18 May 2021

Tom Georg
Manager Wholesale Markets
Electricity Authority
By email to WholesaleConsultation@ea.govt.nz

Dear Tom

Consultation Paper—Internal transfer prices

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Authority (EA) consultation paper "Internal transfer prices (ITP) and segmented profitability reporting" published 8th April 2021 and updated 20th April.[1] MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.

2. The underlying problem is whether the large vertically integrated suppliers (LVIS) have been undertaking on a sustained basis conduct that is leading to outcomes detrimental to the long-term benefit of consumers. Proving there is a problem and having an estimate of the magnitude of the problem is complex but necessary to ensure the mix of policy options proposed to solve the problem are appropriate.

3. Finding the right tools to shine light on whether sustained economic profits by the LVIS in aggregate has occurred is not trivial. MEUG has been working on a pilot study to determine if an economic profit analysis framework is feasible for the electricity sector.[2] That approach is a well-proven regulatory tool. The underlying questions for MEUG in considering the proposed ITP regime and or segmented profitability reporting are:

    a) Whether the consultation paper provides any evidence of sustained economic profits by LVIS to justify the extent of the proposed additional information disclosure compliance on those businesses?

    b) Would implementation of the proposed ITP regime and or segmented profitability reporting provide better, or any, insights into whether LVIS in aggregate have earnt sustained economic profits compared to the pilot framework MEUG is considering?

    The short answer to both these questions is no.

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[1] Updated paper URL https://www.ea.govt.nz/assets/dms-assets/28/Internal-transfer-prices-and-segmented-profitability-reporting-Consultation-paper-updated-20-April.pdf at https://www.ea.govt.nz/development/work-programme/risk-management/internal-transfer-pricing-and-profitability/consultations/#c18839

[2] The best recent example of an application of economic profit analysis has been the submissions by Garth Ireland of Ireland, Wallace & Associates to the Commerce Commission on the Market study into retail fuel in 2019, refer https://comcom.govt.nz/about-us/our-role/competition-studies/fuel-market-study

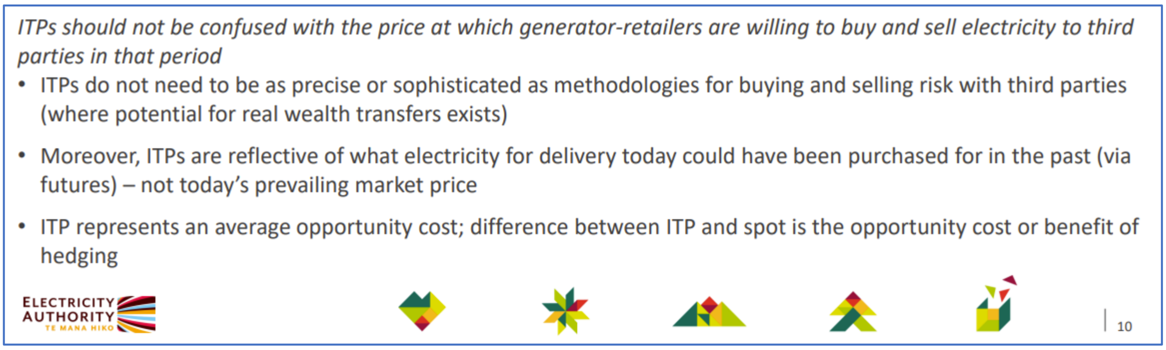
4. There is no evidence in the paper that clearly identifies a problem and the scale of the problem to justify the level of intrusion and additional costs the LVIS will incur (and will pass on to consumers) in the proposed ITP regime. Accordingly, MEUG does not support the proposed full extent of the ITP regime. Support for MEUG's position is found in the consultation paper itself as follows with underlined text highlighted by MEUG[3]:

> "Independent retailers have expressed concern that in recent years the ITPs of large generator-retailers are too low and stable, given the volatility and level of spot prices and Australian Securities Exchange (ASX) New Zealand (NZ) electricity futures. <u>The Electricity Authority's own analysis does not support these claims</u>, and indicates large generator-retailers' <u>internal transfer prices are plausible</u> given historical time-series of ASX futures prices and other factors."

5. And later[4]:

> "Despite their apparent importance to supporting trust and confidence amongst some stakeholders, <u>ITPs are not a particularly strong mechanism for mitigating potential anti-competitive practices by generator-retailers</u>. An ITP simply allocates costs between the generation and retail arms, which ultimately is a zero-sum game when management is incentivised to create wealth for shareholders across the whole entity."

6. Slide 10 of the EA briefing on the consultation paper notes[5]:



7. The EA's own observations in the preceding three paragraphs are, in MEUG's view, sufficient to annul the justification for the full extent of the proposed ITP regime.

8. Nevertheless, while no evidence of the scale of a problem is tabled by the EA, there is continuing uncertainty on whether there are sustained market power issues and that continues to undermine confidence in the market. MEUG's pilot study discussed in paragraph 3 above will, if scaled up, provide that missing evidence. In the meantime, MEUG's preference is to proceed cautiously.

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3 Consultation paper, Executive summary, pi.

4 Ibid, pii.

5 Slides URL https://www.ea.govt.nz/assets/dms-assets/28/Consultation-presentation-Internal-Transfer-Pricing-and-Gross-Margin-Reporting.pdf.

9. Therefore, MEUG does agree that where possible incremental changes to facilitate better existing voluntary ITP disclosures should be considered because, while ITP have limited value, they may with some incremental changes to current practice, add more value and be another lens for the EA and consumer-side analysts to monitor the conduct of LVIS. MEUG therefore suggests the EA, LVIS and interested parties discuss if it is possible to voluntarily move to more standardisation of how ITP disclosures might be achieved. This non-interventionist approach should be used first. The EA retains the options of either mandating standardisation or undertaking further s.46 information requests to conduct another investigation should legitimate concerns about future ITP disclosures arise. MEUG is not in favour of the detailed explanatory disclosures in the proposed Code amendment for ITP that will add costs to LVIS that will add little value, and that consumers will end up paying for. What matters is if any anomalies occur in the headline outputs.

10. This then leads to the option of segmented profitability reporting. The consultation paper notes[6]:

> "Currently the five largest generator-retailers disclose the performance of their retail businesses. Segment reporting is required through IFRS 8 for publicly listed companies – which all five of these businesses are. However, this reporting is for the entire retail segment which can include other products and services beyond electricity."

11. In this case MEUG supports the EA requiring greater visibility by LVIS of the performance of their electricity retail business and electricity wholesale business. The simplest way that can be achieved is to leverage off the IFRS 8 requirements and disclosure process as listed companies and simply require the electricity retail and electricity wholesale businesses to be reported as discrete segments. MEUG does not support the extensive additional disclosure requirements at this stage. In the future further disclosure requirements could be considered If either:

    a) Concerns arise once better high-level gross segment profitability statistics are available; and or

    b) MEUG's pilot economic profit analysis is extended to sufficient LVIS to give a credible assessment of economic profits for the sector in aggregate over time, and that shows more granular or standardised information is required to improve the quality of continuously monitoring trends in economic profits based on annual (or even half yearly) public financial information,

Yours sincerely

Ralph Matthes
Executive Director

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[6] Ibid, paragraph 3.45.