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Your consumer-owned electricity distributor

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Submissions

Electricity Authority

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

Network Tasman Submission to the Electricity Authority on Settlement Residual Allocation Methodology

Network Tasman appreciates the opportunity to submit to the Electricity Authority's consultation on the Settlement Residual Allocation Methodology (SRAM).

Our submission addresses a number of topics raised in the consultation paper. Key points raised in our submission are summarised below:

- It is not clear why the Authority requires principles to guide its decision making on this issue. The Authority's statutory objective provides a clear framework for guiding decision making. The Authority provides no explanation for why the standard framework for Code amendments as set out in the Consultation Charter is insufficient for developing the SRAM.

- Network Tasman's concerns with using principles is that if they are poorly drafted, as we believe the current principles are, there is a risk that solutions that best meet the Authority's statutory objective may be excluded because they don't align with the specified principles.

- If the Authority is to continue with principles to guide the development of the SRAM, we suggest:
  - Proposed principle (c) be removed. Principle (c), to mitigate nodal price volatility, directly conflicts with principle (a), to protect the integrity of nodal prices. Volatility is inherent in nodal prices, to mitigate it via the SRAM would undermine the efficiency of the signals nodal prices were designed to deliver.
  - A new principle should be included that seeks to ensure the benefits to consumers are maximised. There is no mention of consumer benefit in the proposed principles, despite it being the central feature of the Authority's statutory objective. Ensuring any efficiency gains from the SRAM accrue to consumers should be a fundamental to any assessment of potential options.

- The SRAM should be simple, administratively low cost and easily understood. LCE rebates account for around 0.65% of the cost of delivered energy. According to Mercury's Code change request 81% of LCE (by value) is already passed on by distributors, the remaining 19% is stated to be 'retained'. Given these circumstances, the relative benefits of introducing a theoretically more efficient but complicated allocation methodology are likely to be limited when compared to a simple methodology.

- Mandating LCE pass-through will leave Network Tasman consumers worse off and will presumably do the same for other consumers. According to Mercury's Code change request, the vast majority (81%) of LCE payments are already passed on by distributors. Network Tasman is one of the distributors that 'retains' the remaining 19%. Network Tasman treats LCE revenue as direct offset to revenue that would otherwise need to be recovered from consumers via lines charges. This allows Network Tasman to set lower lines charges than would otherwise be the case. Should pass-through (via retailers) be mandated, Network Tasman would need to increase lines charges to recover the value of the lost LCE. This would leave Network Tasman consumers worse off.

The remainder of this submission expands on the points made above.

Proposed principles are narrow in scope and don't consider benefits to consumers

In the consultation paper, the Authority proposes a set of principles to guide the development of the SRAM. The Authority usually relies on its statutory objective to guide its decision making, as set out in the Authority's consultation charter.

It is not clear from the consultation document, why Authority's statutory objective is insufficient to guide the development of the SRAM and how the introduction of principles will assist the Authority to better achieve its statutory objective.

We don't have inherent concerns about the use of principles to guide regulatory decisions. However, we do have concerns about the use of principles in this instance because the proposed principles are limited in scope compared to the Authority's statutory objective. The proposed principles unnecessarily limit the range of potential options and may exclude options that don't align with the proposed principles but better achieve the Authority's statutory objective.

For example, the principles limit the scope of any assessment to maintaining efficient grid use and efficient grid investment. Both are important outcomes and are key to achieving the Authority's statutory objective. However, the principles do not capture potential effects on other sectors of the electricity industry, namely distribution and retail. Both the distribution and retail markets will be affected by the development of a SRAM. Under the proposed principles, the effect of the SRAM on the retail and distribution sectors would not be taken into account. Any analysis undertaken by the Authority should consider the effects of the SRAM on the entire electricity market.

Similarly, there is no reference to consumer benefit. This means that a SRAM could conceivably be introduced that creates little or no benefit to the consumers who ultimately fund the entire electricity sector.

There is also a conflict between principles (a) and (c). Principle (a) is to promote more efficient grid use, which the Authority considers to be critical. Principle (c) is to mitigate nodal price volatility by providing a partial offset to nodal price volatility.

When discussing principle (a) the Authority states:

> "The SRAM must be designed in such a way that it does not work against these nodal price signals. 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, 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)."[1]

Volatility is a fundamental characteristic of an efficient price, which sends an important signal about grid conditions and assists market participants to efficiently respond to those signals.

The Authority has spent considerable time and resources on the Real Time Pricing (RTP) project, the TPM project and various hedge market developments to ensure that nodal transport charges provide grid users with price signals that promote efficient grid use and investment and to ensure they are able to efficiently respond to those signals. If nodal prices are inefficiently volatile, this issue should be resolved via changes to the way nodal prices, the TPM and/or hedge markets operate. It is poor public policy to develop additional regulatory solutions to problems created by other existing regulation.

If the Authority is to persist with the use of principles to guide its development of the SRAM, Network Tasman submits that it should:

- delete the principle (c), tasked with mitigating nodal price volatility;
- broaden the scope of principles (a) and (b) to promote more efficient outcomes across the electricity market; and
- add a new principle that aims to ensure the SRAM is developed in a way that maximises the long term benefits to consumers.

As the incremental benefits of the SRAM are relatively small, a simple methodology should be developed

The Authority's paper shows LCE rebates have been between 5% to 10% of annual transmission costs over the past seven years, 6.5% on average. However, as transmission charges only account for approximately 10% of delivered energy costs, LCE rebates have accounted for only 0.65% of delivered energy costs. Irrespective of the allocation approach adopted by the Authority, the incremental impact on consumers will be minimal, especially given distributors already pass on over 80% of LCE rebates. These circumstances would favour applying a methodology for allocating LCE that is administratively simple to administer and easily understood.

In this respect, Network Tasman submits that the allocation of LCE in proportion to total transmission charges (Option 1) is the most appropriate methodology for the SRAM.

The vast majority of LCE is already passed through by distributors

The final section of the consultation paper discusses the Authority's initial view that distributors should be mandated to pass LCE through to wholesale purchasers of electricity (retailers and large users).

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.

As 81% of LCE rebates are already passed through by distributors, the incremental benefit from regulating how those rebates are passed on is likely to be small. There may be some benefit from adopting an efficient and consistent pass-through methodology, but it is unlikely to be of sufficient magnitude to justify regulatory intervention.

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.

[1] Electricity Authority, *Settlement Residual Allocation Methodology: principles, option and pass-through – Consultation* Paper, 18 January 2022, pp 10-11, para 3.5

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Mandated LCE pass-through will leave Network Tasman's consumers worse off

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.

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).

Mandated pass-through is also likely to leave consumers on other distribution networks worse off

Network Tasman represents just one of the 12 distributors stated to retain LCE. Whether the other 11 treat LCE in a similar manner to Network Tasman is unclear. However, looking at the characteristics of the distributors that retain LCE rebates, it is likely that the majority of consumers will benefit from these distributors retaining LCE rebates.

Of the remaining 11 distributors, nine are fully consumer owned, one is partially consumer owned and just one, Nelson Electricity, is privately owned.[2]

This distinction is important because the beneficiaries of consumer owned networks are the consumers connected to those same lines companies.

The benefits from consumer owned distributors retaining LCE rebates can accrue via a number of channels, such as lower lines charges, higher dividend payments or stronger balance sheets. All outcomes that ultimately benefit consumers. Mandating pass-through would eliminate these benefits and hand a proportion of them directly to retailers.

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.

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

Yours sincerely

Daniel Vincent
Regulatory and Commercial Manager

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[2] For full disclosure, Network Tasman is a 50% owner of Nelson Electricity.