1 MARCH 2022: SUBMISSION TO ELECTRICITY AUTHORITY REGARDING SETTLEMENT RESIDUAL ALLOCATION

Loss Rental Rebates should be given back to consumers

Entrust considers that Loss Rental Rebates (LRR) should be allocated entirely to consumers. Last year the total LRR was $80m but generators received over $11m of this. This money would be of substantial benefit to consumers and help ease financial pressures created by COVID.

Entrust is proud to be playing our part to help consumers.

The September 2021 Entrust dividend distribution was for $283 plus an extra $20 LRR. Customers on the northern network (outside the Entrust catchment) received LRRs via a credit to their power bill. To achieve this Vector makes equivalent payment to the customers' retailers and encourages them to pass on the rebate as a separate line item on their invoices.

Entrust does not support any change in allocation of LRR which would reduce or put at risk the guarantee of 100% pass-through to our trust beneficiaries and Auckland consumers.

Executive summary

- **The Authority's focus should be on returning LRR to consumers.**
- **Lines companies should be encouraged to pass LRR directly to consumers, as Vector does.**
- **It would be better to require transparent pass-through of LRR, than to mandate how this is done.**[1] Mandatory allocation to retailers would result in less surety the money would go to consumers.
- The transmission pricing methodology (TPM) doesn't need to be used to allocate LRR, but if it is **the residual charge should be used as the allocator**.[2]
- **Entrust does not support allocating any LRR to generators.** The benefit-based method would result in an unwarranted, extra $30m per annum, wealth transfer from consumers to generators.
- **The allocation of LRR should not be used to fix problems with the proposed new TPM.** The Authority's priority appears to have shifted from making sure LRR allocation doesn't distort nodal prices to trying to fix deficiencies in the TPM.

[1] The Code provisions should be agnostic whether pass-through is via direct payment or reduction in line charges etc.
[2] If the Authority uses a TPM benefit-based method it should allocate to load-only based on their relative benefits.

Entrust's submission

Entrust considers that LRR should be allocated entirely to consumers. Lines companies should continue to be able to pass LRR directly to consumers, as Vector is doing.

Entrust agrees with the Authority that LRRs arise because "Downstream nodal prices are generally higher than upstream nodal prices, due to transmission losses and congestion" and "These price differences mean consumers pay more for electricity than generators receive".

Electricity generators are already fully compensated for the electricity they generate. There should be no allocation of LRR to generators.

A requirement for lines companies to pass-through LRR to end-consumers in a transparent manner would help ensure 100% pass-through

The Authority has raised concern about the extent to which LRR is passed to end-consumers. Entrust considers that the best way to deal with these concerns is to require lines companies to pass LRR to consumers in a transparent manner, rather than adopt heavy-handed regulation mandating how this is done.

The Authority should be agnostic whether pass-through is via direct payment, reduction in line charges etc if it is done in a clear and transparent manner. This would help ensure 100% pass-through.

It would be consistent with distribution pricing regulation if there was a requirement to disclose the methodology (and mechanism) used to distribute LRR.

Mandatory allocation to retailers would result in less surety the money would go to consumers.

Mercury-Sapere claim allocation to retailers would result in 83% pass-through, but this amount is subject to assumptions about how competitive the electricity retail market is.[3] Sapere implausibly assumes, for example, that a monopolist retailer would pass-through 50% of the LRR.

It is notable Carl Hansen, on behalf of Meridian, criticised the Authority for assuming "a complete pass-through of lower wholesale prices to lower retail prices" and providing "no evidence … in support of it".[4] The same issue would arise in relation to LRR, and may be something worth considering as part of the review into retailer pass-through of network price reductions in 2020.

The residual can be used as the allocator for LRR

Using residual charges to allocate LRR would be the simplest TPM-based option.

The LCE Working Paper, Options Working Paper, 2nd Issues Paper and 3rd Issues Paper all included allocation using the residual as part of the Authority's preferred option.[5]

The Options Working Paper, for example, asked "whether it would be preferable to credit remaining LCE against only residual charges".

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[3] Sapere, Report prepared for Mercury NZ Limited, Loss and constraint rentals economic analysis of Mercury code change proposal, 26 March 2019.
[4] Carl Hansen, Report prepared for Meridian Energy Limited Report on the Electricity Authority's competition and price discrimination papers of 27 October 2021, 10 December 2021.
[5] For example, under the Options Working Paper the Authority's preferred option was to allocate on the basis of connection charges and the residual, and not benefit-based charges.

The Authority previously stated "the residual charge is specifically not intended to actively influence grid use and investment. It does not need to, because this is done by other elements of the TPM guidelines and existing arrangements, in particular nodal pricing".[6] Using the residual charge to allocate LRR would similarly ensure LRR doesn't influence grid use and investment.

The Authority raised the concern that "a customer that incurs a large TPM residual charge" could have "an inefficient marginal incentive … to oppose a grid upgrade which, by relieving congestion, would reduce its settlement residual rebate". This incentive would not arise if there were an explicit requirement for lines companies to pass on LRR to end-consumers in a transparent manner.

Entrust does not support options which allocate any LRR to generators

If the Authority decides to use a TPM benefit-based method, Entrust considers that it should be used to allocate to load-only based on their relative benefits and exclude generators.

The proposed allocation of LRR to generators would simply provide additional windfall gains at the expense of consumers. This would cost consumers $30m per annum, with their share of LRR going down from 86 to 48%.

In previous LRR allocation consultations, the Authority raised concerns about the impact of allocating LRR to generators e.g., "Generators would … take into account transmission charges in addition to all of the other inputs they currently take into account when developing their offers, and may have the incentive and ability to game the system by modifying their offers to take the treatment of LCE into account."[7]

Mercury has similarly expressed concern "some parties may have both the incentive and the ability to inefficiently "game" the spot market to alter the creation and allocation of LCE in order to reduce their transmission charges". Mercury advocated "Crediting remaining LCE against the remainder of the MAR" as this "will significantly reduce gaming risk". The Mercury recommendation is equivalent to using residual charges to allocate LRR (crediting against MAR simply reduces residual charges).[8]

The Authority should rule out policy which would exacerbate market power problems with additional windfalls and wealth transfers

The Authority has done a good job of identifying large scale over-pricing in the wholesale market, particularly due to Meridian's market power. The Authority proposal would add an additional $30m to generators on top of the $850m per annum of over-pricing the Authority found was caused by the arrangements Meridian and Contact have with Tiwai.

Allocation using the benefit-based method appears to be inconsistent with the Authority's decisions on transmission pricing

Allocation of LRR using a benefit-based method would effectively water down the TPM benefit-based charges and mean they would not recover the full cost of "benefit-based investments". This could undermine the policy intent that the Authority has prescribed in the TPM Guidelines and the purported benefits from application of benefit-based charges.

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[6] Electricity Authority, Transmission pricing methodology 2020 Guidelines and process for development of a proposed TPM, Decision, 10 June 2020.
[7] Electricity Authority, Transmission pricing methodology: Use of LCE to offset transmission charges Working paper 21 January 2014.
[8] Mighty River Power, Working Paper - Use of LCE to offset transmission charges, 4 March 2014.

LRR allocation does not need to "influenc[e] incentives for grid use and investment". This is the role of the proposed new benefit-based charges combined with nodal pricing.

The LRR allocation proposal appears to be intended to try to fix issues with the proposed new TPM, including the absence of an "exacerbator-pays" or congestion charge.

For example, the Authority has stated "The SRAM should be designed in such a way that it supports the long-term signal for efficient grid use and investment decisions" and "grid user whose expected use of the grid is – and so its benefit-based charges are – low, but whose use of the grid increases rapidly and unexpectedly, and as a result, the grid must be upgraded … should expect to pay higher transmission charges relating to that grid upgrade". This is the role of an "exacerbator-pays" or a congestion charge which the Authority has rejected.

Allocation of LRR should be used exclusively to deal with the LRR over-payment problem and not TPM problems.

Recommendations

Entrust **recommends** the Authority:

- adopt an LRR allocation method which returns LRR to consumers in the least distortionary way;
- does not allocate any LRR to generators;
- does not use LRR allocation to fix problems with the proposed new TPM;
- does not foreclose options, such as lines companies directly passing through LRR to consumers, which guarantee consumers receive the money;
- use the residual charge as the allocator, if a TPM-based method is used;[9] and
- consider requiring lines companies to pass-through the LRR to end-consumers in a transparent manner, and to disclose the methodology (and mechanism) used to distribute LRR.

Concluding remarks

LRR arises because consumers pay more for electricity than required to compensate generators for the electricity they generate. The focus should be on the least distortionary mechanism for ensuring the money is returned to consumers.

Giving any LRR allocation to generators exacerbates this problem. Giving LRR to generators would also exacerbate the spot market over-pricing the Authority has identified in its sound wholesale market review.

Entrust would support using residual charges as the allocator and a requirement for lines companies to pass-through LRR to end-consumers in a transparent manner.

The Authority should be careful not to foreclose options, such as lines companies directly passing through LRR to consumers, which guarantee consumers receive the money.

[9] If the Authority wants to use a TPM benefit-based method as the allocator it should allocate to load-only based on their relative benefits.

Entrust ensured 100% of customers in the trust-area can access the LRR. On the northern network, where Vector relies on retailers to pass-through the LRR to end-consumers, our understanding is one of the major incumbent retailers has not deducted the LRR from their customer bills. Our understanding is that the other incumbent retailers and main independent retailers pass it through as a separate line item, as requested by Vector.

Entrust is conscious Kiwis are struggling with the impact of COVID19 on incomes and stressed budgets, and can ill afford a loss of LRR, including the potential $30m wealth transfer to generators.

Kind Regards,

Alastair Bell
Chair of Regulation and Policy Sub-committee