27 September 2022

Dr Tim Sparks
Director, Network Pricing Directorate
Electricity Authority
By email to network.pricing@ea.govt.nz

Dear Tim

Consultation paper - settlement residual allocation methodology

1. This is a submission from the Major Electricity Users' Group (MEUG) on the Electricity Authority consultation paper "Settlement Residual Allocation Methodology" (SRAM) dated 16 August 2022 and supporting materials.[1]

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Members may lodge separate submissions.

3. In this submission we use the term loss and constraint excess surpluses ("LCE surpluses") interchangeably with "LCE rentals" and any references to "over-payments" by consumers.

SRAM should use TPM residual charges rather than the BBC simple methodology

4. Paragraph [2.1] of the consultation paper states:

   > "Nodal transport charges (the difference in nodal prices between market nodes) increase the amount paid by load and decrease the amount paid to generators and so in aggregate produce a surplus – the loss and constraint excess (LCE)."

5. Footnote 8 of the paper provides a more detailed explanation of how LCE surpluses arise in New Zealand's mandatory wholesale electricity market (WEM) using the market pricing principle known as "bid-based security-constrained economic dispatch with nodal prices".[2] Footnote 8 does not use the phrase "nodal transport charges" used at the start of paragraph [2.1]. In our view the phrase "nodal transport charges" is misleading by inferring LCE surpluses created in the WEM by over-payment by consumers are somehow linked to generators paying in part for transmission charges and hence justifies generators being allocated part of residual settlements in the proposed SRAM. MEUG disputes that logic.

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[1] Document URL https://www.ea.govt.nz/assets/dms-assets/30/Settlement-Residue-Allocation-Methodology-consultation-paper.pdf at https://www.ea.govt.nz/development/work-programme/pricing-cost-allocation/settlement-residual-allocation-methodology-sram/consultation/

[2] Refer https://en.wikipedia.org/wiki/New_Zealand_electricity_market.

6. In the “market” for transmission services, buyers comprise end consumers and generators, and the seller is Transpower. However, that is not the market that LCE rentals derive from. LCE rentals derive from the wholesale electricity market where the sellers are generators, and the buyers are consumers.

7. In the wholesale market generators are never under-paid because if dispatched they never receive less than their offer price. On the other hand, consumers do over-pay because of the physics, market design and economics of a monopoly transmission provider and the mandatory dispatch wholesale spot market design.

8. The LCE over-payment by consumers in the WEM is partly allocated for FTR, with the balance being the settlement residual. The SRAM should return the over-payment to consumers only.

9. If the EA decides to pass through some of the settlement residual to generators, then the direct rebate to consumers will be short. It is difficult to think of a scenario where generators would use settlement rental income to improve consumer welfare more than consumers would be able to choose for themselves how to spend that income.

10. If the EA decides to pass through some of the settlement residual to generators, then a generator setting the marginal dispatch price in the WEM would receive more revenue than that solely from their offer price to WEM because of the additional settlement residual income. That would be a fundamental distortion of the “bid-based security-constrained economic dispatch with nodal prices” market design.

11. There appears to be a consensus among participants and Transpower that the SRAM should not undermine nodal price signals in the WEM nor transmission prices (TPM) in the transmission services market.

12. MEUG agrees with paragraph [2.13] of the consultation paper:[3]

    > “To support efficient grid use, a party’s rebate should not be correlated with its use of the grid. If a party’s rebate is correlated with its use of the grid, this would create incentives for inefficient grid use decisions (essentially by dampening down the nodal price signal).”

13. The new TPM component that best fits the above are residual charges. That was an option previously considered by the Authority but dismissed in the current paper. As set out in this submission, MEUG disagrees BBC simple is an appropriate allocator for the settlement residual because over-payment by consumers in the WEM should be allocated back to consumers. Residual charges meet that criterion, whereas BBC simple charges does not.

14. MEUG therefore recommends the Authority adopt residual charges as the allocator for SRAM.

[3] Transpower, paragraph [12].

Distributors pass through of settlement residual

15. Paragraph 5.5 of the consultation paper states there was relatively widespread support for mandating pass-through by distributors and lists, in footnote 37, those submitters as Contact, Electric-Kiwi, ERANZ, Flick, Genesis, Mercury, Meridian, Nova and Transpower. Distributors did not support mandating pass-through and MEUG was circumspect and wanted more evidence before being able to take a view.

16. The consultation paper has not provided the evidence we need to support an amendment to the Code to require either a limited pass-through or full-pass-through obligation. Below are reasons why MEUG does not support a change from the status quo:

    - The consultation paper and submissions by other parties provide no evidence that distributors are allocating settlement residual income into unregulated (i.e., not regulated by Part 4 of the Commerce Act) businesses. If there is some uncertainty or evidence emerges that there is a problem, then the solution is for the Commerce Commission to change Part 4 disclosure requirements to improve transparency and or change relevant ex post regulatory requirements.

    - Distributors are subject to voluntary disclosure guidelines, by way of a Practice Note, for designing and implementing distribution charges.[4] On 20 September 2022 the EA published an open letter updating the Practice Note including transmission-charge pass through to accommodate the change in TPM effective 1 April 2023.[5] Transpower in August 2022 estimated transmission charges to distributors from 1 April 2023 to be around $600m for 2023-24.[6] There is uncertainty how the $600m of charges will be passed through. It is inconsistent for the Authority to maintain a light-handed guidance approach to the pass through of $600m of transmission charges but considers pass through of less than $100m of settlement residual requires immediate mandatory requirements.

Yours sincerely

Ralph Matthes
Executive Director

4 https://www.ea.govt.nz/development/work-programme/pricing-cost-allocation/distribution-pricing-review/
5 https://www.ea.govt.nz/operations/distribution/pricing/
6 https://www.transpower.co.nz/sites/default/files/uncontrolled_docs/TPM%20Indicative%20Prices%20August.pdf