From the Electricity Networks Association

Submission on Transmission Pricing Methodology: Use of LCE to offset transmission charges

4 March 2014

The Electricity Networks Association makes this submission along with the explicit support of its members listed below.

Alpine Energy Ltd
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Buller Electricity Ltd
Centralines Ltd
Counties Power Ltd
Eastland Network Ltd
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EA Networks Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
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1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission on the Electricity Authority's (Authority's) working paper "Transmission Pricing Methodology: Use of LCE to offset transmission charges" (LCE paper).

2. The ENA represents the 29 electricity network businesses (ENBs) in New Zealand.

1.1 Summary

3. The Authority has released the LCE paper in response to submissions it received on its Transmission Pricing Methodology (TPM) issues paper.[1] The Authority notes that submitters expressed concern that, by allocating LCEs to individual assets, the proposed TPM would create inefficiencies in the nodal price signals, and create the potential for gaming.

4. The ENA supports in principle the proposed use of residual LCEs to offset against transmission charges (both the interconnection and connection charges). The ENA reiterates the comments we made in relation to the October TPM Issues Paper that we would not support a proposal "that aims to off-set the LCEs to the assets and participants that generated them, as this approach would negate (or at the least reduce) the otherwise efficient wholesale market signals related to losses and congestion" and that "The most straightforward approach to this off-set would be to deduct the residual LCEs from Transpower's overall annual revenue requirement, prior to setting the level of the IC and connection charges. Unless the Authority is able to demonstrate there is a more efficient off-set mechanism we recommend this straightforward approach." This is equivalent to option 1 in the LCE Paper.

5. However, the ENA considers that more analysis of the implementation and ongoing administration costs of deducting the LCEs from the MAR rather than rebating LCEs *ex post* (as per the status quo) is needed. The results of this analysis may indicate that there is no net benefit to moving away from the status quo.

6. We provide more detailed comment on these points in the body of our submission.

7. The ENA's contact person for this submission is:

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1 Electricity Authority, *Transmission Pricing Methodology: issues and proposal*, 10 October 2012.

2. Comments

8. The Authority has indicated that its preferred option is crediting LCEs to individual connection assets and the residual against the remainder of Transpower's Maximum Allowable Revenue (MAR). The ENA considers that this option is likely to have significant practical implementation and administration issues, and that the Authority has neither investigated these costs nor identified the source of any efficiency benefits from a change.

9. The ENA considers that if the LCEs are deducted from the MAR this should be done at an aggregate level to reduce the implementation and administration costs. However, the ENA's view is that the Authority has not yet made a sufficiently strong case for a change from the status quo as neither the costs of change nor the level of benefits are well-defined. Retaining the status quo would avoid change costs and more complicated ongoing administration, and it would retain flexibility around the future use of LCEs (in particular allocation to customers with customer investment contracts or other providers) which may be limited if the LCEs are deducted from the MAR. The ENA's view is that unless a MAR approach to allocating LCEs is better at managing the volatility of the LCEs in the context of overall transmission charges, or provides significant improvement in the transparency of LCE to end-users, the status quo should be retained. A more rigorous assessment of the options and their implementation issues is required.

2.1 Assessment of options

10. The LCE paper lacks a clear framework against which to test the options. The result is a limited intra-option comparison against some qualitative and incomplete criteria. In particular:

(a) No consideration is given to the cost of implementing any of the options. This is discussed further with respect to option 2 and 3 in particular in the next section. It is probable that implementation and ongoing administration costs will determine the best approach in this instance.

(b) The counterfactual is not well specified. The correct counterfactual is the status quo, which is rebating direct to transmission customers based on asset class pools. To the extent that a counterfactual is implied it is the proposal from the October TPM Issues Paper.

11. The extent to which there are issues with the current methodology is not established in either this paper or the October TPM Issues Paper. We note that the section relating to LCEs in the October TPM Issues Paper was headed 'Proposal to codify current arrangements…' (Section 5.3). Neither this section nor the current LCE paper clearly sets out the scope or scale of any inefficiency associated with the current method. There is then a lack of analysis of the improvement in efficiency (net of implementation costs) that is expected from any of the options proposed compared to the status quo.

12. We infer from the commentary in the LCE paper that there are some concerns regarding cross-subsidies between assets which generate the LCEs and those that

benefit from the rebate. The LCE paper states the key disadvantage of option 1 (pooling LCEs over all assets) is that "LCE originating from particular assets would not necessarily offset the charges for those assets directly" (paragraph 8.6). This is in fact a restatement of submitters' key *objection* to the proposal in the October TPM Issues Paper that apportioning LCEs to individual assets would offset the transmission charges in a way that undermines nodal price signals relating to losses and congestion. The ENA considers that this characteristic of option 1 is therefore an advantage, not a disadvantage as the Authority implies.

13. We also note that the Authority has described the various methods to allocate LCEs as a "market based approach" and thereby accords it a higher status in its economic and decision making framework. The ENA considers that this is a misunderstanding of either the framework or the manner in which LCEs are allocated. Although the LCEs arise from the application of the wholesale market model (SPD), the manner in which the LCEs are estimated and allocated to counterparties is an administrative process conducted by Transpower. The fact that there is consultation on the best manner in which to make this allocation illustrates this administrative, and non-market, reality.

2.2 Implementation

14. The ENA's view is that inadequate consideration has been given to the implementation costs of changing the LCE allocation and rebating process and the ongoing administration costs of the proposed changes. The ENA observes that any efficiency gain would need to be material in order to offset the likely implementation and ongoing administration costs associated with changing the rebating process from the status quo to one which includes adjustments to Transpower's MAR. Such costs are likely to be particularly high for options 2 and 3 where the allocations would be to individual connection assets and to other asset classes.

2.2.1 Including LCE in MAR

15. One of the touchstones that the ENA considers the Authority should adopt for the TPM is that it should generate steady and predictable transmission prices. Including LCEs in the MAR would likely require forecasting LCEs for the annual MAR calculation (although it may be possible to use other approaches such as to deduct LCEs with a one year lag). In options 2 and 3 any forecasting would need to occur at an asset level and any such forecasting is likely to be problematic given the volatility of LCEs and the lack of any structural relationship. In our view, one important test as to how LCEs are rebated is to identify which approach best manages the volatility inherent in the amount of LCEs year on year.

16. A second touchstone that the ENA considers important in the development of the TPM is that it does not interfere with Transpower's ability to earn its MAR as set by the Commerce Commission. Including LCEs in the MAR is likely to complicate the forecasting of MAR (depending on how the LCEs are included). Deducting LCEs from the MAR may require changes to the Commerce Commission regime and such changes tend to be time consuming and costly and would need to be weighed against any benefit to Transpower, market participants or consumers from changing the current approach.

17. Changing the process of rebating the LCEs to customers may also require changes to the Benchmark Agreement which specifies that LCEs are shared *ex post* through the issuing of a credit note in the following month. Amending the Benchmark Agreement is a non-trivial task that must be done in accordance with the requirements of the Code. This does not appear to have been considered by the Authority.

2.2.2 Individualising connection asset LCE payments

18. It is not clear whether the Authority has worked through all the implications of individualising the allocation of LCEs to connection assets. The Transpower booklet "Transmission Rentals (Losses and Constraints Excess Payments)" (March 2008) sets out the way in which transmission losses are modelled across transformers (including connection assets). This shows that, depending on the relative level of average and marginal losses, the LCEs across a transformer may be either positive or negative, with the latter occurring at low power flows. If LCEs were to be applied on an asset by asset basis, a negative value would require the relevant transmission customer to pay a surcharge for this modelling anomaly. The more granular the application of LCEs to assets the more this anomaly would be an issue.

19. Thus individualising LCEs to assets may, in effect, result in an additional connection charge to some transmission customers, because of the way the losses are *modelled*. It is not clear how this outcome would be implemented, particularly for newer connection assets that are subject to an individual Customer Investment Contract (CIC). One could imagine that the contracts may require renegotiation, which would be a costly exercise.

20. The ENA recommends that allocation of LCEs to individual assets not be considered further unless the Authority can demonstrate that there is a significant efficiency gain that would outweigh these implementation and ongoing administration costs.