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Submissions
Electricity Authority

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LCE allocation should address that LCE arises from consumer over-payment while preserving the efficiency of locational marginal prices

Electric Kiwi and Haast Energy Trading (Haast) consider that the matter of LCE allocation has more to do with the performance, and efficient outcomes, in the wholesale market than network pricing. Consistent with Transpower's views we don't consider LCE allocation needs to be tied to transmission pricing.

Our starting point is that LCE allocation should recognise LCE arises because "consumers pay more for electricity than generators [need to] receive" to be fully compensated. We agree "ways [should] be found to return the settlement residue to those who pay the nodal transport charge for the investment". When considered this way, allocation options should be limited to options which allocate LCE back to wholesale purchasers.

We consider that LCE allocation should be designed to preserve the integrity of WEM pricing. Electric Kiwi and Haast do not have any concerns about spot market pricing volatility if it reflects the genuine outcomes of a workably competitive market. While SRAM is determined by spot market outcomes it will always be correlated to locational price spreads and distort efficient prices net of SRAM. To avoid this the Authority should utilise a greater level of auctioning against the LCE pool so that SRAM reflects longer-term price expectations.

Summary of Electric Kiwi and Haast's views

- **There are two fundamental principles which should be adhered to:** Any LCE allocation method should align with the following two principles, the allocation method should: (i) address that LCE arises because "consumers pay more for electricity than generators receive"; and, consistent with principle 1 in the consultation paper, (ii) preserve the integrity of WEM nodal pricing.

- **The goal should not be to mitigate volatility.** Principle 3 in the consultation paper is diametrically in conflict with principle 1. We agree "the SRAM must be designed in such a way that it does not work against nodal price signals". The goal should be to expose all participants to efficient price signals net of "SRAM". The goal of NZ's locational marginal pricing market design is that prices are efficient, so it follows that SRAM should not mitigate volatility at all if those price signals are to be preserved.

- **Issuing more FTRs and residue products against the LCE can make SRAM more predictable and uncorrelated with spot outcomes** (consistent with the consultation paper's principle 1). This could keep the price signals consumers and generators see net of SRAM close to efficient levels and increase wholesale market liquidity via increased opportunities for risk repackaging.

- **Electric Kiwi and Haast do not support any option which allocates LCE to generators.** Any such options (including allocation on the basis of the benefit-based method) fails to recognise LCE arises from consumer over-payment for electricity on the spot market.

The Authority has given consideration to whether consumers ultimately receive the benefit of LCE in relation to the current allocations to electricity distributors, but has been silent on what happens to LCE allocated to generators.[1]

- **SRAM can be decoupled from TPM:** Electric Kiwi and Haast agree with Transpower that LCE allocation does not need to be tied to the TPM. By issuing FTRs and residue products against the LCE currently not covered by FTRs, the SRAM returns would become uncorrelated to spot pricing outcomes and price signals will be preserved.

- Our preferred option is **Option D**. Coupled with full auctioning of the LCE via FTRs and a new residual product this is the most efficient option and has the added benefit of increasing the amount of LCE which can be repackaged into risk management tools to enhance wider wholesale market liquidity.

- **If the TPM is used to allocate LCE the residual should be the allocator:** If the TPM is used to allocate LCE the best option – consistent with protecting the "Integrity of the (proposed) TPM benefit-based charge" – would be to use residual charges as the allocator. This is consistent with our principle that SRAM should address that LCE arises because "consumers pay more for electricity than generators receive".

  This is also consistent with the Authority's desire for a 'two-part tariff' with nodal pricing sending the variable pricing signals and the TPM being recovered through fixed charges. Our understanding is that the residual is intended to be fixed and non-distortionary so, as a corollary, it follows that allocation of LCE using the residual would be fixed and non-distortionary, preserving variable nodal pricing signals.

- Regardless of whether the residual, a benefit-based method or some other TPM-based method is used the allocation should be to load customers only.

The SRAM should preserve the integrity of the WEM nodal pricing and should not be used to mitigate volatility

Electric Kiwi and Haast support principle 1 in the consultation paper, and consider that any SRAM should preserve the integrity of WEM nodal pricing.

Principle 3 in the consultation paper is diametrically in conflict with principle 1.

The goal should not be to mitigate volatility. The Authority was very clear on this point in its feedback to Transpower in relation to the potential benefits of a transitional congestion charge.[2] The MDAG 100% renewables consultation also emphasises that volatility is likely to increase as we transition to 100% renewables, "increased price volatility per se is not the primary concern" and heavily focusses on the importance that price volatility is not reduced through "artificial price suppression".

The goal should be to expose all participants to efficient price signals net of SRAM. The goal of NZ's locational marginal pricing market design is that prices are efficient, so it follows that SRAM should not mitigate volatility at all if those price signals are to be preserved.

It would be undesirable if SRAM payments reduced the effective nodal price signals.

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[1] LCE allocation to generators does not change SRMC (indicating it would not be passed-through in lower spot prices) but can impact the marginal revenue generators receive.
[2] The Authority rejected reduction in nodal price volatility as a valid benefit.

The Authority should consider the benefits of issuing more FTRs and residual products

Issuing more FTRs and residue products against the LCE can make SRAM more predictable and uncorrelated with spot outcomes. This could keep the price signals consumers and generators see net of SRAM close to efficient levels and increase wholesale market liquidity via increased opportunities for risk repackaging.

The Australian NEM utilises a market design which more closely matches residues with financial products in a Settlement Residue Auction, a similar approach in NZ could increase the total amount of products sold and reduce underfunding risk. For example, the NZ FTR market could have more FTRs added, higher release factors and be extended to include a spot-SRAM product designed to match to the remaining LCE component which does not have FTRs issued against it. This would have the benefit of passing on the volatile SRAM pool to traders who can repackage other wholesale products against it and increase liquidity in the wider wholesale market, while the level of SRAM would be relatively constant and based on longer-term expectations of spot-SRAM. With appropriate product design the buyers of spot-SRAM could bear the underfunding risk in the FTR market allowing the Authority to more confidently increase FTR release factors.

Concluding remarks

The Authority's SRAM consultation should be considered in light of its wholesale market review and the appalling results from the UMR survey on perceptions about the level of competition in the electricity market.[3] It is clear that the scale of competition problems the Authority has confirmed from the WMR and UMR are such that addressing these issues should be given highest priority, even if it means issues such as TPM and LCE allocation need to be delayed or put on hold.

The incumbent gentailers are benefitting from record high spot prices over the last several years.[4] The proposed new TPM the Authority is currently considering will result in substantial windfall gains for generators; particularly for Meridian. The Authority's preferred SRAM options (allocating on the basis of one of the benefit-based methods in the new TPM) would result in further substatial additional windfall gains, with the majority of LCE being transferred from consumers to generators. We consider this to be neither efficient or to the long-term benefit of consumers.

We are also concerned that artificially inflating generator revenues at a time when there are serious concerns about artificially high spot prices and the competitiveness of the electricity market are incompatible with the durability or stability of existing market settings.

Our preferred options is Option D. When combined with increased FTR and residual auctioning it preserves nodal price signals and is the most efficient option.

Any LCE allocation methodology which results in allocation of LCE to generators, or an increase in allocation of LCE to generators, would be fundamentally in conflict with the principles that LCE (SRAM) allocation should: (i) address that LCE arises because "consumers pay more for electricity than generators receive"; and, as consistent with principle 1 in the consultation paper, (ii) preserve the integrity of WEM nodal pricing.

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[3] Even the dismally low perceptions of the competitiveness of the electricity market are likely to be inflated due to the impact on gentailer vested interests on the survey results.

We doubt it is a coincidence 19% of survey participants are gentailers and 19% of respondents think new entrant retailers can operate on a level playing field with established retailers. We note also that only 18% of participants agreed new entrant generators operate on a level playing field

[4] Including long enough for any debate about net versus gross pivotal to become irrelevant.

Yours sincerely,

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