Via email: network.pricing@ea.govt.nz

28 February 2022

Settlement Residual Allocation Methodology: principle, options and pass-through

Mercury welcomes the opportunity to provide feedback on the Electricity Authority's (Authority's) consultation paper *Settlement Residual Allocation Methodology: principle, options and pass-through*, 18 January 2022 (Consultation Paper).

The Authority seeks stakeholders' views on its proposed settlement residual allocation methodology (SRAM) principles, and initial feedback on its early thinking on options to be considered for the SRAM. The Authority also seeks to test its thinking on the related issue of whether distributors should be required to pass through settlement residual rebates to their own customers.

Mercury supports the Authority's "… *initial view is that distributors should pass their [settlement residual] rebates through to their customers each month, using distribution charges as an allocator"*.[1] Mercury, in addition, proposes that this *distributor pass-through requirement* should be implemented independently of the SRAM. We propose that this requirement should be implemented during 2022, before the implementation of the new transmission pricing methodology (TPM) that is indicatively set down for 1 April 2023.

The distributor pass-through requirement does not depend on the particular form of SRAM that is in place now or that might be implemented in the future. As shown in the Consultation Paper, the value of the rebate that distributors would receive differs depending on the choice of the SRAM, but irrespective of the particular SRAM and therefore the rebate value, distributors should pass their rebate through to their customers.

The distributor pass-through requirement should be implemented as soon as possible in 2022 because it would promote economic efficiency under the status quo using the current TPM, and it would continue to promote economic efficiency under a new SRAM that is based on the new TPM. Delaying the implementation of the pass-through requirement would delay an enhancement to economic efficiency.

Mercury's submission expands on this proposal. In addition, comments are provided in Annex in response to the Authority's consultation questions regarding the proposed SRAM principles and options for implementing the SRAM.

Distributor pass-through requirement is independent of the SRAM

Mercury submits that the distributor pass-through requirement is independent of the SRAM, and therefore it can be implemented separately from the SRAM.

[1] Authority's Consultation Paper, paragraph 5.6.

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As the Authority notes, the Code does not prescribe how the settlement residual rebate should be allocated or to whom.[2] In order to address this omission, as noted above the Authority's initial view is that distributors should pass their settlement residual rebates through to their customers each month, using distribution charges as an allocator. This initial view is consistent with the approach Mercury set out in its *Proposal to amend the Electricity Industry Participation Code* 2010, 1 April 2019, which the Authority has attached to its consultation.

The requirement that distributors' pass their rebate through to their customers does not depend on the particular form of SRAM that might be implemented now or at some future point in time. For instance, consideration is given in the Consultation Paper to the following SRAM options:

Option A: TPM charges – allocates in proportion to total TPM charges
Option B: Simple Benefits Base (BB) – uses regional allocators (BBC simple method in the proposed new TPM)
Option C: Full BB – uses proposed new TPM allocators based on all applicable methods
Option D: WEM purchasers – based on wholesale energy purchase volumes

The analysis provided in the Consultation Paper indicates that each of these options would result in distributors receiving different values for the rebate, and that these values do not depend on the distributor pass-through requirement. It indicates that the value of the distributors' rebate for Option A would be around the same value as the status quo, whereas for Options B and C it would be significantly less than Option A and the status quo.[3] Furthermore, in the case of Option D, which is Authority has indicated is its least preferred option and likely to be ruled out,[4] distributors would not receive any rebate. [5] None of these calculations depend on the distributor pass-through requirement.

The option that is implemented, however, will determine the level of the rebate that distributors would pass through to their customers using distribution charges as an allocator. The choice of option will therefore affect the extent to which the distributor pass-through requirement would promote economic efficiency.

Distributor pass-through requirement would promote economic efficiency

The Authority has included in the present consultation economic analysis prepared by Sapere[6] that Mercury submitted with its proposed Code amendment in 2019. This economic analysis is directly relevant to the present consultation and gives strong support to the Authority's initial view regarding the introduction of the distributor pass-through requirement.

Mercury submits that its conclusions are consistent the Authority's view that the allocating the rebate to distributors' customers using distribution charges would help preservice the integrity of nodal price signals; better support the long-term signal for efficient long-term grid use and investment decisions; and partially offset monthly congestion charge volatility.[7]

Mercury also submits that Sapere's analysis implies that introducing the distributor pass-through requirement now, at this time and maintaining it following the introduction of a new SRAM would promote economic efficiency based on the following rationale:

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[2] Ibid. paragraph 5.2.
[3] Ibid. paragraphs 4.20 to 4.22.
[4] Ibid. paragraph 4.19 and footnote 38.
[5] In the case of Option D, distributors would not receive any rebate, which suggests that implementing the distributor pass-through requirement would be redundant. Even so, if a distributors' pass-through requirement happened to be implemented alongside Option D, it would not have any effect on the market as distributors would not have any rebate to pass through to customers.
[6] *Loss and constraint rentals - economic analysis of Mercury code change proposal*, Kieran Murray, Dean Yarrall, Sapere Research Group, 26 March 2019.
[7] Ibid. page 26

a) Sapere's analysis concluded that the introduction of the distributor pass-through requirement in 2019 would have promoted economic efficiency. As there has been no substantial change subsequently in distributors' treatment of the rebate, Mercury considers that the analysis' general conclusions are still relevant now.
b) The distributor pass-through requirement would continue to promote economic efficiency should any of Options A, B or C, noted above, is implemented in the future as distributors would continue to receive a settlement residual rebate. In the event that Option D is implemented, the requirement would cease to have effect because distributors would not receive a rebate.

Sapere's analysis provided a comparison of the impact on economic efficiency between the distributor pass-through requirement that is the same as the Authority's proposal and alternative approaches including: a rebate that is credited to transmission charges; distributors passing through the rebate to customers; and maintaining the status quo in 2019.

The comparison indicated that a distributor pass-through requirement would promote economic efficiency better than these alternatives because it was the only approach that would maintain efficient infra-marginal prices. That is, Sapere found that the alternatives to a distributor pass-through requirement would "*artificially lower charges for lines services (transmission and or distribution) while raising total energy prices*".[8]

Sapere noted that this distortion in line and energy prices could potentially impact many decisions by end consumers concerning fuel choices particularly during the transition to the low emissions economy.[9] Mercury considers that promoting efficient line and energy prices is crucial for reducing emissions and meeting New Zealand's emissions targets. Failure to introduce the distributor pass through requirement would make achieving these targets more challenging.

Sapere concluded that it would therefore be difficult to reconcile the Authority's statutory objective with retaining or implementing the alternative approaches considered as a distortion to efficient infra-marginal prices cannot be consistent with promoting economic efficiency.[10]

Distributor pass-through requirement should be implemented during 2022

Mercury submits that for the reasons set out above that the distributor pass-through requirement should be implemented separately from the SRAM, and as soon as possible in 2022.

Separating the implementation of the distributor pass-through requirement the SRAM would promote economic efficiency without further delay. This would allow, furthermore, the Authority to finalise a SRAM in due course, ensuring that is aligned with the new TPM.

Mercury looks forward to engaging constructively with Authority and industry stakeholders on implementing the distributor pass-through requirement in 2022 and continuing to work on finalizing the TPM and the SRAM.

Yours sincerely

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Head of Government and Industry Relations

[8] Ibid. page 25.
[9] Ibid. page 26
[10] Ibid.

Attachment: Mercury response to consultation questions

Consultation Questions	Mercury Response
Section 2 – Background and problem definition # Do you have any comments on the problem definition and background material in this chapter?	Mercury has no comments regarding the problem definition and background material in this chapter.
Section 3 - Proposed SRAM principles # Do you have comments on the proposed SRAM principles, or on anything else in this chapter?	Mercury has no comments regarding the proposed SRAM principles.
Section 4 - SRAM options: early thinking # Do you have comments on our initial thinking on options under consideration for the SRAM? # Do you wish to propose an alternative option for consideration? # Do you have comments on anything else in this chapter?	Mercury supports the *Option A: TPM charges – allocates in proportion to total TPM charges*. The Consultation Paper notes that this methodology would be similar to the current methodology. As such, it would provide continuity, certainty and transparency with respect to the allocation of the settlement residual, thereby minimising the risk of any untended consequence that may be associated with the other, more novel options. Mercury also considers that *Option D: WEM purchasers – based on wholesale energy purchase volumes* deserves further, more detailed analysis. Mercury notes the Authority's concern that the Option D may severely undermine nodal pricing signals because the settlement residual would be returned to wholesale electricity market (WEM) purchasers directly in proportion to their energy purchases each month. However, it is not clear that this would be an issue, particularly for large WEM purchasers, as the return of the residual would essentially be based on an average of their purchases across a number of nodes over the whole month. This averaging process may mitigate any risk to pricing signals at individual nodes. Furthermore, a key benefit of this option is that removes the need to pass the residual through to Transpower, then through to the distributors, and then to distributors' customers. Avoiding this complicated chain of allocations would greatly enhance transparency and reduce the administrative burden being placed on the industry and Authority.
Section 5 - Proposal to require distributors to pass settlement residual rebates to customers # Do you have any comments on the proposal for passing settlement residual rebates to distributors' customers that is discussed in this chapter?	Mercury supports the Authority's "… *initial view is that distributors should pass their [settlement residual] rebates through to their customers each month, using distribution charges as an allocator"*.[11] Mercury, in addition, proposes that this *distributor pass-through requirement* should be implemented independently of the SRAM. We propose that this requirement should be implemented during 2022, before the implementation of the new TPM that is indicatively set down for 1 April 2023. Our reasoning for this position is set out in the body of this submission.

[11] Authority's Consultation Paper, paragraph 5.6.

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