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Retailers and customer representatives

Emailed

CC: Electricity Networks Association and Electricity Authority



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Dear retailers and customer representatives

Response to TPM notification feedback

Thank you to those who have provided feedback to our Distribution Pricing consultation. We will use this feedback to develop our future distribution pricing structures which we plan to apply from April 2024. As highlighted in the consultation documents, we have more thinking to do on prices for large commercial customers. We expect to consult again on more detailed structures in 2023. We will be responding directly to feedback relating to distribution prices once our prices for the upcoming pricing year are released.

Two submissions included comments on our notification of how we will calculate Transmission prices for the year starting 1 April 2023. Specifically, one commented that the cost allocation methodology used to allocate Transmission Residual costs was incorrect and another said that using an Anytime Maximum Demand (**AMD**) cost driver could be more appropriate.

This note outlines why energy used (**GWH**) was selected as the cost allocator for Residual costs and why this aligns with the Transmission Pricing Methodology (**TPM**) and the Electricity Authority (**EA**) Pricing Principles.

We based our allocation methodology on guidelines developed by the Electricity Network Association (**ENA**). The ENA's guidelines were developed using the EA's Distribution Pricing Practice Note¹, which provides specific guidance on how to apply the TPM to Distribution Prices. The EA's expectations are:

- fixed Transmission charges, which are not intended to influence customers' network use decisions, should be passed through as fixed (daily) distribution charges.

¹ <https://www.ea.govt.nz/assets/dms-assets/30/Distribution-Pricing-Practice-Note-v-2.2-October-2022.pdf>

- Transmission charges intended to send price signals that influence network use should be passed through as distribution charges that send the same price signal (and influence network use in the same way) as the Transmission charge.

Then Transmission costs allocated to Wellington Electricity are all fixed so the cost allocation methodology focuses on prices that will not influence a customer's energy behaviours.

The Distribution Pricing Practice Note also provided practical guidance about the application methodology. The ENA's guidelines summarise this guidance in two principles:

- Principle 1—distributors should not attempt a detailed replication of the allocation approach used in the TPM. Rather the allocation approach should be consistent with and have regard for the allocation approaches adopted by the TPM. In practice, this can be achieved by adopting the same underlying allocation drivers of demand (AMD) or usage (kWh) share.
- Principle 2—the pricing structures for the recovery of Transmission costs should reflect the non-distortionary principle (prices should not influence the ongoing use of the grid) implicit in the fixed charge adopted by Transpower.

We used these two principles to select the cost drivers used to allocated Transmission costs to each customer group. Our pricing paper provided the allocation methodology and the cost drivers used. Specifically, we selected energy used (GWH) to allocated Residual costs because:

- **It is consistent with the TPM allocation approach (principle 1):** Consistent with the guidance provided by the EA and the ENA, we have used an allocation approach that has regard to the TPM, rather than replicating it. We have used a simple single cost allocator and a one year's historic data set to simplify the allocation calculation.

The TPM uses both AMD (for the initial cost allocation) and GWH (to annually update the cost allocation). As provided by the ENA pricing guidelines, it is therefore appropriate that distributors use either approach when allocating Residual charges to pricing groups.

- **It meets the non-distortionary principle (principle 2):** Costs are allocated to the customer groups using historic energy used. A single customer cannot materially impact the proportion of total Transmission cost allocated to a customer group by changing how they consume electricity. The EA's Distribution Pricing Practice Note provides that GWH is the best cost driver for ensuring customers cannot influence the ongoing use of the grid (paragraph 4.40).
- **The GWH cost driver is transparent, readily available and is an accurate data source:** Historical electricity use is disclosed publicly as part of our Annual Compliance Statement Disclosures. The electricity used data is externally audited and certified by our directors before it is disclosed on our website and provided to the Commerce Commission.

An alternative approach could be to use historic AMD as the allocation cost driver – as highlighted above, the TPM used both AMD and GWH to allocate Residual costs so either would be a viable choice. Both drivers would also meet the non-distortionary principle. We have selected energy used as the best cost driver because it is less distortionary than using AMD (as per the Distribution Pricing Practice Note).

Wellington Electricity also does not have a reliable data source of AMD data. Connected capacity can be used as a proxy for AMD (like we have used for allocating the Transmission Connection Charges), but the data source is not as good as GWH data. We have also chosen to use electricity used because GWH data is already collected, externally audited and disclosed as part of our regulatory obligations.

Responding to specific customer comments

1. Feedback suggested that Residual costs should be allocated using the two-step approach used in the TPM – the TPM allocates Residual charges firstly by historical AMD and secondly by four years of lagged historic kWh. The feedback said that the two-step method better reflects the intent of the TPM. Feedback also said that our pricing paper did not provide the reason for selecting kWh as the cost driver. Similar feedback asked that we review the Residual cost allocation methodology to ensure that GWH is the most appropriate driver.

Our response: As outlined above, the Authorities guidance for Distribution networks applying Transmission costs is that the TPM allocation does not have to be mimicked or replicated. As highlighted in 4.35 of the Distribution Pricing Practice Note, the case of mimicking Transmission charges is not strong, and priority should be given to ensuring the allocation methods don't inadvertently create incentives for customers to alter their usage of built grid assets. The ENA's Pricing Guidance provides a useful summary of simplified cost allocation methods which reflect the TPM (without complex replication) and are non-distortionary.

We have selected GWH from the two viable cost allocators (GWH or AMD) as the cost driver is more 'fixed like' than the alternative AMD driver. The EA's Distribution Pricing Practice Note (4.40) also provides guidance about how "fixed like" cost drivers are – providing an order of merit in terms of how non-distortionary a driver is. GWH or energy used is deemed the best because it's unlikely that a customer can influence usage between customer groups. kW or peak demand measures are not as good because customers are more easily able to change when they use electricity and influence usage between customer groups. While using connected capacity as a proxy for AMD will help reduce the ability for a customer to influence

cost allocations, customers still have some ability to reducing peak demand use by down grading their connection size.

Another reason for selecting GWH from the two viable cost allocators (GWH or AMD) is because the regulatory framework provides a publicly disclosed and audited source of energy consumption.

2. Feedback suggested that Wellington Electricity could use connected capacity as a proxy for AMD for allocating residential costs – like we have done for allocating Connection Charges.

Our response: We agree that connected capacity does provide a good proxy for AMD. However, we have an even better data source of GWH consumption data. Where we have a choice of cost driver (like we have for Residual costs) we have selected the best underlying data source and a cost driver that is the most ‘fixed like’.

Thank you for those who have provided feedback. If you have any questions or there are aspects you would like to discuss, please don't hesitate to contact Scott Scrimgeour, Commercial and Regulatory Manager, at scott.scrimgeour@welectricity.co.nz .

Yours sincerely

Scott Scrimgeour

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