Entrust
Majority shareholder of Vector

22 December 2021

Stronger competition needed to make electricity more affordable

Entrust welcomes the Electricity Authority's wholesale market review. Entrust has advocated competition issues be prioritised for several years.

The Authority's initial findings confirm Entrust's long-held concern that market outcomes are inconsistent with a healthy competitive environment and the Tiwai contracts are harming consumers.

While Tiwai is benefiting from paying just 3.5c for every kWh they consume, the wholesale price everyone else pays has gone up by 6c. According to Electric Kiwi, that's an extra $500 each year the average Kiwi family is having to pay.[1]

A well-functioning and competitive market is needed to make electricity more affordable for Kiwis, and to put New Zealand businesses on a stronger footing. This will require step changes in regulatory and industry settings.

Summary of Entrust's views

- The Authority has demonstrated ongoing, systemic problems in the wholesale market, with the three largest generators having more than 70% market share.

- The Authority has found clear evidence the large generators, particularly Meridian, have been increasingly abusing their market power.

- The Authority has confirmed Entrust was right and that "Sweetheart deals with Tiwai are being used to artificially prop up wholesale prices".[2]

- Entrust is concerned about the impact of the wholesale market on prices for Kiwi households and businesses; particularly given the impact of COVID19 on household incomes and stressed budgets. It appears Aucklanders didn't benefit from Vector's $25 million price reduction last year because they were absorbed by wholesale increases.[3]

- The Authority should consider the climate and environmental implications of its findings. Energy affordability for consumers is key to progressing the transition to electrification and lowering carbon emissions.

[1] https://www.nzherald.co.nz/business/luke-blincoe-how-to-fix-the-electricity-market/4S4DHLTNMQ57MDXAX5YCPRQBFU/

[2] Entrust, Electricity Price Review submission, including consumer concerns about retailers' power pricing, 24 October 2018: https://www.entrustnz.co.nz/media/70017/submission-to-epr-23-oct-2018.pdf.

[3] Residential prices have been increasing over the last two decades while line charges have been held in check. Refer, for example, to Entrust, Electricity Price Review submission, including consumer concerns about retailers' power pricing, Appendix 1.

- The Authority's review confirms our concern[4] the Climate Change Commission has erred in assuming electricity prices are going to fall from 2021 and remain low for the next 15 years.

- Structural reform will be required to deliver a fully competitive and thriving market.

We agree "The market is dominated by a few large firms" and there is evidence of increasing exercise of market power

We agree with the Authority's principal findings that there are problems with competition and market power, and these problems can be expected to get worse e.g.:

- "The market is dominated by a few large firms, with Meridian needed to meet demand over 90 percent of the time".

- "We observed some evidence to suggest that prices may not have been determined in a competitive environment."

- "we observed some evidence to suggest that generators have an increased incentive and ability to exercise market power, and may have been doing so …"

- "There is some evidence of an increased incentive and ability for electricity generators to structure their offers into the market in a way that keeps prices high (economic withholding)."

- "Both Meridian and Contact were able to profit from selling to NZAS because they benefit from increased revenue from the rest of New Zealand … only a generator about the size of Meridian could sell to a customer on those terms … these issues arise from the scale of generation (particularly in the South Island) …"

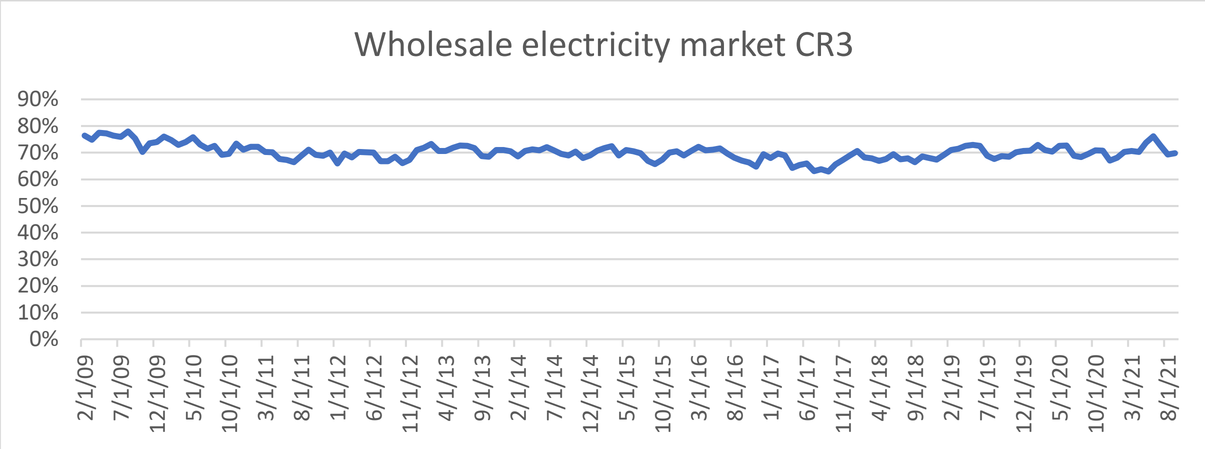
The Authority's findings are supported by the evidence Entrust provided to the Electricity Price Review

The Authority has observed "The HHI for generation in New Zealand has been hovering around 2,000 since 2014" and meets various definitions of a concentrated market used by international regulators.

Consistent with this, the UK Competition and Markets Authority defines a market with an HHI above 2,000 as highly concentrated and between 1,000 and 2,000 as concentrated.

[4] Entrust, Submission to Climate Change Commission on climate action in New Zealand, 25 March 2021, https://www.entrustnz.co.nz/media/89547/Entrust-Submission-to-Climate-Change-Commission-25-March-2021.pdf

The Authority did not mention market concentration ratios (CR). The wholesale market meets the Commerce Commission's definition of a "concentrated market" as a market where the three largest firms have a total market share of 70% or more (CR3).[5]



Sweetheart deals with Tiwai are being used to artificially prop up wholesale prices

Our submission to the EPR in 2018 considered in detail evidence of the impact of the Tiwai contracts that were in place at the time.

Our findings mirror and support the Authority.

We concluded, "The incumbent suppliers' arrangements with Tiwai Smelter artificially keep prices up for all other consumers in New Zealand. The size of Tiwai Smelter's electricity consumption means this has a substantial impact on electricity affordability".

The modelling we commissioned from Scientia Consulting estimated the annual net impact to consumers of the Tiwai contracts was $51 (in Auckland) and $182 (in Invercargill) for residential consumers.[6] The Authority's modelling isn't as granular as that undertaken by Scientia but indicates the price reduction would average about $200 annually.

The $860m per annum of over-pricing across New Zealand due to the Tiwai contracts belongs in the hands of Kiwi households and businesses.

It would appear reasonable to conclude the main difference in the Scientia and Authority modelling results reflects that the Tiwai contract price dropped from 5.5c/kWh to 3.5c/kWh and that the Scientia calculations accounted for transmission charges.

Contact and Meridian have been upfront that the reason for agreeing to the contractual arrangements was to protect (keep raised) wholesale prices.

For example, Contact's chief executive, Dennis Barnes, confirmed the price his company was paid by Tiwai Smelter is lower than it could have gotten elsewhere[7] and Contact advised "supply to Tiwai impacted Generation EBITDAF" by $9 million in the 2017

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[5] Source: www.emi.govt.nz

[6] The estimated impact per residential consumer due to calculated wholesale price impact only is -$73 in Auckland and -$207 in Invercargill.

[7] https://www.radionz.co.nz/news/national/350329/contact-energy-to-sell-its-electricity-to-tiwai-point

financial year.[8] The rationale Contact provided for the arrangements "is the market-wide effect of the smelter staying".[9]

Meridian acknowledged if Tiwai closed or significantly reduced its electricity consumption, "the impact on Meridian may be severe" and "This is because such a closure or reduction is likely to result, in the near term, in a reduction in Meridian's revenue, largely caused by a reduction in electricity prices (both wholesale and retail)".[10]

It appears this is confirmed by Board Papers the Authority has obtained from Meridian:

> "Meridian also anticipated that "competition for existing load would increase" and estimated the effect on households if the smelter were to exit. It also identified a risk that it would cause lower retail prices if it tried to sell into the retail market too aggressively."

Residential prices continue to rise

While the Authority has estimated the impact of the Tiwai deal on spot prices and residential prices, a gap in the analysis is the consequence of market concentration and increasing evidence that use of market power has impacted prices more generally.

Last year, Kiwi households and businesses should have got some price relief from line charge reductions totalling over $210 million. Auckland households and businesses, struggling with COVID19, could ill afford to miss out on Vector's $25 million reduction.[11]

It would seem apparent the line charge decreases have been absorbed through high wholesale electricity prices.[12]

A review of how much of the lines company price reductions were passed-through to consumers is on the Authority's work programme but remains unanswered. We think it's very relevant.[13]

Increasing retail price change transparency	Review how the network price changes that took effect on 1 April 2020 passed through into the retail electricity market.	**Publish** NZIER Cost Index Published on EMI in early 2021 **Publish** The Retailer Survey externally in April 2021		The work to rebuild the NZIER cost index in a way that we can easily maintain it is on track to be completed by early 2021. The survey is also on track to be completed by April 2021.

Increasing retail price change transparency	Review how the network price changes that took effect on 1 April 2020 passed through into the retail electricity market.	**Publish** NZIER Cost Index Published on EMI in early 2021 **Publish** The Retailer Survey externally in April 2021		**Target partially achieved, project continuing in 2021/22** The Cost Index has been drafted and we are working through the publishing process, with the process due to be completed by the end of August 2021.

The way forward

Stronger competition is needed to make electricity more affordable. The Authority's market review shows major reforms are needed to achieve full and thriving competition.

We support the Authority's intention to explore proposals to prohibit 'Tiwai-type' contracts. We caution, however, that prohibiting Tiwai-type deals would address the

[8] Contact, 2018 Interim Results Presentation, Six months ended 31 December 2017, 12 February 2018, page 23.
[9] https://www.radionz.co.nz/news/national/350329/contact-energy-to-sell-its-electricity-to-tiwai-point
[10] Meridian, Annual Report for the year ended 30 June 2015, page 32. Meridian made essentially the same comments in its 2016 Annual Report.
[11] Distribution component only. Excludes transmission.
[12] https://www.ena.org.nz/news-and-events/news/lines-charge-reductions-dont-make-their-way-into-consumers-pockets/
[13] https://www.ea.govt.nz/assets/dms-assets/27/Copy-of-Four-month-work-programme-report-Jul-2020-Oct-20201284882.1.pdf

https://www.ea.govt.nz/assets/dms-assets/28/Electricity-Authority-Work-Programme-Report-for-the-12-month-period-to-30-June-2021.pdf symptom and not the underlying problem. We agree with the Authority's assessment the Tiwai contract is a result of the size and market power of Meridian, in particular:

> "Both Meridian and Contact were able to profit from selling to NZAS because they benefit from increased revenue from the rest of New Zealand … However, only a generator about the size of Meridian could sell to a customer on those terms … these issues arise from the scale of generation (particularly in the South Island) …"

The problems the Authority has identified are fundamentally structural and require a structural solution.

The option the Authority listed of "limiting the size of generators" aligns with our EPR recommendation of a "Cap on any generator owning more than, say, 15% of New Zealand generation capacity".

The option the Authority listed of "splitting Manapōuri off from Meridian's other assets" would not go far enough to fully address the problems the Authority has identified or achieve full competition. It would still leave Meridian too large, and the other dominant generators unaffected.

It could be useful for the Authority to model different structural options to test the competitive outcomes that could be expected. Our understanding is this was done when the decision to break-up ECNZ and establish Genesis, Mercury and Meridian was made.

Concluding remarks

Entrust wants to ensure electricity is supplied in an efficient and affordable way to all consumers and its beneficiaries, including the 344,500 households and businesses in Auckland, Manukau, and parts of Papakura and eastern Franklin.

The wholesale market review is likely to be the most important part of the Authority's work programme since it was established in 2010.

The adverse effect of the Tiwai contracts alone ($860m per annum for New Zealand businesses and households) dwarfs any of the other issues the Authority has addressed or is presently dealing with.

It is clear from the Authority's findings there are major structural problems in the electricity market and, if nothing is done about it, the problems will only get worse.[14]

It is also clear the large, incumbent, generators are becoming increasingly brazen in the way they exploit and mis-use market power and their ability to manipulate and raise prices.

The review provides a timely opportunity to deal with unresolved competition and consumer exploitation issues. It also comes at a time when electricity is set to be an increased energy contributor into the NZ market. The impact of non-competitive structures and behaviours will be multiplied in the new environment.

Consumers will benefit from stronger and more rigorous competition in the wholesale and retail markets, and the electricity sector more generally.

[14] The review findings are in stark contrast to the Authority's previous dismissal of concerns about competition problems and its claim wholesale market "concentration [is] decreasing over the long-term": Electricity Authority, 2019/20 Annual Report.

Kind Regards,

Alastair Bell
Chair of Regulation and Policy sub-committee