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Consultation – Settlement Residual Allocation Methodology

Genesis Energy Limited (**Genesis**) welcomes the opportunity to provide feedback on the Electricity Authority's (**Authority**) consultation paper: *Settlement Residual Allocation Methodology: principles, options and pass-through* dated January 2022.

Amend Code now to require pass through of settlement residue

We agree that how the settlement residue (as defined in the consultation paper) is:

- (a) allocated should be reviewed ahead of the new transmission pricing methodology (**TPM**) taking effect;
- (b) returned to grid users must also be addressed.

The Authority's problem definition is, however, limited to the first of these two issues.¹

The Authority has recognised that:

- (a) the settlement residue should be returned to those who bear the cost of congestion;
- (b) currently, distributors are not required by the Code to pass through rebated settlement residue, and so current practice varies, with some not passing it through at all; and
- (c) to the extent that settlement residue is not being returned to spot market purchasers of electricity, they are paying more for the use of and access to the grid than it costs to provide.

¹ Refer paragraph 2.4 of the consultation paper.

Accordingly, we ask that the problem definition for developing a new Settlement Residue Allocation Methodology (**SRAM**) specifically incorporate the issue of how the settlement residue is returned.

This gap in the regulatory framework is, however, a longstanding and material issue. The Sapere report which went with Mercury's 2019 Code amendment proposal to address the issue estimated that 19% of settlement residue rebates were being kept by distributors.² Given the settlement residue amounts set out in the Authority's consultation paper,³ this suggests that distributors have withheld \$60.4 million from grid users over the last seven pricing years, with \$15.2 million in the 2020-21 pricing year alone.

It is fundamentally inequitable that these funds have been, and continue to be, withheld from the parties which have made the overpayments and that face the risks and costs of congestion. This matter can, and should, be addressed now.

The Authority has said that its preliminary view is that the Code be amended to require distributors to pass the settlement residue to purchasers of electricity. We suggest that Mercury's 2019 Code amendment proposal and accompanying Sapere report, and the submissions made by various participants in the various TPM consultations concerning the return of the residue, provide the Authority with the information that it requires to amend the Code and eliminate this regulatory gap now.

Looking ahead to a new SRAM, the mechanism for returning the settlement residue should be included in the problem definition so that it can be refined, if necessary, once a new SRAM is determined.

Settlement Residue Allocation Methodology - Principles and Options

We agree that the development of a new SRAM should be principles based. It is unclear, however, how the Authority's proposed principles are to be weighted. As the nodal pricing system, by design, results in overpayments by purchasers of electricity, we ask that principle of full cost recovery should be paramount.

We agree that a holistic approach should be taken and (subject to the full cost recovery principle being paramount), the SRAM should not give rise to a material risk that nodal pricing signals would be distorted or undermined.

In relation to this latter principle, the consultation paper states:⁴

3.5 If a party's settlement residual rebate is correlated with its use of the grid, this would undermine the efficiency of nodal prices in coordinating grid usage and result in inefficient grid use and investment incentives. Specifically, if a customer knows that if it increases its use of the grid,

² Refer "Loss and constraint rentals – economic analysis of Mercury code change proposal", Sapere Research Group (2019), page 14.

³ Refer "Table 2 Settlement residue is a material part of overall transmission revenue" at page 24 of the consultation paper.

⁴ Refer paragraphs 3.5 and 3.6 of the consultation paper.

the additional nodal price it pays for the additional energy use, in particular any increase in the transport component, will be offset by an increase in its settlement residual rebate, then it has an incentive to increase its use of the grid even when that is inefficient (as it is not then facing the full cost of the congestion it causes).

- 3.6 *The Authority considers this principle to be critical – as nodal pricing is central to the efficient use of the grid. It is also relevant to reliability (dampening the nodal pricing signal would make congestion issues more likely) and competition (which could be affected if the SRAM allowed parties with market power to use it to extract larger rebates). [The Authority provides as an example in a footnote: “For example, a generator could structure its offers to cause or worsen price separation across a congested line, with its loss of sales revenue outweighed by an increase in settlement residual rebate.] Accordingly, any SRAM option which allowed a user’s own use of the grid to significantly affect the size of its settlement residual rebate is likely to be rejected due to this principle.*

[emphasis added]

The development of the new SRAM should be principles based and also, so far as possible, evidence based.

We observe that:

- (a) No detailed analysis is provided to support the conclusion that a pro-rata allocation methodology would have this effect.
- (b) The current methodology is proportional based, and leaving aside the withholding issue discussed earlier, there is no data to suggest that the concerns raised by the Authority have occurred or are probable.
- (c) The vast proportion of load is represented by retailers. Decisions to compete in a particular region (and the consequential impact on load) are driven by a range of factors, with exposure to spot price volatility is managed through hedges (and transfer prices in the case of gentailers). It is difficult to see settlement residue rebates, in and of themselves, driving decisions to increase load in a particular region.
- (d) Generator offers are principally driven by hydrology, fuel costs and availability, water values, anticipated available generation, market conditions and perceptions of risk. It is also difficult to see – given the spread and scale of their generation and retail activities – that there would be a material financial incentive for generators (with retail businesses) to exercise market power and undertake the elaborate offer behaviour described by the Authority at a particular node. In the unlikely event such behaviour occurred, we note that the trading conduct rules in the Code should address this.

The Authority has also identified cost and practical considerations as a design principle. We agree with this and recommend that, subject to the full cost recovery principle discussed above, simplicity, transparency and administrative efficiency should be preferred.

Options A and D set out in the paper provide the simplest and most administratively efficient options, although the Authority has indicated that Option D is likely to be ruled out. Options B and C bring with them considerable complexity both to implement and operate, with the Authority indicating that Option C is likely to be ruled out.

We think that the principles of full cost recovery and simplicity should be given primacy, and that further analysis of Options A and D is required. For example, the Authority suggests that Option A could provide an incentive to a grid customer to oppose a grid upgrade which relieves congestion, where the upgrade would reduce its settlement rebate. We question this conclusion as (all else being equal) we would expect the price paid by the customer to be lower reflecting the reduced congestion.

Similarly, a key issue which the Authority has with Option D is the impact on investment decisions concerning where to locate new load or embedded generation. It is unclear whether this would have an impact, and if so, whether it would be material. We would be grateful if the Authority could clarify whether it has discussed this with those allocating capital and making investment decisions before forming this view.

In short, we would support an SRAM that is pro-rata based, simple to administer and understand, and which ensures full cost recovery of the amounts overpaid by purchasers of electricity from the wholesale market.

Summary

Genesis welcomes the Authority's view that the Code should be amended to require distributors to pass through rebated settlement residue to wholesale purchasers of electricity. The sums withheld to date by some distributors are material and the Code change should be made as soon as possible. We agree with the Authority that this should be simple to implement and enforce.

In relation to a new SRAM, we:

- (a) support a principles and evidence-based approach;
- (b) ask that the principle of full cost recovery be paramount, and that further consideration be given to Options A and D. The simplest method that ensures full cost recovery should be preferred.

However, this further consideration and the development of a new SRAM should not prevent changing the Code to ensure that settlement residue allocated under the current method is passed through by distributors.

There is no reason to delay this until a new SRAM is determined. Doing so would result in another \$15 million annual windfall for distributors who choose not to pass through the rebated residue.⁵

Please contact me should you wish to discuss our response further.

Yours sincerely



Warwick Williams
Senior Regulatory Counsel and Group Insurance Manager

⁵ Assuming that the aggregate settlement residue for the 2021-22 pricing year is the same as the previous pricing year. See "Table 2 Settlement residue is a material part of overall transmission revenue" at page 24 of the consultation paper.