Electricity Authority
By email: wholesaleconsultation@ea.govt.nz

18 May 2021

Internal transfer prices and segmented profitability reporting

Mercury welcomes the opportunity to provide a submission to the Electricity Authority (EA) on the consultation paper "Internal transfer prices (ITP) and segmented profitability reporting (SPR)".

Mercury supports transparency of market information and intends to work constructively with the EA to share information regarding the process for establishing internal transfer prices. However, and as previously raised with the EA, transfer prices are not material to the operation of our business other than for the purposes of facilitating management reporting and in some situations establishing annual targets. Mercury's main concern is that no clear problem definition has been identified and there are risks in the proposal which could result in misleading conclusions being drawn that undermine the integrity and confidence in the market by creating confusion as to what published transfer prices represent.

1 Clarity on problem definition needed

The consultation paper suggests that while vertical integration can be a beneficial structure in terms of mitigating risk there are potential competition concerns with generator-retailers ('gentailers') controlling the bulk of electricity generation. In the absence of transparency, there is a chance that gentailers "may be stifling competition by advantaging their own retail arms via preferential pricing of electricity and/or cross subsidation."

Segmental reporting and disclosures on internal transfer prices therefore justify intervention, according to the paper, on the basis of a lack of confidence around predatory pricing practices and pricing strategies between the generation and retail arms of a gentailer.

In Mercury's view, the statements made in the paper on the problem definition require further consideration and evidence. The reasonableness of gentailer transfer prices as compared with EA calculated benchmarks further suggests the lack of any identifiable problem. The need to properly identify a problem is a fundamental step in carrying out a policy process and in our view this has not been done clearly nor has one been demonstrated with any evidence. This is important because the appropriate solutions to a problem can only be assessed once the problem has been identified.

Mercury is a keen proponent of better market information which improves decision making for all parties. We do not find publishing ITPs will influence better decision making but we assume the EA is concerned about information asymmetry. We have considered the remainder of the paper on this basis. We do request the EA clarifies the problem it is attempting to solve, noting that information asymmetry is a valid justification for recommending a policy intervention. Comments around predatory pricing are not only confusing but they are without merit and would otherwise suggest the need for policy interventions other than information disclosure.

2 Mercury’s internal transfer price process

2.1 Why does Mercury set an internal transfer price?

Mercury sets an internal transfer price for the purposes of benchmarking our internal business units against annual business plans. Having a fixed transfer price simplifies regular management accounting, simplifies budgeting and forecasting to our executive and board teams, which in some circumstances can also set performance targets and measurements against which remuneration can be set. We also set a transfer price in order to transfer spot market risk to our Portfolio team which is best placed to manage this risk, often using complex market risk products. There are no predatory or market anti-competitive reasons for structuring our business in this manner, it is rather a method of reducing resource duplication across the business and enables each respective business to concentrate on its core function. Mercury itself is still exposed to mass market volatility, but it is our Portfolio team which manages this risk on behalf of the retail businesses. Mercury’s net exposure, including our generation position, can be strategically or inadvertently long, neutral or short depending on a variety of prevailing market conditions.

Mercury historically has not updated its transfer price more than once per annum. The prevailing transfer price is used throughout an entire financial year and used to report against internally on a regular basis and, from our 2020 financial year, in our external financial reporting. As the process below will demonstrate, the transfer price is set in accordance with market prices at the time the price is calculated. This can mean that as wholesale market conditions change, the effect of a transfer price being fixed for a calendar year may benefit or disbenefit our retail business in reporting carried out at that time but this will be offset with a proportional benefit or disbenefit in the generation business.

2.2 General overview of process

Below is a condensed version of the process we outlined to the Electricity Authority in our response to its request for information and data in August 2020. This process was also broadly discussed in Mighty River Power’s Initial Public Offer prospectus in 2011 and the strategy has not materially changed since then.

- Mercury is a vertically integrated generator retailer with a historically strong retail presence in Auckland backed by hydro generation along the Waikato river and significant investment in geothermal generation in the Taupo-Bay of Plenty region over the past decade. Mercury is currently constructing New Zealand's largest wind farm at Turitea near Palmerston North;
- Mercury aims to run its geothermal units as baseload energy, typically 24 hours a day 7 days a week;
- Mercury’s hydro/wholesale strategy is based around flexibly serving its net sales position across multiple timeframes, taking the above geothermal output as its starting point. Mercury assesses its net position based on committed sales/average inflows and the outlook for wholesale prices and accordingly attempts to maximise revenue. Transfer prices do not play any role in this dynamic decision-making process.
- Mercury sets a transfer price once per annum at or near the start of each financial year. Within the retail segment of our business the transfer price is only relevant to Mercury’s residential/small commercial customer sales portfolio.
- The transfer price is set based on a 3-year outlook of baseload futures at Otahuhu plus a percentage margin to reflect profiling less a percentage margin to reflect generally expected lower locational prices in other areas of New Zealand where Mercury has a retail presence (compared with Otahuhu). Management may periodically manually adjust this if it is deemed the price outlook is unreliable or volatile, but this is done rarely. A small adjustment was made by management for FY2021 to reflect volatility during the budget process caused by disruptions from Covid-19 lockdowns in New Zealand.
- While the annual transfer price calculated typically references public ASX futures prices, Mercury may use its own internal view on futures instead. In the case of the latter mechanistic inputs are used, most of which are publicly available, but is updated for confidential information Mercury holds (for example generation investment decisions). This model is commercially sensitive. Mercury may change its methodology from time to time and may use various input methods to provide a range of values.
- Historically, once a transfer price has been set it is not subsequently updated until the following financial year’s transfer price is set.
- Third party pricing requests are quoted on a case-by-case basis per the bespoke conditions sought by the counterparty. As Mercury sets its transfer price once per annum on a three year forward basis, third party

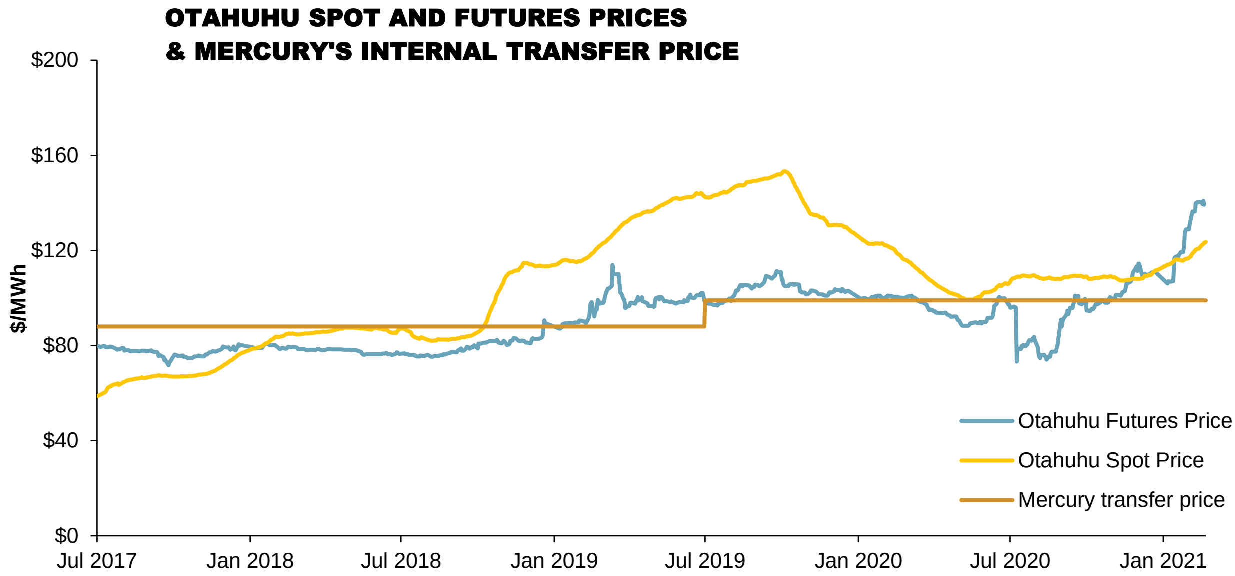
pricing may not be comparable given timing, term, profile and location elements may each or all differ significantly.

The above process has resulted in the following transfer prices being used by Mercury's retail business:

Financial Year	Mass market transfer price
01.07.17 to 31.06.18	$88 / MWh
01.07.18 to 31.06.19	$88 / MWh
01.07.19 to 31.06.20	$99 / MWh
01.07.20 to 31.06.21	$99 / MWh

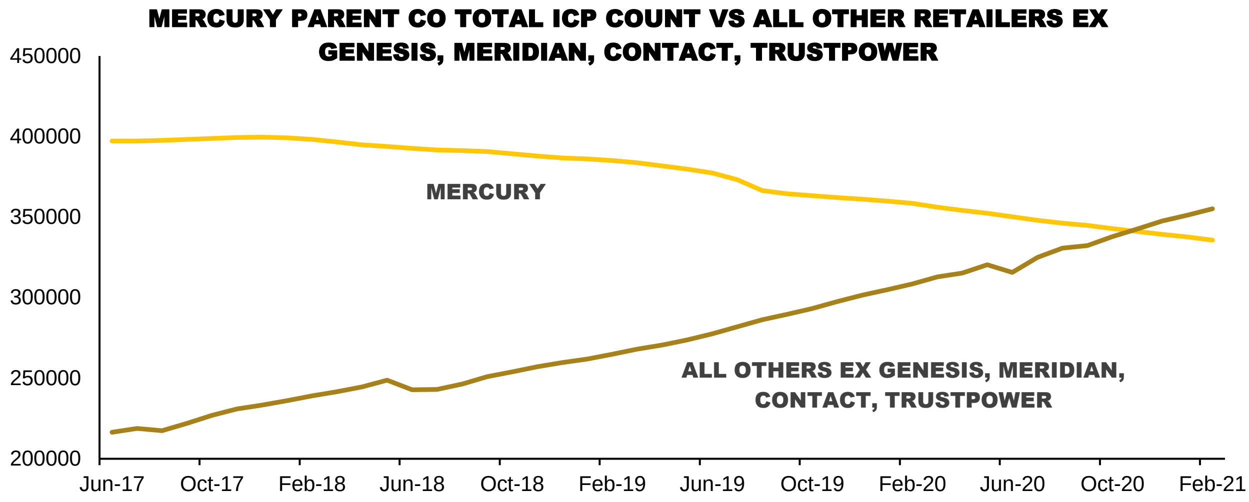
2.3 Mercury's internal transfer price and market conditions

The following chart shows the transfer prices used by Mercury compared with spot and futures prices at Otahuhu over the corresponding period.



For several years Mercury has published transparently to the market our thesis that wholesale market prices were likely to increase.[1] Our internal transfer price has moved upwards over the same period to reflect this view. According to the chart above as well as the compilation of gentailer transfer prices shown in the paper Mercury's transfer price has been above or in line with benchmarking carried out by the EA. The inference from the chart above is that Mercury's mass market ITP is not distorting or creating any competition issues. Over this same period Mercury had also been transparent about how competitive the mass market retail segment was and that our expectation was for margin pressure to see a reduction in customer numbers. The following chart clearly demonstrates this, as well as the significant gains made by other retailers outside the five largest.

[1] For example see our Investor Presentation November 2019 at the following link



In Mercury's half year financial results for the six months ending 31 December 2020 we again noted that mass market competition was intense, margins were under considerable pressure, and we would continue to focus on value. In our overall earnings for the period our retail business contributed 5.4% of segmental EBITDAF despite contributing ~40% of our revenue.

Given the EA has assessed our ITP as reasonable and coupled with our views and financial results expressed above, Mercury is of the view there can be no way our ITP can be stifling competition by advantaging our own retail unit via preferential pricing of electricity and/or cross subsidisation.

3 Comments on the proposal

3.1 Internal transfer price requirement

The EA proposes to mandate annual disclosure of ITPs expressed as $/MWh and the methodologies used to calculate them. The methodology should be backed with explanations on the assumptions used including detailed information on the type of hedge book and load profile. The information will be posted to the EMI website.

Mercury is able to provide some of information requested. However, the information sought in the consultation paper in sections 3.11(b) and 3.11(c) cannot be provided by Mercury because it is not used in deriving a transfer price. We do not propose or expect that we would be required to update our transfer price process in order to comply with the information outlined in the paper. Mercury's ITP process, as outlined in section 2, is relatively high level. This reflects the lack of materiality the ITP has for our wider business planning process.

The paper questions whether ITPs should be used to reference whether independent retailers can secure electricity at prices and on terms without discrimination or whether a gentailer's ITP should reflect being part of a vertically integrated entity. Mercury's view is that an ITP is an internal accounting benchmark and the uses proposed in sections 3.20-3.23 are evidence of ITPs being used for purposes other than how we currently apply them. We would not support disclosure of ITPs if they were to be used as a reference point for this type of framework.

The FPVV discussion ignores two important aspects relevant to transfer prices. The first is that an internal FPVV arrangement at a fixed transfer price is likely to match the contracts put in place with mass market customers – and is therefore a risk matching arrangement. The second is that Mercury would have some oversight or forecasting confidence over the amount of volume to be allocated to mass market customers. Neither of these would be possible for supplying a FPVV arrangement with a third party and the risk/price profile therefore will differ.

3.2 Segmented reporting requirement

The proposal on segmental reporting will require certain participants to disclose their gross margin figures for mass market retail customers, where gross margin was equal to:

Revenue – cost of electricity – transmission and distribution costs – metering costs and levies

Mercury is willing to comply with the requirements but the usefulness of this will be minimal owing to the way different companies compile their financial information. Comparability may be impossible as companies will base their transfer prices at different locations. There will also be issues on whether the relevant level of information should be at a node or ICP level and the reference may be used interchangeably by various parties rendering the information meaningless. This reporting also seems susceptible to misuse and we recommend the EA carefully prepares some disclosure notes for the reporting.

4 Potential issues with the proposal

4.1 Confusion regarding the meaning of published transfer prices

We strongly agree with the following quote from the paper:

> *"Vertically integrated entities seek to maximise shareholder value at the group level – not the individual business unit level. In this context an 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. 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."*

Electricity Authority, ITP consultation paper, page 8

A concept to frame the relevance of transfer prices is to assume a scenario where six months into Mercury's financial year futures prices had fallen well below levels of our relevant transfer price for that year. Any retailer requesting a contract from Mercury at that point in time, and provided their requirements were reasonably straight forward in terms of its locational aspect, volume, baseload and peak, could reasonably expect to be offered below Mercury's transfer price. Mercury would never make quotes for third parties with reference only to an internal transfer price. The process for quoting third party prices would be broadly like that outlined in section two, with futures prices being the key determinant of the quote.

4.2 Proposal should apply to all retailers

In the interests of overall greater market transparency, we would welcome gross margin reporting for all retailers, regardless of their size. Either there is an information benefit to the market having this information – and therefore all parties should be required to meet it – or there is no benefit and the information should not be required at all.

5 Suggested amendments

5.1 Sunset provision

In the event published transfer prices were being used perversely and for reasons which resulted in disruption of confidence and/or trust in the market we would expect the EA to condone any such comments. We would also expect prompt steps to remove the requirement to publish transfer prices as, in our view, any minor information transparency benefit would be outweighed by the disruption caused by their potential misuse.

We recommend baking in a sunset date to the proposed Code such that the Code will expire on a certain future date unless a process is undertaken to extend it with industry consultation.

5.2 Importance of clear disclaimers on public data

Mercury is of the view that any public information website must contain clear disclaimers on what ITPs and segmental results represent. In our view there is scope for misuse of the type of information being proposed here and the EA is likely to have to defend this information.

If you have any further queries on this submission please contact John Bright at john.bright@mercury.co.nz

Yours Sincerely,

John Bright
Regulatory Strategist

Mercury

Appendix A. Mercury responses to consultation questions

#	Question	Answer
1	Do you agree the issues identified by the Authority are worthy of attention?	Refer to our cover letter. We do not accept this is a material issue but we are willing to comply with the requirements provided they are not expanded in future or used for purposes that may diminish confidence and trust in the market.
2	Do you agree with the objectives of the proposed amendment? If not, why not?	Refer to our cover letter and the response to Q1.
3	Do you agree that disclosure of ITP by large generator/retailers is important for trust and confidence in electricity markets?	We are willing to provide this information in the anticipation trust and confidence will be enhanced however we are concerned it may have the opposite effect. We therefore recommend the disclosure regime is time bound by way of a sunset clause. This will encourage an active review of the proposal's usefulness.
4	Do you agree with the benefits of mandating ITP disclosure over voluntary disclosure?	In principle, Mercury would support mandatory information disclosure. This is the position we have taken on other workstreams such as information disclosure for thermal fuels.
5	Do you agree that the generator-retailers subject to these provisions should have an obligation to ITP transfer prices are a fair reflection of the cost of electricity?	Mercury strongly disagrees with this question. Transfer prices have little relevance for our mass market retail pricing which is set with reference to assessment of competition in the market. All retailers are free within this market framework to set prices at whatever level they assess as relevant
6	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?	Refer to our cover letter for an overview of how we calculate a transfer price. We will not amend our transfer price process for the purposes of complying with these requirements.
7	Do you have any comments on the specifics of the information requirements with respect to the price, methodology, component parts, and terms and conditions?	Only as noted in our cover letter and responses to the previous questions.
8	Do you agree with the proposed criteria for determining which generator-retailers should be subject to the ITP requirements?	This seems like a reasonable determination.
9	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?	Yes, although we would recommend that a choice could be made by such a generator-retailer in the event their financial reporting systems were not integrated (for example).
10	Do you agree that it would be valuable if the ITP disclosures were reported on the Authority's EMI website?	It makes sense to have as much industry information stored in a single place as possible, we support the use of EMI for this.
11	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?	Mercury would find no benefit of published benchmark prices.

12	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?	Refer to comments made in our cover letter.
13	Do you agree the respective cost and risk profiles largely explain any variation in appetite, pricing, and terms and conditions offered by generators to internal parties, commercial and industrial clients, independent retailers?	No comment.
14	Do you agree that where a generator-retailer changes change 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?	No comment.
15	Do you support electricity retail segment profitability reporting?	Mercury does not support this reporting as we suspect comparability will be difficult or meaningless. If this reporting goes ahead it is important it is completed by all retailers regardless of size to ensure a level playing field and a sunset clause is included to ensure a check is in place for usefulness.
16	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?	This should be possible at a gross margin level but there will be comparability issues as mentioned in our cover letter.
17	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?	Refer to previous responses, we do not support this type of reporting but are willing to comply if all retailers must also meet the requirements and the usefulness of the information is reviewed at a set date in the future.
18	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?	Refer to previous comments.
19	Do you agree that gross margin segmented retail reporting at an aggregate country level is sufficient to support confidence in the wholesale market? If	Refer to our previous comments.

	not: 41 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 granularity be compared to the proposal in the paper?	
20	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?	No, Mercury does not support any gross margin reporting for these segments particularly as there has been no analysis or problem definition.
21	Do you agree the benefits of the proposed amendment outweigh its costs?	It is possible the proposal will be net beneficial, particularly if all retailers have to complete the reporting. We recommend including a sunset provision in case the proposal is shown to be a net cost to the industry at a later date.
22	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.	Refer to our cover letter. Other possible options are difficult to frame given the way the problem definition has been scoped. In general, we would support a low-cost intervention initially with it removed by default unless it could be demonstrated to have ongoing benefits.
23	Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?	No comments.
24	Do you have any comments on the drafting of the proposed amendment?	No comments.