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2degrees supports better dry-year risk management

2degrees welcomes the Ministry of Business, Innovation and Employment (MBIE) consultation on a proposed two-tier obligation to manage dry-year risk. We support the Government's focus on tackling energy reliability and supply issues, and the objective "To enable a market-led electricity system which turns abundant renewable energy into reliable and affordable electricity that is reliable in dry years."

We agree the shortcomings of the electricity market highlighted by winter 2024 are "something New Zealanders should not have to accept in a country with our natural resources." 2024 was not just a one off problem. New Zealand has suffered from regular supply issues since the Pohokura Outage nearly a decade ago.

The consultation sets out a clear justification for action to ensure sufficient back up generation" and to support "renewable investment, stronger competition, and downward pressure on electricity prices for industry, businesses and households", including targeting the large, incumbent gentailers.

The market power Contact, Genesis, Mercury and Meridian enjoy means their decisions can affect both the scale of dry-year risk and how well it is managed. Smaller participants, including independent retailers, independent generators, financial intermediaries and consumers such as data centres, cannot exert the same influence.

2degrees considers that the major gentailers' dominance creates a material dependency for the electricity sector and market outcomes on the investment, contracting and operational decisions of four integrated firms. That structure is not conducive to a dynamic, competitive market in which a diverse range of suppliers compete to deliver efficient investment, innovation and lower prices. The more concentrated the market, the more important it is that regulation directly addresses market power, wholesale access and hedge market liquidity.

2degrees considers the proposed two-tier obligation is likely to help improve dry-year preparedness and may reduce the risk of acute shortages and price spikes. However, it is unlikely to fully meet the Government's broader objectives of reliable, affordable electricity, stronger competition and downward pressure on prices unless it is implemented as part of a wider reform package that addresses incumbent market power, restricted and discriminatory access to wholesale supply and hedge products, and barriers to independent investment in firming capacity.

Summary of 2degrees' views

- **2degrees supports Government intervention** to address structural problems in the electricity market. We agree the market has not delivered enough firm, reliable generation cover. However, we consider that the proposed dry-year reforms would be most effective if they are part of a wider reform package addressing incumbent market power, hedge access and competition. Without that broader package, New Zealand is unlikely to achieve reliable and affordable electricity supply.

- **2degrees considers regulation should apply to the parties best placed to manage dry-year risk.** In practical terms, this means the obligations should apply to Contact, Genesis, Mercury, Meridian and NZAS where relevant, rather than relying on arbitrary size thresholds that could act as a ceiling on independent market participant growth. As a guiding principle, regulatory invention is best targeted at the parties able to materially address the problem. In this case, that means the parties that control or materially influence generation investment, hydro storage, thermal fuel arrangements, plant availability, dispatch decisions, and access to firming and hedge products. Independent retailers, smaller generators, financial intermediaries and enterprise purchasers of electricity are largely exposed to the consequences of dry-year risk, rather than able to address its underlying causes.

- **The obligated parties could comply with the proposed obligation without increasing market-wide access to firming.** 2degrees is concerned that because of the nature of the obligations, Contact, Genesis, Mercury and Meridian, who control most of the firming capacity, may respond to the obligation by reserving existing capacity and hedge cover for their own portfolios. If that occurs, independent retailers, independent generators and large consumers may have limited (or reduced) practical access to the wholesale supply and OTC hedge products they need to manage dry-year risk, including any reliability obligations of their own. MBIE should therefore test whether the proposed obligation will increase system-wide firming capacity and hedge availability, or simply reallocate existing capacity within integrated gentailer portfolios.

- **Dry-year risk is closely tied to competition problems:** The relationship is symbiotic. You won't be able to fully address one without fixing the other. Dry-year risk should not be treated as a stand-alone problem. Market power amongst the major gentailers contributes to under-investment and high wholesale prices and exacerbates dry-year risk.

- **A multi-faceted reform package is needed**: dry-year interventions should be complemented by stronger competition reforms, better hedge access, and robust wholesale market regulation. Given that inadequate investment in firming capacity is a core element of the problem, there should be a specific focus on barriers to investment in generation; particularly from international and independent investors. New Zealand should not continue to be structurally dependent on the investment and contracting incentives of Contact, Genesis, Mercury and Meridian to deliver sufficient firming capacity and affordable wholesale supply.

- **Corporate separation of generation and retail should be considered as part of the dry-year reform package:** 2degrees does not suggest that vertical separation would, by itself, solve New Zealand's dry-year problem. However, it is directly relevant to the incentives that sit behind the proposed obligation. It should therefore be considered alongside the proposed obligation as a structural reform that would help the market manage this unique feature of New Zealand's electricity sector more effectively.

Dry-year market failure needs to be fixed

New Zealand's electricity system is exposed to dry-year risk. It is widely recognised that this vulnerability is likely to become more pronounced as we transition to greater reliance on renewable energy resources unless changes are made to market settings and regulation. This point was well made by the Market Development Advisory Group (MDAG) in work its on "Price discovery in a renewables-based electricity system".

We agree "the current market has not consistently delivered enough firm, reliable, generation cover", and New Zealand has seen "very high peaks, and sustained higher wholesale electricity prices", "industrial curtailment and disruption" and "increased costs for households and businesses." The OECD has similarly observed that "electricity prices are structurally too high" including due to under-investment in firming capacity.[1]

The OECD is clear that New Zealand's success in "Increasing renewables electricity to electrify industry and transport" and "achiev[ing] net zero emissions", including the rate at which we can transition, is contingent on electricity prices that are affordable. According to the OECD, there are "Several structural factors" which "limit … investment in key sectors and productivity performance" some of which are outside of New Zealand's control, such as "geographic remoteness" but other elements can be managed, including "high energy costs" through energy policy and robust market regulation and competition.

2degrees own experience as a new entrant, independent retailer illustrates the importance of access to suitable hedge products to manage risk. Without effective access, independent retailers and industrial customers are left with limited options to manage their exposure to the volatility of wholesale prices and are likely to curtail their growth ambitions, cease acquiring new customers as a temporary measure, or retreat entirely from the market, as a means of protection from wholesale market risks including dry-year risk.

Dry-year risk isn't an isolated problem

Q1. Do you agree with the analysis in this chapter of why New Zealand does not currently have sufficient dry-year firming? If not, where do you disagree?

While we fully support Government intervention to address dry-year risk and consider the harm the risk creates has been well articulated in the consultation, caution is needed in looking at the problem separately or in isolation of broader market problems and failures.

The 'dry-year problem' is tightly related to the 'competition problem' in the electricity market. The relationship between dry-year and competition problems is symbiotic.

Dry-years increase market power, particularly in the short-term, and market failure amplifies the extent to which dry-years result in elevated electricity prices. Likewise, the less competitive any market, the lower the investment in production of goods and services will be which heightens the risk of shortages including, in relation to electricity, during dry-years.

Case Study: The impact of cannibalisation on generation investment

The link between limited competition, market power and potential for under-investment in electricity generation is illustrated well by the Concept Consulting and the Electricity Authority. In substance, that work suggests that where incumbent gentailers have market power and can influence prices through their investment decisions they may take into

[1] https://www.oecd.org/en/publications/oecd-economic-surveys-new-zealand-2026_3ec5de98-en.html

account the impact of any new generation investment decisions on spot prices and on revenue from their existing portfolio. For example:[2]

> "We commissioned Concept to investigate why prices are higher than LRMC, and whether this can be expected to self-correct. Concept found that there are market conditions which exist that suggest new development may not achieve the 'target' rate of new generation development. This may mean higher than economic use of thermal and continued prices above the long-run cost of new supply … Concept observed that one reason the market may not self-correct may be due to the incumbents and 'portfolio effects'. That is, the four major generators face some potential cannibalisation of revenues from existing assets when new projects are commissioned, and as such this may dampen their development incentives. This may indicate a lack of competition and engagement from the major generators in the PPA market. While there were mixed reports that this may be a problem and it was not possible to definitively test the strength of such claims, based on underlying incentives Concept suggest this area merits closer monitoring."

The tight inter-relationship between dry-year risk and competition problems highlights that the Government is correct "The dry-year problem … is a difficult one", "It is also not a problem for which there is any obvious single solution" and "A multi-faceted response is therefore required."

There may be some interventions, such as those detailed in the consultation, that can be directed at one element of the broader electricity market failings, but the dry-year problem won't be fully fixed if the competition problem is allowed to continue to fester and grow. A fully competitive electricity market is the best way to manage dry-year risk in the long-run.

2degrees considers that reforms targeted at competition issues should be developed and considered as part of a complementary set of reforms as part of the Government's interventions to the fix the dry-year risk problem. The OECD report[3] provided some useful potential guidance in this respect, as well as reforms that have been advocated by 2degrees and other independent market participants.

The proposed two-tier winter energy reliability obligation is surgically targeted

Q6. Do you agree that the long-term obligation should be placed on large wholesale purchasers rather than on, say, generators or the market more broadly? If not, which parties should hold the obligation, and why?

Q16. Do you agree that the short-term obligation should apply to large generators whose contribution to annual energy supply exceeds a defined de minimis threshold? We welcome views on whether 2,500GWh of expected annual generation is the appropriate threshold.

2degrees supports the proposal that the long-term, ex ante obligation would apply to large wholesale purchasers only, i.e. Contact, Genesis, Mercury, Meridian and NZAS, and the short-term obligation would apply to large generators only i.e. Contact, Genesis, Mercury and Meridian.

It may be better to specify the obligations as applying specifically to Contact, Genesis, Mercury and Meridian (and NZAS where applicable), rather than relying solely on arbitrary GWh size thresholds. The rationale for the obligation is not simply scale; it is the ability of those parties to materially influence dry-year outcomes through generation investment, hydro storage, thermal fuel arrangements, plant availability, dispatch decisions, and access to firming and hedge products.

[2] https://www.ea.govt.nz/documents/2213/response-to-submissions-review-of-structure-conduct-and-performance.pdf
[3] https://www.oecd.org/en/publications/oecd-economic-surveys-new-zealand-2026_3ec5de98-en.html

Use of size thresholds could have unintended consequences, including creating an artificial regulatory ceiling on the growth of independent and new entrant market participants. The incentive of small independent generators and retailers would be to stay under the cap.

While the reasons outlined in the consultation for targeting larger market participants are sound, the underlying justification should be linked to the entities' control and/or market power. Large generators' plant, fuel arrangements, storage positions, contracting arrangements and operational decisions will often determine whether firm fuel cover is actually available when conditions tighten. That is precisely why the obligation should sit with the parties best placed to address the underlying risk, rather than with participants that are primarily exposed to the consequences of that risk.

We fully expect Contact, Genesis, Mercury and Meridian will object to the proposals on the basis that targeting them could give rise to "equity considerations", as suggested in the consultation, and/or with pejorative commentary about 'free riding' or providing a 'leg up' for their competitors etc but refute these types of arguments entirely.

It is appropriate, and orthodox, to target regulation at larger market participants with significant and/or substantial market power. Excluding smaller market participants would be consistent with "principles of materiality, proportionality, competition, and regulatory efficiency."

We consider the proposals are consistent with 'causer' or 'exacerbator-pays' principles. If the market was fully competitive, and there were no market participants with market power, there would be far less justification or need for the interventions the Government is proposing. A healthy, fully competitive market with a large number of generators would be more likely deliver generation investment when it is needed than an oligopolistic market.

Ultimately it is the actions of Contact, Genesis, Mercury and Meridian that can influence the extent of dry-year risk and not small market participants, including independent retailers, independent generators, financial intermediaries and consumers such as data centres.

Careful consideration of all options is needed given the impact they could have on the electricity market

Any intervention to address dry-year risk is likely to have a significant impact on the operation of the electricity market. It will be important to ensure the costs and benefits of the proposed obligation are fully considered against the Government's stated objectives, including whether the proposal is likely to increase system-wide firming capacity and hedge availability, rather than simply reallocating existing capacity within incumbent portfolios.

It is inevitable that whatever intervention the Government ultimately adopts will have unintended consequences which need to be carefully considered and addressed before final decisions are made.

While the proposals in the consultation could incentivise Contact, Genesis, Mercury and Meridian to ensure their generation capacity exceeds their retail load (which could be a good thing) the obligations could also (further) incentivise them to limit access to hedge products to other market participants (which would have a negative impact on competition and the electricity market) to minimise their compliance costs. This example of the incumbent gentailers' incentives reinforces the need for robust wholesale access regulation and that weak regulation has the potential to undermine the success/exacerbate the costs of the proposed intervention.

Concluding remarks

2degrees supports the Government taking proactive steps to address dry-year risk and improve electricity system reliability. The consultation appropriately recognises that New Zealand faces a material risk current market settings will not deliver sufficient firm, reliable generation cover, particularly as the system becomes more dependent on renewable generation and legacy thermal plant becomes less secure.

In 2degrees' view, dry-year risk cannot be addressed effectively in isolation from broader wholesale electricity market competition issues.

Market power amongst the major incumbent gentailers contributes to under-investment, elevated wholesale prices, and inadequate access to the hedge products that independent retailers, independent generators, and large consumers need to manage risk and compete effectively.

The proposed obligation model should be implemented as part of a broader, coherent reform package that targets both dry-year risk and wholesale market competition problems. In particular, the proposed intervention should be accompanied by stronger wholesale market regulation, robust non-discriminatory access to hedge products and wholesale supply, deeper hedge market liquidity, and active monitoring of whether the regime increases market-wide firming availability.

The proposed obligation model should be implemented as part of a broader, coherent reform package that targets both the dry-year risk and broader wholesale market competition problems. In particular, the proposed intervention should be accompanied by stronger wholesale market regulation, robust non-discriminatory access to hedge products, and deeper hedge market liquidity, and active monitoring of whether the regime increases market-wide firming availability.

2degrees encourages the Government to design any dry-year intervention carefully, with a clear focus on strengthening competition, supporting new investment in firming capacity, and avoiding unintended consequences that could further restrict hedge access or entrench incumbent market power. A more competitive, better-regulated electricity market is the best long-term protection against dry-year risk and the best pathway to reliable, affordable electricity for New Zealand households, businesses and industry.