

AEMC Review: Differences between actual and forecast demand in network regulation

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Tariff pricing – current framework

- Focus on DNSPs since it is the DNSP who pass on the transmission charges and determine the structure of network prices faced by consumers.
- How they structure their annual network tariffs depends on:
 - The form of control mechanism applicable to them; and
 - the extent to which their tariffs take into account the distribution pricing principles in the NER
 - Additional application of side constraints
- NER requires AER to approve the DNSPs' annual network prices
- NSPs currently use actual demand volumes from previous year to determine tariffs in the forthcoming coming year.

Control mechanism implication for tariff pricing

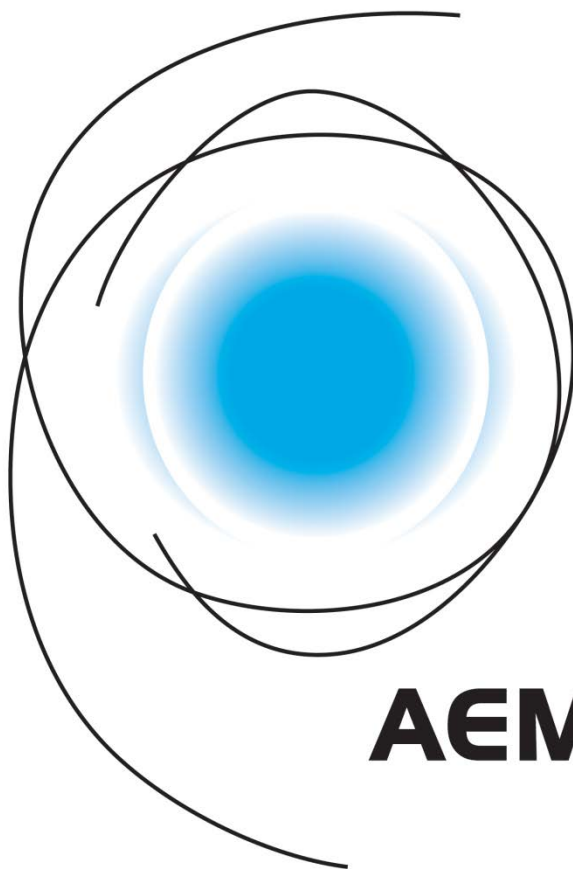
- If tariffs are not cost reflective (ie fixed and variable cost components are not proportionally recovered by fixed and variable charges), then changes in demand from that estimated may result in over or under recovery of costs,.
- Different impacts on DNSPs and consumers under revenue cap and price caps
- AER recently considered the impacts of these forms of controls in the NSW and ACT Framework and Approach Paper (June 2012)
- Revenue cap = consumers bear the volume risk as DNSP will adjust tariffs to recover allowed revenues irrespective of changing demand. This results in within period price instability and weak incentives for efficient tariff pricing
- WAPC = DNSP bears volume risk as revenue varies with the volume of sales. Provides sound theoretical basis for incentives for efficient tariff pricing. However, it also creates incentives to under forecast volume at time of determination and rebalance tariffs within period to manage profit risk.

Impact to consumers under WAPC

- AER cites Ausgrid and VIC DNSPs example in the Framework and Approach Paper:
 - Ausgrid reported \$8.3 million (real \$2010) revenue recovery above the forecast for the 2009–10
 - VIC DNSPs over-recovered \$568 million (real \$2010) in revenue above forecast during 2006-2010 regulatory period, representing an over recovery of revenue of above 8% annually for each DNSP.
- While WAPC adopted to provide incentives for efficient pricing, the ability to change or “rebalance” tariff structures can be used as a way of transferring volume risk onto consumers.
- Role of distribution and pricing principles and the network annual tariff setting process. **Power of Choice review recommendations:**
 - Changes to distribution pricing principles
 - more robust consultation and verification framework is applied to the annual network tariff setting process.
 - the AER be required to develop and publish a guideline for network tariff arrangements

Discussion questions

- What incentives and risks are created for efficient tariff structures from the choice of control mechanism?
- How much discretion should NSPs have in restructuring their network tariffs? Should DNSPs under a price cap be allowed to restructure their tariffs as means of managing volume risks?



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