authority currently considers that the Code should be amended to require <u>large generator-retailers</u> to disclose annually their ITP ...” • “... the Authority is proposing that the ITPs of generator-retailers, <u>of a size that could raise competition concerns</u>, should be disclosed annually ...” • “Confidence in the industry, and the regulation of the industry by the Authority, may be undermined by <u>dominant vertically integrated generator-retailers</u> behaving strategically to increase the costs of rivals, thereby limiting competition and increasing their own profitability.” <p>While the Authority thresholds presently capture the suppliers that meet these criteria (Contact, Genesis, Mercury, Meridian and Trustpower) there is the possibility of false-negatives if a small new entrant reaches the 5% thresholds. For the avoidance of doubt, we do not consider that a 5% market share is an appropriate threshold for determining whether a supplier is large or has market power.</p> |

| Consultation question | Response |
|--|---|
| <p>Q9. Do you agree that generator-retailers which own more than one retail business, and supply electricity to each by way of an ITP, should be permitted to report on a consolidated basis?</p> | <p>No. If a vertically-integrated supplier uses different ITPs for different retail businesses these should be disclosed. In making these comments, we note that related parties may not necessarily be all 100% owned subsidiaries, so some retail businesses may be treated more favourably than others.</p> <p>Averaging through consolidation would provide blunt information and could mask evidence of prices that may result in a price squeeze against 3rd party/independent retailers and/or discriminatory practices.</p> |
| <p>Q10. Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?</p> | <p>Yes.</p> <p>Including the ITP price, the methodology, rationale for the methodology and any caveats / instructions about how to understand the information plus the Authority's notional benchmark information and methodology.</p> |
| <p>Q11. Do you agree it would be helpful if the Authority published prices for a series of benchmark hedging strategies, for the purposes of evaluating whether generator-retailers' internal pricing reflects the cost of electricity? Are there any specific benchmark strategies you would like to see published?</p> | <p>We consider the Authority should require disclosure of information that would enable testing whether there are any barriers to competition and/or the extent of the barriers e.g. vertical price squeezes.</p> <p>The disclosure requirements can be set so the Authority has the information needed to test/expose the extent to which vertical-integration is a barrier to competition e.g.:⁸²</p> <ul style="list-style-type: none"> • Equivalence of Inputs⁸³/price squeeze tests: To what extent would vertically-integrated operators' own downstream operations be able to profitably supply the downstream product if faced with the upstream access price i.e. would 'no price squeeze' tests be satisfied based on an 'equally efficient competitor' standard? <p>The Commerce Commission has provided the following test which could usefully be applied to the electricity retail market:⁸⁴</p> |

⁸² From Vocus, Hedge Market Enhancements (market making) – Discussion Paper, Submission to Electricity Authority, 2 December 2019, at <https://www.ea.govt.nz/assets/dms-assets/26/26535Vocus-Hedge-Market-Enhancements-submission.pdf>.

⁸³ The definition of 'equivalence' is provided in s 156AB of the Telecommunications Act.

⁸⁴ Commerce Commission, We seek your views on the report from our expert economic advisor, Dr Ingo Vogelsang, on the interpretation of the equivalence and non-discrimination obligations imposed on local fibre companies, 18 October 2019, paragraph 15, at: https://comcom.govt.nz/data/assets/pdf_file/0024/182760/Commerce-Commission-seeking-views-on-Telco-application-of-equivalence-and-non-discrimination-obligations-18-October-2019.pdf.

| Consultation question | Response |
|--|--|
| | <p>$p_{\text{upstream}} \leq \text{LRIC}_{\text{upstream}}, p_{\text{downstream}} - c_{\text{compdownstream}})$,</p> <p>where $\text{LRIC}_{\text{upstream}}$ is the long-run incremental cost of the upstream product, $p_{\text{downstream}}$ is the downstream price, and $c_{\text{compdownstream}}$ is the downstream cost of an efficient competitor.</p> <ul style="list-style-type: none"> • Non-discrimination tests: To what extent do vertically-integrated operators' offer hedge products to access seekers (independent retailers) on the same basis as their own downstream operations? To what extent are vertically-integrated operators advantaged by access to cheaper access to wholesale electricity (and internally hedging) compared to independent retailers? <p>This type of testing is useful for determining the extent of implicit subsidies between vertically-integrated wholesale and retail.</p> |
| <p>Q12. Do you agree that to be a fair reflection of the cost of electricity, large integrated generator-retailers' ITPs should reflect the costs and risks of being part of a vertically integrated entity? Or should their ITPs include the additional costs and risks their retail arms would face if they were not part of an integrated business?</p> | <p>We are not sure of the relevance of this question. It appears to be outside of the clear scope of the consultation and pre-judging what might be an acceptable ITP methodology. If the Authority considers there is merit in providing guidance on what an appropriate ITP methodology might look like this is a much broader question than the treatment of "the costs and risks of being part of a vertically integrated entity" versus "the additional costs and risks their retail arm would face if they were not part of an integrated businesses".</p> <p>The role of the consultation is to establish a disclosure regime which will help identify the extent to which vertical-integration is impeding competition. It is not or should not be the role of the consultation to provide justification for current discriminatory behaviour that may inhibit or reduce competition.</p> |
| <p>Q13. Do you agree that differences in risk largely explain the variation in the appetite and pricing generators are willing to offer fixed price variable volume contracts to</p> | <p>The entire discussion on this topic (paragraphs 3.27-3.41) is outside the scope of the current consultation and is unhelpful. The Authority has been clear "The efficiency of wholesale pricing and hedge markets are outside the scope of this investigation". The role of the consultation is to determine appropriate ITP and profitability disclosure requirements, and not to determine whether current practices are legitimate.</p> |

| Consultation question | Response |
|--|--|
| internal parties, commercial and industrial clients, and independent retailers? ⁸⁵ | |
| Q14. Do you agree that where a generator-retailer changes their ITP methodology and it has an impact of more than 5% on the current years ITP, that they be required to disclose the impact the new policy would have on the preceding three financial years and the current years ITP and retail segment profitability disclosures? ⁸⁶ | <p>Yes, for the reasons provided in the consultation document.</p> <p>Where the ITP/wholesale cost input price is used for retail pricing purposes, the disclosure should apply PRIOR to it being adopted for retail price setting purposes.</p> |
| Q15. Do you support electricity retail segment of profitability reporting? | <p>Yes. We agree with the Authority that: “Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power.”⁸⁷ Disclosure of retail profitability by incumbent retailers with market power is needed to identify whether there are problems with persistently high prices/profits which are inconsistent with the outcomes that would be expected in a workably competitive market.</p> <p>We consider that the Authority should require retail and generation segments margin and profitability disclosure, and this should only apply to vertically-integrated suppliers with significant or substantial market power/suppliers with significant or substantial market power.</p> |
| Q16. Do you believe that for multiple product line retail businesses, the costs and revenues specific to electricity can be unbundled from other product lines, with sufficient rigour to advance confidence in the electricity industry? | <p>Yes. The EPR noted the Authority can draw on “the segmental reporting rules issued by Ofgem in the United Kingdom”.⁸⁸</p> <p>OFGEM introduced retail-wholesale disclosure requirements in 2009, and has addressed segmentation, for example, between gas and electricity, and between residential and non-residential customers.</p> |

⁸⁵ Wording of the question was clarified/amended after e-mail exchange with the Electricity Authority.

⁸⁶ Wording of the question was clarified/amended after e-mail exchange with the Electricity Authority.

⁸⁷ Electricity Authority, Industry and market monitoring: Competition Information paper, 31 August 2011 at: <https://www.ea.govt.nz/assets/dms-assets/11/11525Industry-market-monitoring-information-paper.pdf>.

⁸⁸ Electricity Price Review, FINAL REPORT, 21 May 2019.

| Consultation question | Response |
|---|---|
| | <p>OFGEM considers that the segmented financial disclosure requirements have “improved the transparency of large suppliers’ profits” .⁸⁹</p> <p>We also note that this is a more significant issue in telecommunications, where an access service can be used to provide multiple different retail services but has been addressed in various jurisdictions where imputation tests/economic replicability tests/equivalence tests/non-discrimination tests etc are applied.</p> |
| <p>Q17. Do you support requiring gross margin electricity retail segment reporting? a. If so: i. How precisely would this information be used to identify potential anti-competition concerns and improve decision making on retail competition settings? Please provide illustrations. ii. What assurances are there that reported differences arising due to legitimate commercial reasons won’t be misconstrued as evidence of anti-competitive practices? b. If not: i. Do you have a preferred alternative retail segment profitability metric which is feasible and low cost to implement, and would improve information on potential anti-competitive practices?</p> | <p>We strongly support disclosure of retail gross margins by vertically-integrated suppliers/retailers with market power.</p> <p>The following OFGEM commentary provides useful explanation:</p> <p style="text-align: center;">Ofgem motivations for reporting ITP and segment profitability</p> <ul style="list-style-type: none"> • Transparency of energy company profits matters. It is important for consumer confidence, and for new firms thinking to enter the energy market. Robust data also allows us to monitor and assess how well the market is working for consumers. • Regarding transparency of profits, we aim to provide meaningful and robust information in a way that can be clearly understood. We want to inform the debate on energy company profits and the link to the functioning of the market. There should not be disagreements over facts. <p>https://www.ofgem.gov.uk/ofgem-publications/86388/actionstoimprovethe Transparency of energy company profits.pdf</p> <ul style="list-style-type: none"> • Ofgem 2014 consultation paper proposing to increase number of companies required to reporting • Large energy companies’ profits continue to attract significant public interest. Rising domestic supply prices and profits over the last five years have resulted in concerns about the effectiveness of competition. This has been coupled with distrust over the profits that the large companies have reported for their generation and supply businesses. • Proposal: tighten scrutiny of companies’ transfer pricing policies: keeping transfer pricing policies under review as the market changes, for example by ensuring that supporting comparable data underpinning their transfer prices remains appropriate, and ensuring that transfer pricing policies and procedures are subject to internal audit. • The potential benefits we consider most relevant for this assessment include: <ul style="list-style-type: none"> ☐ enhancing transparency on the profitability of different energy companies ☐ facilitating potential new entrants assessing opportunities to enter the market ☐ helping increase assurance of the information that vertically-integrated companies publish by providing comparator data ☐ helping government gather a broader evidence base on the impact of its policies on company costs ☐ exerting downward pressure on the cost of capital by reducing information risk. <p>https://www.ofgem.gov.uk/ofgem-publications/86388/actionstoimprovethe Transparency of energy company profits.pdf</p> <p>The fact the gross margins revealed by this disclosure might be different across retailers is not a reason not to require the disclosure (ie para 3.55 provides those against doing the disclosure with reasons why it is not useful).</p> |

⁸⁹ https://www.ofgem.gov.uk/sites/default/files/docs/2013/04/factsheet-understanding-profits_0.pdf

| Consultation question | Response | | | | | | | | | | | | |
|------------------------------------|--|---|--|----------------------|-------------------------|--|--|-------------------------|--|--------------------------|------------------------------------|---|---|
| | <p>17ai - iii. By way of example, refer to the response to Q11.</p> <p>The Authority’s Competition Information Paper also sets out various measures that can be used to determine and monitor the state of competition which would be supported by segmented financial and profitability disclosures e.g.:</p> <table border="1" data-bbox="784 430 1904 694"> <thead> <tr> <th>Measure</th> <th>Why important for competitive pressure in industry</th> <th>Potential indicators</th> </tr> </thead> <tbody> <tr> <td>Price-cost relationship</td> <td>Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power.</td> <td>Price-cost margin index; Lerner Index.</td> </tr> <tr> <td>Revenue and input costs</td> <td>In a competitive market, if input costs rise then marginal costs and marginal revenue rise by the same amount.</td> <td>Panzar-Rosse H Statistic</td> </tr> <tr> <td>Profitability/return on investment</td> <td>No firm should be able to make supernormal profits on an ongoing basis unless it is linked to innovation and a pushing out of the production efficiency frontier.</td> <td>Cost to income ratios; Net revenue benchmark analysis; Return on investment; Return on equity</td> </tr> </tbody> </table> <p>17aii. To the extent the Authority has concerns information may be “misconstrued”, it is important to ensure the disclosure information is helpful for identifying potential barriers to competition and/or evidence of outcomes that are inconsistent with the outcomes in workably competitive markets e.g. we agree with the Authority that: “Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power.”⁹⁰</p> <p>The Commerce Commission has similarly noted if “longer term profits ... persistently greater than a normal level of return, generally indicate a competition problems as competition is not eroding them”.⁹¹</p> <p>The Authority can also usefully undertake its own reporting and analysis of how it considers the information should be interpreted but, all else being equal, the more information that is provided on incumbent margins/profitability the better informed the market will be.</p> | Measure | Why important for competitive pressure in industry | Potential indicators | Price-cost relationship | Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power. | Price-cost margin index; Lerner Index. | Revenue and input costs | In a competitive market, if input costs rise then marginal costs and marginal revenue rise by the same amount. | Panzar-Rosse H Statistic | Profitability/return on investment | No firm should be able to make supernormal profits on an ongoing basis unless it is linked to innovation and a pushing out of the production efficiency frontier. | Cost to income ratios; Net revenue benchmark analysis; Return on investment; Return on equity |
| Measure | Why important for competitive pressure in industry | Potential indicators | | | | | | | | | | | |
| Price-cost relationship | Prices should reflect costs. If they are persistently higher, this suggests suppliers have market power. | Price-cost margin index; Lerner Index. | | | | | | | | | | | |
| Revenue and input costs | In a competitive market, if input costs rise then marginal costs and marginal revenue rise by the same amount. | Panzar-Rosse H Statistic | | | | | | | | | | | |
| Profitability/return on investment | No firm should be able to make supernormal profits on an ongoing basis unless it is linked to innovation and a pushing out of the production efficiency frontier. | Cost to income ratios; Net revenue benchmark analysis; Return on investment; Return on equity | | | | | | | | | | | |

⁹⁰ Electricity Authority, Industry and market monitoring: Competition Information paper, 31 August 2011 at: <https://www.ea.govt.nz/assets/dms-assets/11/11525Industry-market-monitoring-information-paper.pdf>.

⁹¹ Wellington International Airport Ltd and Others v Commerce Commission [2013] NZHC 3289, paragraphs [20]-[23] at <https://forms.justice.govt.nz/search/Documents/pdf/jdo/53/alfresco/service/api/node/content/workspace/SpacesStore/1c117dea-b8ba-491e-ba1d-d4cd30dbe522/1c117dea-b8ba-491e-ba1d-d4cd30dbe522.pdf>.

| Consultation question | Response |
|--|--|
| <p>Q18. If retail segment gross margin reporting was introduced, do you agree: a. With the proposed definition and line items constituting gross margin? b. That gross margin and the constituent parts should be reported on nominal dollars and a per MWh basis? c. That firms with more than 1% market share of all ICPs should be subject to these provisions? d. That reporting should be centralised on the Authority's EMI website? e. That firms with less than 5% market share of ICPs would be reported on an anonymised basis on the EMI, and only report on a per MWh basis? f. That entities with more than one retail business can report on a consolidated basis?</p> | <p>a. We agree with the proposed definition and line items constituting gross margin. It is important to require disclosure of individual line items so that, for example, alternative wholesale input costs etc can be used to undertake different types of testing of the vertically-integrated suppliers pricing/profitability.</p> <p>b. Yes. We suggest requiring a count of ICPS by the reported segments as well. This information is often already published but consistent reporting of ICPs will enable a gross margin per ICP to be compared.</p> <p>c. No. We consider that the disclosure requirements should apply to suppliers who are: (i) vertically-integrated; and (ii) have market power. It is unclear from the consultation paper what market failure applying disclosure regulation on other retailers would help resolve. d. Yes. We support disclosure on EMI.</p> <p>e. No. See response to Q18c. Retailers with 1% or 5% market share in an individual retail market will not have market power and therefore the disclosure requirements should not apply to them. If the regulation is to apply to retailers regardless of whether they have market power, then we support the proposal in e. If the Authority includes all retailers with a market share of 1% or more, it should expand its EMI market concentration statistics to include the Lorenz curve and GINI coefficient.</p> |
| <p>Q19. Do you agree that gross margin segmented retail reporting at an aggregate country level is sufficient to support confidence in the wholesale market? If not:</p> <p>a. What categorisations would you propose? b. How would further granularity advance trust and confidence? c. What would the marginal cost of reporting at increased</p> | <p>We support breakdown of profitability reporting by residential/non-residential consistent with OFGEM precedent. The EPR consultation – and comparison of market concentration statistics – illustrates that there are potential differences in competitive market outcomes between residential and non-residential.⁹²</p> |

⁹² The Electricity Authority EMI website breaks-down market concentration by residential, small-medium enterprises, commercial and industrial.

| Consultation question | Response |
|---|---|
| granularity be compared to the proposal in the paper? | |
| <p>Q20. Do you support mandating gross margin reporting for the generation, and commercial and industrial segments? If so, a. What line items would you propose for each segment? b. How precisely would this information be used to identify potential anti-competition concerns? Please provide illustrations. c. What assurances are there that reported differences arising due to legitimate commercial reasons won't be misconstrued as evidence of anti-competitive practices?</p> | <p>Yes. We consider the Authority should follow OFGEM precedent on this matter. Consistent with the Authority's Competition Information Paper, the disclosures of generation profitability, and breakdown of residential/non-residential (including commercial and industrial) would help identify whether market outcomes are consistent with workably competitive markets.</p> <p>As noted above in response to Q17, the Authority can also usefully undertake its own reporting and analysis of how it considers the information should be interpreted but, all else being equal, the more information that is provided on incumbent margins/profitability the better informed the market will be.</p> <p>It is not unusual that information is misconstrued e.g. information on the number of electricity retailers and generators in the market is often used to promote the view that the electricity market is highly competitive, while not taking into account market concentration measures such as HHI and Concentration Ratios.</p> |
| Q21. Do you agree the benefits of the proposed amendment outweigh its costs? | Yes. |
| <p>Q22. Do you agree the proposed amendment is preferable to the other options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.</p> | <p>We consider the proposed amendment is superior to the status quo but is not preferable to all other options including the EPR recommendations.</p> <p>We consider that the new ITP and profitability disclosure requirements should be implemented as a two stage project and include:</p> <p>Phase 1</p> <ul style="list-style-type: none"> • Disclosure of the justification/reasons for the vertically-integrated suppliers' ITP/see response to Q5. • Where the ITP used for financial reporting differs from the wholesale cost used for retail pricing, the disclosure requirements should also apply to the methodology used to |

| Consultation question | Response |
|--|---|
| | <p>determine the wholesale cost for retail pricing purposes. Both the accounting and pricing ITPs should be used. For the gross retail margin disclosure.</p> <ul style="list-style-type: none"> • Retail gross margins broken down by residential/non-residential. • The disclosure requirements should include independent audit and director certification requirements to ensure the integrity of the information (following OFGEM/Commerce Commission precedent). For the avoidance of doubt, while the 20 April Market Brief suggested the Authority had added “bespoke audit provision”⁹³ the new “independent person” review provisions fall well short of an audit requirement. • The disclosure requirements (ITP and profitability) should only apply to suppliers who: (i) are vertically-integrated and (ii) have market power i.e. Contact, Genesis, Mercury, Meridian and Trustpower. <p>Phase II</p> <ul style="list-style-type: none"> • The profitability disclosure requirements should include full financial segmentation of wholesale and retail (not just gross margin disclosure). • The Authority should expand the profitability metrics to align with OFGEM precedent and the Authority’s Competition Information Paper. <p>See also response to Q5.</p> |
| Q23. Do you agree the Authority’s proposed amendment complies with section 32(1) of the Act? | See response to Q22. |
| Q24. Do you have any comments on the drafting of the proposed amendment? | See response to Q22. |

⁹³ <https://www.ea.govt.nz/assets/dms-assets/28/Market-Brief-20-April-2021.html>