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Carl Hansen

Electricity Authority

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By email: submissions@ea.govt.nz

Dear Carl

Use of LCE to offset transmission charges

Genesis Energy Limited welcomes the opportunity to provide a submission to the Electricity Authority ("the Authority") on the working paper "Transmission Pricing Methodology: Use of LCE to offset transmission charges" dated 21 January 2014 ("LCE working paper").

Importance of maintaining signals via the FTR market

Genesis Energy is a strong supporter of an effective Financial Transmission Rights (FTR) market. We agree with Hogan's point, summarised in the consultation paper, that the "economically efficient treatment of loss and constraint excess (LCE) is to use LCE to fund the holders of transmission rights".[1] In this regard, it is essential that any diversion of LCE to offset transmission charges does not impact on the operation of the current or future FTR market.

We appreciate that the expansion of the FTR market to new nodes will likely "mean an increase in the amount of LCE that is first allocated to fund the FTR market".[2] We suggest this means that for any TPM proposal that offsets LCE against transmission charges, it must be clear that:

[1] Paragraph 4.7 of the consultation paper.

[2] Paragraph 4.11 of the consultation paper.

- only residual LCE will be diverted. The FTR market (current and future) will be the primary method by which LCE will be returned to the market; and

- the incorporation of LCE into the TPM will still enable the development of the FTR market, without any need to change the TPM itself. This includes the potential use of most or all of the LCE to fund future FTR products (if necessary).

Recommended approach to evaluating LCE options

Genesis Energy has concerns with the Authority's approach to evaluating the options for using the LCE to offset transmission charges.

The Authority has selected five qualitative criteria and used these to evaluate the four options and determine its preferred option.[3] We are concerned that these criteria have been tailored too specifically towards this component of the proposed TPM, are unduly weighted towards addressing criticisms of the October 2012 TPM proposal, and are therefore not consistent with the criteria used for assessing other components of the proposed TPM. For example:

Table 1: Comparison of assessment criteria for LCE options and beneficiaries-pays options

Allocating LCE	Beneficiaries-pays charge[4]
• allocation method	• prices reflect benefit of investment
• accuracy of allocation once residual LCE is taken into account	• extent of application of beneficiaries-pay
• distortion to costs to be recovered for transmission assets	• recovery of costs of reliability investments
• muting of short-term price signals	• simplicity
• potential for gaming	• avoid altering use of the grid
	• incentives for evolution of more efficient charging over time

[3] Paragraph 8.20 and Table 3 of the consultation paper.

[4] Table 1, *Transmission pricing methodology review: Beneficiaries-pay options*, Electricity Authority working paper, 21 January 2014.

	• costs involved in implementing option • incremental participation costs • other costs

We encourage the Authority to adopt a more consistent set of criteria for qualitatively evaluating each element of the proposed TPM, as the Authority develops the second issues paper outlining the revised TPM proposal. We refer the Authority to Castalia's analysis of the October 2012 TPM proposal, where they evaluated each component of the proposed TPM against five possible sources of efficiency:

1. providing efficient investment signals for load;
2. providing efficient investment signals for generation;
3. enabling efficient outcomes in the wholesale market;
4. enabling efficient outcomes in the retail market; and
5. ensuring efficient transmission investment.[5]

In our view, this approach provides a more robust assessment framework that considers the impact of each component across all aspects of the electricity market. It also provides a clearer framework for quantifying benefits (where possible) and developing the cost-benefit analysis of the revised TPM proposal (notably facilitating a bottom-up approach to assessing costs and benefits).[6]

Genesis Energy's view on the proposed options

We acknowledge the additional work the Authority has undertaken to address submitters' concerns with the possible muting of nodal price signals and the gaming risk that may arise via the use of the LCE for offsetting transmission charges. Understanding these risks and the potential impact on efficiency has

[5] *Review of the Electricity Authority's Cost Benefit Analysis of the Proposed Transmission Pricing Methodology*, Castalia Strategic Advisors report to Genesis Energy, 25 February 2013. Our straw man suggested that the LCE be aggregated annually and offset against the following year's MAR.

[6] As endorsed through Genesis Energy's submission to the Electricity Authority on the Cost-benefit analysis TPM working paper (15 October 2013).

enabled the Authority to develop three options that we consider are an improvement upon the October 2012 TPM proposal.

We have the following comments on the Authority's proposed options:

- <u>Option one</u>: Genesis Energy supports option one that proposes to credit LCE against the maximum allowable revenue (MAR) in bulk. This is the option we advocated for as part our straw-man for a revised TPM proposal.[7]

  We consider that this option reduces the volatility of the TPM charge, is simpler than offsetting against individual assets, and addresses the concern that offsetting LCE against specific assets will negate the efficient wholesale market signals.

- <u>Option two</u>: Genesis Energy is comfortable with option two as it is essentially a variation of option one, and is again a simpler option to implement (than October 2012 proposed TPM). However, we would want to review the Authority's upcoming working paper on connection charges before we could fully support this option.

- <u>Option three</u>: We do not support this option. We consider that this option is overly complex. We prefer a simpler methodology that is easy to implement and understand. We are also concerned that Option 3 may establish an alternative price signal for beneficiaries of the HVDC. In our view, such an alternative price signal risks undermining the effectiveness of this existing FTR market.

The Authority has noted that "a long averaging period to calculate the distribution of LCE to assets or asset classes goes some way to diminishing the identified risks" of gaming.[8] We support aggregating the LCE over a longer period as we consider that this will address many participants concerns with the volatility of the proposed TPM charge. We encourage the Authority to ensure that it aligns any averaging approach for LCE with any other averaging approaches that may be applied to other components of a revised TPM proposal.

Approach going forward

Genesis Energy recommends that the Authority take both options one and two through to the development stage of a revised TPM proposal. Both options

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[7] *Cross submissions on Proposed TPM issues and guidance paper*, Genesis Energy cross-submission to the Electricity Authority, 28 March 2013.

[8] Paragraph 8.25 of the consultation paper.

appear to have merit that should be robustly assessed against the criteria we have suggested above.

If you would like to discuss any of these matters further, please contact me on 04 495 6354.

Yours sincerely

Karen Collins
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