

# LRMC and tariff classes

Workshop Two - Cost Reflective Network Pricing  
11 April 2014

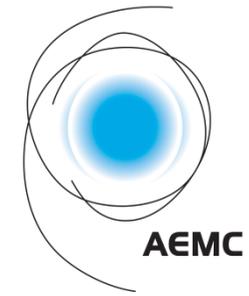


**Con Van Kemenade**  
Senior Economist  
AUSTRALIAN ENERGY MARKET COMMISSION

# Outline

---

- **Cost reflective network pricing**
  - Objectives
  - SCER proposals for LRMC
  - Implications and issues
- **Tariff class provisions**
  - Objectives
  - SCER proposals for tariff classes
  - Implications and issues



# Cost reflective network pricing



# Objectives of cost reflective network pricing

---

- **What are we trying to achieve?**
  - Network tariffs that promote efficient investment, operation and use of network services
- **What would such tariffs look like?**
  - 1) *send price signals to consumers about future costs of providing network services; and*
  - 2) *allow distributors to recover the costs already incurred in providing network services.*
- Signals about future costs allow consumers to balance the benefits of network services with costs. If consumers change consumption in response, the need for additional investment will be reduced.
- If distributors cannot recover their existing costs, then they will be not financially viable and won't attract the money for future investments.

# SCER proposal – Mandatory LRMC plus “have regard to” factors

---

- Rule request amends LRMC provision (stand alone/avoidable costs principle remains unchanged)
- LRMC as a basis for tariffs will be mandatory, having regard to:
  - Peak demand;
  - Geographic variation in LRMC
  - Transactions costs and consumer impacts;
- “Have regard to” factors condition how LRMC should be considered and implemented by DNSPs:
  1. They focus DNSP attention on peak demand and locational variation in costs; and
  2. Require DNSPs to take into account complexity and customer impacts.
- The proposed rule provides no further guidance:
  - leaves it open for AER to develop guideline.

# SCER proposal – Implications and issues (1)

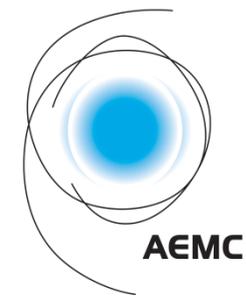
---

- The proposed rule provides flexibility for DNSPs to develop their own methodologies, and how to apply and implement them; however,
  - may also increase uncertainty for DNSPs eg about whether AER will approve methodology and/or tariffs chosen to reflect LRMC; and
  - may increase complexity and administrative burden for AER in assessing the compliance of multiple approaches with the rules.
- The alternative is to provide more guidance and/or prescription in the rules:
  - how prescriptive should any further guidance be?
  - eg single or multiple methodologies

# SCER proposal – Implications and issues (2)

---

- Benefits of greater prescription in the rules:
  - A single approach would provide uniformity and certainty; and
  - make it easier for AER to assess compliance and for retailers/customers to assess tariffs across different DNSPs
- Disadvantages of greater prescription:
  - Application of sophisticated methodologies in its infancy;
  - it may take a long time for agreement to be reached on suitable methodology; and
  - reduces scope for innovation (eg taking advantage of new techniques and approaches as they evolve)
- What is the best balance between prescription and flexibility?



# Tariff classes



# Objectives of tariff class provisions

---

- Purpose of the tariff class provisions is to group retail customers together on an economically efficient basis, while avoiding unnecessary transactions costs;
  - economic efficiency is not specifically defined however; further
  - DNSPs only need to “have regard” to economic efficiency in allocating customers to specific tariff classes;
  - in principle, this means they can constitute tariff classes on any other basis they deem appropriate.
- How do DNSPs constitute their tariff classes in practice?
  - some attention paid to economic efficiency (customers with similar network impacts or profiles grouped together); but
  - tariff classes provisions also used to address equity considerations (as required by jurisdictional policy).

# SCER proposal - Tariff classes

---

- SCER proposed to make tariff class provisions mandatory so that customers must
  - be grouped together on an “economically efficient basis”; and
  - unnecessary transaction costs must be avoided

# SCER proposal – Implications and issues

---

- The proposal seeks to make tariff classes consistent with pricing principles:
  - economic efficiency should be the basis for both tariff setting and grouping customers together for the purposes of applying tariffs;
- However, it raises two important issues that we will need to address in this consultation:
  - There is difference in language which may lead to misinterpretation (economic efficiency versus LRMC), consequently, should economic efficiency should be further defined to specifically refer to LRMC?
  - How should jurisdictional requirements be addressed, given a new mandatory requirement for tariff classes to be constituted on an economically efficient basis?