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Cross-submissions: Congestion rebate methodology

1. This is Vector's cross-submission on the Electricity Authority's (Authority) consultation on Settlement Residual Allocation Methodology (SRAM) principles.
2. As the Authority noted when inviting cross-submissions, stakeholders provided a diverse range of views to the SRAM consultation. However, a clear theme from submissions was that the SRAM should be designed to return loss and constraint excess (LCE) to end consumers. It is consumer payments that ultimately give rise to LCE payments.
3. As noted by Unison, "*consumers ultimately bear all the costs of the electricity supply chain. Therefore, if there is a surplus that arises that is unnecessary to compensate for a cost that is incurred within the industry (as is the case with LCE) then it should be proportionately allocated back to consumers in a manner that is simple and cost effective.*"¹
4. As raised in our submission, ahead of consultation on the SRAM, the Authority first needs to establish that losses are calculated accurately and eliminate any overpayment by consumers. It is notable that the market solver, SPD, has fundamentally not changed since the market started in 1996. The Authority should consider whether new technology can enable a more sophisticated and effective means of coordinating resources than the traditional SPD model.
5. We consider the Authority needs to progress its investigation into whether network price reductions have been passed through to consumers. This was announced two years ago but has not yet been delivered.² This is a crucial piece of analysis the sector is waiting for. The outcome of this investigation will also be relevant to LCE payments. There can be no justification for the proposal to require distributor pass through to retailers ahead of this investigation, given the significant concern that consumers have not seen the benefit of material price reductions by EDBs following their regulatory price-path resets.

Distributor pass-through to retailers should not be mandatory

6. Vector's submission strongly opposed the proposal by the Authority to mandate distributor pass-through to retailers which would merely increase administrative costs with no benefit to consumers.
7. Instead, we suggested the Authority could still ensure distributor pass-through of LCE to consumers while remaining agnostic as to the method of pass-through, for example by requiring distributors to disclose their pass-through methodology. This would be a less heavy-handed and lower cost mechanism to achieve the desired outcome.
8. Northpower and Entrust made similar suggestions.

¹ Unison submission on the SRAM, page 2

² Electricity Authority, *Interim Work Programme 1 July 2020 - 30 June 2021* (June 2020), page 4

9. For example, Northpower submitted, “We would support an approach that enables each EDB to determine how it returns the LCE payment to consumers. EDBs could be required to disclose and publish this methodology, providing transparency to consumers and retailers.”³
10. We note Meridian submitted there was “inefficiency created by the current ad hoc distributor practices in respect of rebates.” Meridian cited Vector’s approach over the past few years as an example.⁴
11. We disagree that this represents an “ad hoc practice”. Vector’s approach to passing on LCE has been largely consistent (i.e. directly through the Entrust dividend for Entrust consumers and via retailer bills for Northern Network customers). However, we have taken a different approach from time to time where this was judged more efficient in the circumstances for Vector and our customers.
12. We note it should not result in any additional cost to retailers if a distributor has used LCE to offset future lines charge increases in a particular year, as this does not require any action from retailers to implement.
13. We do not consider changing the approach by mandating pass-through to retailers would alleviate any existing inefficiencies from “ad hoc” practices nor would it alleviate any existing confusion for consumers. If LCE is passed to retailers, they would presumably also maintain their own approaches for passing on LCE for consumers and this may vary per year depending on retailer and consumer circumstances.
14. If the Authority is swayed by Meridian’s argument, it would need to specify a standard approach for retailers to pass on LCE to consumers. Otherwise the same concerns about a lack of standardisation and ad hoc practices giving rise to inefficiencies would apply.
15. Network Tasman’s submission explained how mandating LCE pass-through to retailers would leave network consumers worse off:

“The Authority referenced figures provided in Mercury’s Code change request that 81% of LCE is currently passed on by distributors. The remaining 19% is stated to be ‘retained’ by distributors...”

Focus therefore turns to the remaining 19% of LCE that is stated by Mercury to be retained by 12 distributors, one of which is Network Tasman...

Network Tasman does not retain LCE rebates. We pass LCE on to our large directly billed consumers, with the remainder being incorporated into our annual budgeting process. By doing this, we are able to pass LCE through to consumers via lower lines charges than would otherwise be the case. This process is an efficient channel for passing LCE through to consumers as it requires no changes to our billing system or retailer billing systems and incurs negligible costs internally.

If the Authority were to mandate LCE pass-through to retailers, Network Tasman would need to increase lines charges to recover the value of those lost LCE rebates. This would leave consumers worse off because we expect retailers would pass the full value of the lines charge increase through to consumers, whilst retaining a portion of the LCE rebates received from Network Tasman. Mercury has estimated that retailers would retain 17% of all LCE payments they receive. Presumably as a windfall gain.

³ Northpower submission on the SRAM, page 2

⁴ Meridian submission on the SRAM, page 2

On a national basis, the magnitude of this windfall gain to retailers is significant. If distributors had passed LCE through to retailers over the past seven years, retailers would have enjoyed windfall gains totalling \$72m (in nominal terms).⁵

16. Accordingly, our view remains that mandating distributors pass LCE to retailers will not promote the long-term benefit to consumers (and, in fact, risks undermining it by increasing administrative costs for distributors by requiring them to depart from the approaches they have established as the best method of pass-through in their and their customers particular circumstances. This would reduce efficiency for no consumer benefit). The long-term benefit of consumers is best promoted by an approach that is agnostic as to the method of pass-through, such as a requirement distributor disclose their pass-through method and methodology.
17. We also support Network Tasman's recommendation that, *"Before formally consulting on the idea of mandated LCE pass-through, Network Tasman suggests the Authority gain a better understanding of how the various distributors that retain LCE rebates currently treat those rebates and how they are likely to respond should the Authority mandate pass-through of LCE to retailers. Doing so would assist the Authority to construct an informed cost/benefit analysis."*⁶

The residual charge should be used as the allocator

18. Submitters had varied views as to the allocation methodology. However, the majority were opposed to allocating LCE to generators.
19. As Vector raised in our submission, there is no justification for generators to receive LCE since they have already been fully compensated for energy generated. Rather, the effect would be to provide windfall gains to generators that would not translate to any benefits to consumers.
20. We consider allocation through the residual charge remains the best option to promote the long-term benefit of consumers, as it is simple (and therefore lower cost) and non-distortionary.
21. We note a number of submitters who preferred Option D (allocation based on wholesale energy purchase volumes) considered allocation through the residual charge as their next preferred option.
22. For example, Transpower submitted:

"If the Authority opts for a TPM-based SRAM, we consider residual charges, not benefit-based charges, should be used as the allocator..."

Allocating settlement residue based on residual charges would also have the following advantages:

- *It would directly address the underlying problem discussed at paragraph 12 above - that "consumers pay more for electricity than generators receive" - by returning settlement residue to load rather than generation. We are mindful any allocation of settlement residue to generators would mean they receive greater compensation for their generation than is required to clear the market, and would lock in the wedge between the price consumers pay and the net price generators receive*

⁵ Network Tasman submission on the SRAM, pages 3 - 4.

⁶ Ibid, page 4

- *it would avoid the SRAM distorting nodal prices to generators and, consequently, impacting generators' offer strategies and behaviour. The Authority has previously raised these types of issues. For example, in the LCE Working Paper the Authority expressed its concern that "Generators ... may have the incentive and ability to game the system by modifying their offers to take the treatment of LCE into account" and "some parties may have both the incentives and ability to inefficiently 'game' the spot market to alter the creation and allocation of LCE in order to reduce their transmission charges. This may be at the expense of other participants*
 - *It would not water down the policy objectives behind benefit-based charges. All of options A, B and C in the SRAM Consultation Paper would effectively result in beneficiaries paying less than the covered cost of benefit-based investments through benefit-based charges, and therefore under-signal transmission costs. This is because settlement residue would effectively be deducted from benefit-based charges under the Authority proposal. This would effectively mean WEM purchasers (the source of the settlement residue) would subsidise benefit-based investments. The TPM Guidelines specify only limited circumstances where benefit-based charges are not required to recover the entire covered cost of benefit-based investments."*⁷
23. We note the Authority's statements in the consultation paper that, "Option D would likely severely undermine nodal pricing signals for load parties as rebates would be directly linked to WEM purchases...We would expect reduced responsiveness to nodal price signals would lead to increased price volatility and possibly reliability problems."⁸ Accordingly, The Authority stated this option is likely to be ruled out.
24. These considerations raised by stakeholders have bolstered our view that the residual charge is the best option for the SRAM. It has the same benefit of simplicity (as would be provided by Option D) but also raises no concern about distorting the nodal price signal.

Decision making principles

25. Vector's submission noted there were contradictions between the principles proposed in the consultation document (i.e. between the principle of non-distortion versus providing a hedge to volatility).
26. This was raised by a number of submitters, the majority of which appeared favour the principle of non-distortion. We agree avoiding distortion should be paramount in designing the SRAM.
27. We also note Network Tasman and Transpower raised concerns about the Authority implementing new principles for making its decision on the SRAM over its established decision-making framework.
28. Transpower submitted:
- "the Authority should be cautious about creating new decision-making principles when it undertakes new consultations. There is a risk using different principles for different decisions will cloud or pre-determine the Authority's thinking, resulting in regulation that is inconsistent and unpredictable."*⁹

⁷ Transpower submission on the SRAM, page 7

⁸ Electricity Authority, *Settlement Residual Allocation Methodology: Principles, options and pass-through* (18 January 2022) page 16-17

⁹ Transpower submission on the SRAM, page 14

29. We agree the Authority should be cautious about new decision-making principles. We appreciate the opportunity to comment on the Authority's approach ahead of substantive consultation. However, as identified by Transpower, implementing new decision-making principles does run the risk of pre-determining the Authority's thinking. This would make any consultation process a foregone conclusion.

Yours sincerely



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