1 March 2022

Submissions
Electricity Authority

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

Settlement Residual Allocation Methodology – Consultation paper

Meridian appreciates the opportunity to provide feedback to the Electricity Authority on its consultation paper *Settlement Residual Allocation Methodology: principles, options and pass-through*.

The Authority's problem definition

Meridian agrees that the absence of a settlement residual allocation methodology is a problem and that the TPM reform process is an opportunity to address this problem. Considerable sums of money are allocated through settlement residual rebates. Meridian considers it an anomaly of the current market design that settlement residual rebates occur seemingly by convention alone, based on a method developed by Transpower. The Authority is right to take an interest in the allocation of settlement residual as different allocation methods will have different long-term impacts on consumers.

Meridian strongly agrees with the associated problem identified by the Authority, namely that distributors are not required to pass on the settlement residual rebates to consumers, and sometimes this does not occur (approximately 20% of the time according to Sapere Research Group). The Authority states that: "In such circumstances, wholesale purchasers of electricity (retailers and industrial consumers) are effectively overpaying for their energy purchases and do not receive any benefit from settlement residual rebates." Meridian agrees but would go further to say that when distributors do not pass on settlement residual

Meridian Energy Limited

Level 2, 55 Lady Elizabeth Lane
PO Box 10-840
Wellington 6143
New Zealand

Phone +64-4 381 1200
Fax +64-4 381 1272
www.meridianenergy.co.nz

rebates to consumers there is a direct detriment to consumers. We understand that settlement residual rebates are unregulated revenue for distributors and are in effect a windfall gain for the shareholders of distribution companies. There is no market justification why a windfall gain should go to the shareholders of any distribution company from the proceeds of the wholesale electricity market in which distributors do not participate.

A further dimension of this problem is the inefficiency created by the current ad hoc distributor practices in respect of rebates. To take just one network as an example:

- In 2018, Vector made a one-off payment of $30 to consumers in the Entrust District as part of their Entrust dividend payment. For consumers in the Vector Northern network the payment was made by mailing of a cheque with Vector requesting assistance from retailers to gather consumer information (and deal with associated privacy considerations).[1]
- In 2019, Vector made a one-off payment of $15 to consumers in the Entrust District as part of their Entrust dividend payment. For the Vector Northern network rebates were passed on through retailers with Vector asking for specific treatment on bills.[2]
- In 2020, Vector decided to retain all settlement residual rebates to offset a fall in regulated revenue.[3]
- In 2021, Vector made a one-off payment of $20 to consumers in the Entrust District as part of their Entrust dividend payment. For the Vector Northern network rebates were passed on through retailers with Vector asking for specific treatment on bills.[4]

Different approaches are also used by the other distribution network across New Zealand. The lack of standardisation leads to administrative costs for retailers (and presumably distributors) and likely detriment to consumers in the long term because of the increased cost to serve. There is also evidence, acknowledged by Vector, that ad hoc rebate processes cause confusion for consumers.[5]

The nature of the problem with distributor pass through suggests the Authority should codify a standardised allocation method that either:

- allocates settlement residual to wholesale purchasers rather than transmission customers; or

---

[1] http://www.voxy.co.nz/business/5/316016
[2] http://www.voxy.co.nz/national/5/346800
[3] https://www.vector.co.nz/news/vector-changes-approach-to-loss-rental-rebates
[4] https://www.vector.co.nz/powerpayment?fbclid=IwAR1vuSaYvo0MnuNIK6NRoBk1jYyILI-7r-T-q0Wv0eQi2W6fRH4YhpLJI3w
[5] https://thespinoff.co.nz/the-bulletin/01-09-2018/no-its-not-a-scam-why-vector-is-sending-you-a-cheque-in-the-mail

- requires distributors to pass through settlement residual rebates in whole to consumers on their networks.

It seems the Authority's initial view is that the latter of those options is preferable. Meridian supports that initial view.

Proposed principles

Meridian generally supports the principles proposed by the Authority. Care should be taken to assess the options against the Authority's statutory objective. The principles may assist in that assessment; however, the principles must not take on a life of their own and be considered in isolation from the underlying statutory objective. While the principles seem focused on efficient grid use and investment, we note that settlement residual allocation methods may also give rise to long-term benefits to consumers in ways not seemingly contemplated by the principles, for example through increased retail competition.

Early thinking on options

Option A: TPM charges – allocated in proportion to total TPM charges

This option seems overly simplistic and there does not seem to be a strong rationale to ignore the matching of settlement residue to the connection or interconnection assets that gave rise to that settlement residue.

Meridian agrees with the Authority's initial view that this option would not perform very well compared to the potential benefits that a more targeted method could provide in offsetting volatility and returning revenue to the class of customers who bear the cost of congestion.

Option B: Simple BB – uses regional allocators

This option would match the settlement residue to grid assets and allocate it to customers using TPM allocators for connection assets and in respect of interconnection assets using the simple benefit based approach.

Meridian agrees that Option B would perform better than a pro rata allocation like Option A because it would:

- return settlement residual rebates broadly to the parties who bear the cost of congestion in the long term;
- broadly match the settlement residue to the parties paying for the asset where the congestion occurs meaning a more effective partial offset against nodal transport charge volatility;
- support efficient grid use and investment decisions; and
- carry a very low risk of impacting nodal price signals given the regional aggregate approach in the simple method and allocation across a broad set of beneficiaries, meaning the ability of any one party to influence the size of its own rebate would be limited.

Option C: Full BB – uses proposed new TPM allocators based on all applicable methods

In theory, this option could perform even better than Option B. However, the increased precision would come with additional complexity and associated administrative cost, which Meridian considers unlikely to be justified.

Option D: WEM purchasers – based on wholesale energy purchase volumes

Option D would be administratively simple and would remove the need for further consideration of distributor pass through because distributors would never see rebates. Settlement residual rebates would be paid directly to wholesale purchasers that have effectively overpaid for energy purchases.

However, we acknowledge the downsides noted in the Authority's consultation paper.

Require distributors to pass settlement residual rebates to customers

Regardless of the methodology the Authority ultimately adopts to allocate settlement residual, Meridian considers it critical that distributors be required to pass through rebates to customers (retailers and network-connected large consumers).

Some distributors do this already, others do not trust retail competition to deliver long term benefits to end consumers and therefore develop ad hoc methods to ask retailers to add line items to an invoice once a year noting a rebate "paid by the distributor". Other distributors treat settlement residual as a discount on network charges to retailers. However, for some there is no transparency and settlement residuals are retained in whole or in part by the shareholders of the distribution company.

As the Authority states in the first line of its consultation paper: "The wholesale electricity market generates a surplus, called loss and constraint excess, as consumers pay more for electricity than generators receive." Settlement residual is a product of the wholesale market and should be retained by the wholesale market to ensure efficient outcomes and long term consumer benefit.

Distributors are not wholesale market participants. Wholesale purchasers include large industrial direct purchasers and retailers on behalf of their customers. For direct purchasers, settlement residual rebates are a direct benefit to offset energy costs. For retailers serving mass market consumers, receiving settlement residual rebates by default and through an efficient, standardised process would help to defray nodal price risk (particularly in places where FTRs are not available) and reduce cost to serve, increasing retail competition and benefiting consumers in the long term. The process of competition in the retail market would mean that, in the long term, wholesale energy purchase cost reductions would be factored into the retail price offerings of each retailer. Such passthrough would be necessary for a retailer to compete effectively and retain its customer base.

Monopoly distribution companies do not face the same competitive pressures as retailers and therefore the issue of whether settlement residual rebates are passed on to consumers is not likely to be resolved by market forces and would depend entirely on the choice of each distributor. Certainly, for distributors that are not wholly consumer owned, there is nothing preventing shareholders retaining settlement residual payments and to the extent that occurs, consumers will suffer a loss.

Meridian therefore strongly supports the Authority's initial view that distributors should pass settlement residual rebates through to their customers each month, using distribution charges as an allocator. A simple mechanism might be to require distributors to bake rebates into their distribution charges, which retailers tend to pass through to customers as a matter of course. Regardless of the precise method eventually codified, one way or another Meridian would ensure customers receive the benefit of rebates.

As well as the consumer benefits likely to result in the long term, Meridian also sees a Code change along the lines proposed as a means to deliver standardisation and associated efficiencies relative to the current ad hoc distributor practices which retailers are required to manage. Again, consumers will benefit from this increased efficiency.

Meridian therefore broadly agrees that an appropriate Code amendment would likely require three things:

1. that Transpower calculate rebates using a prescribed method;
2. that Transpower rebate that amount to each of its transmission customers; and
3. that distributors then rebate those sums to network customers (i.e. retailers and directly connected consumers) using distribution charges as an allocator.

Finally, we note that the Authority could deliver increased benefits to consumers by progressing the Code change to require distributor pass through ahead of the TPM reforms.

Please contact me if you have any queries regarding this submission.

Yours sincerely

Sam Fleming
Manager Regulatory and Government Relations