DNSP Perspective on Pricing Principles under Draft Rule

AEMC Public Forum on Draft Determination

Kelvin Gebert, Regulation and Network Strategy

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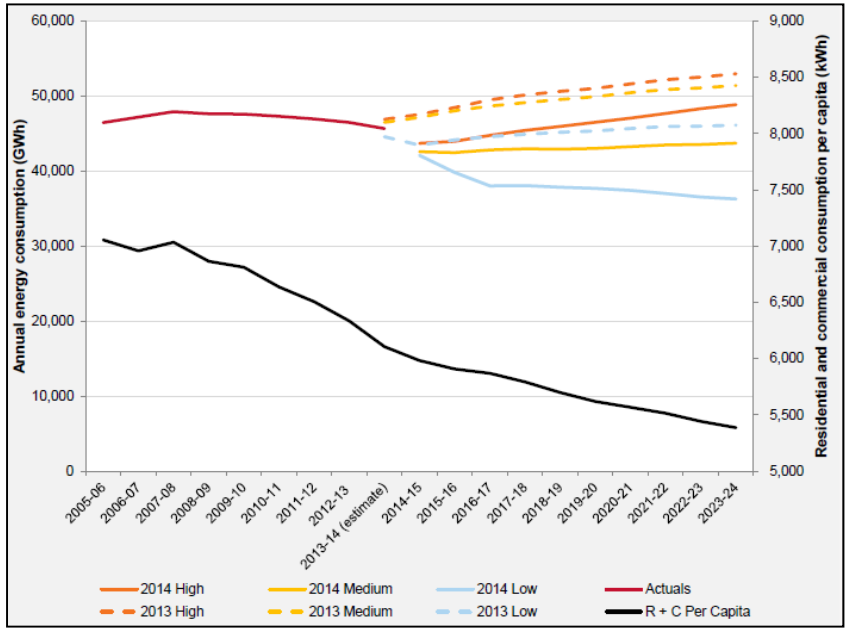
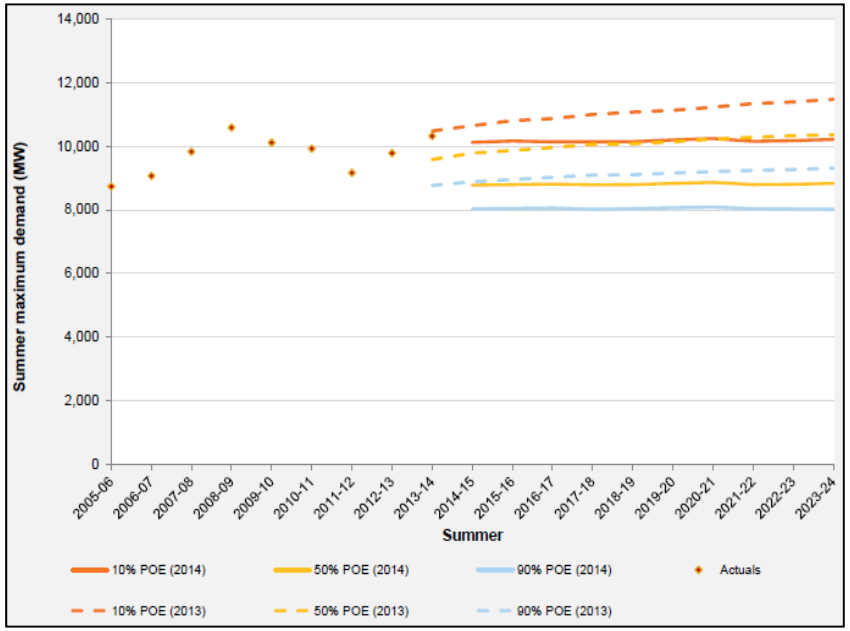
Some Observations

Vic Energy Forecasts

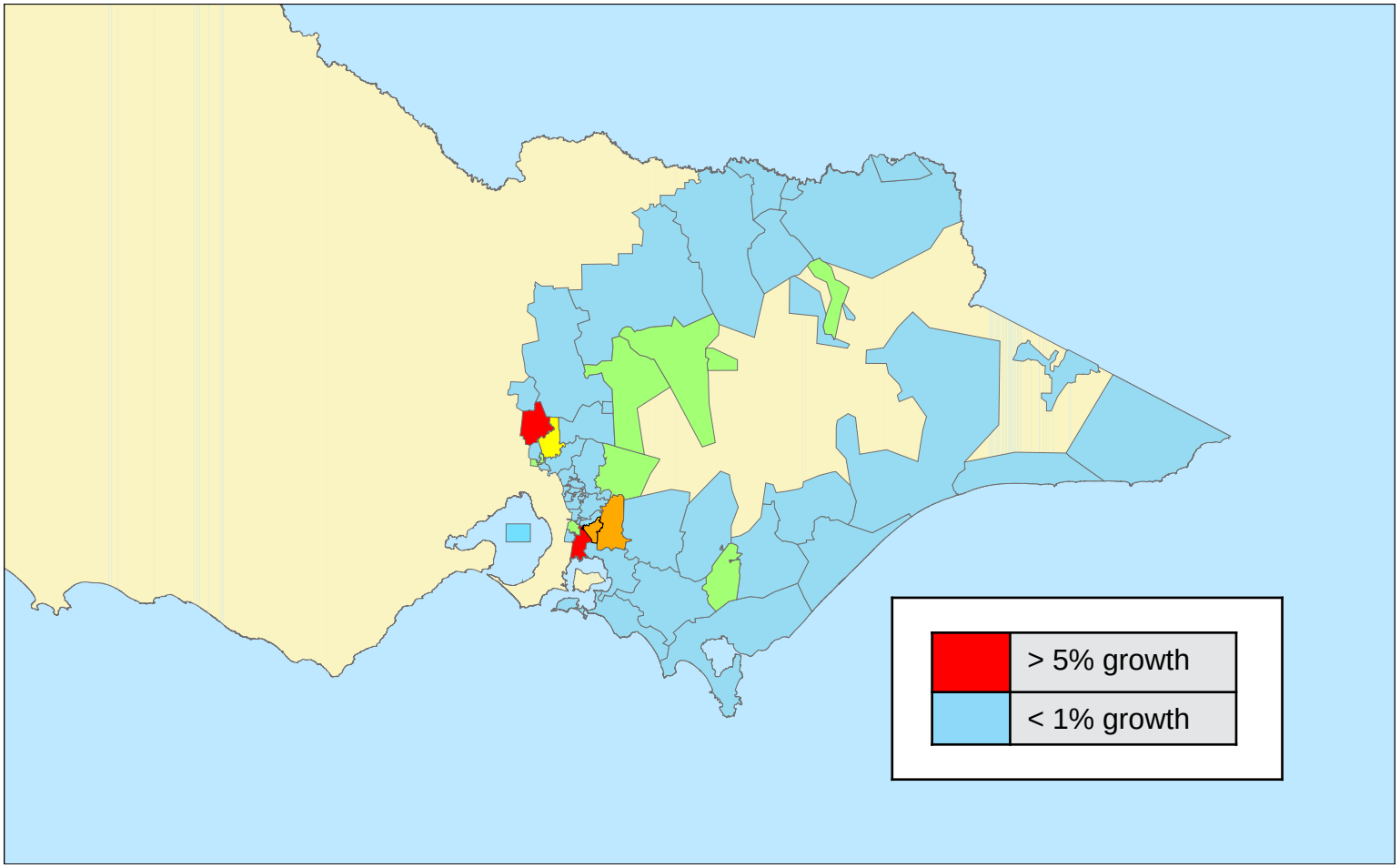


Vic Demand Forecasts



- **Trend is variable**
  - Population growth corridors maintaining demand growth
  - The AEMO forecasts are reflected in trends across established communities

Topographical Demand Growth



Objectives for Tariff Reform

In our view these are

- **Fairness**
  - Pricing arrangements do not equitably allocate costs on a ‘cost to serve’ basis
- **Dis-incentivise inefficient network bypass**
  - Cross-subsidisation leads to energy choice decisions which may be inefficient compared to network provided energy
    - And the network cost is not mitigated
- **There is a need to recognise efficient new technology solutions**
  - At the network fringe, stand-alone energy solutions may be more efficient
    - Networks should be able to optimise the service provided to customers
- **Pricing should align to an altering service paradigm**
  - The definition of customer cannot be stereo-typed as an energy ‘consumer’
    - The network may be better described as part of a customers energy solution
      - The attributes of network include supply security, stability and sharing
      - The value of these broader benefits needs to be captured in the service model
- **Retail tariffs should reflect DNSP pricing intentions**

Proposed Pricing Objective

- **Clause 6.18.5 (a)** (draft)
  - The network pricing objective is that the tariffs that a Distribution Network Service Provider charges in respect of its provision of direct control services to a retail customer should **reflect the Distribution Network Service Provider's efficient costs of providing those services** to the retail customer.
    - The AEMC describes the objective as having a cost reflectivity focus
    - 3 key components of cost reflectivity are identified by AEMC (see next slide)
      - which form the basis of the pricing principles
- **General Comment**
  - Guidance via an over-arching objective is supported
  - The components of cost reflectivity described help give it meaning
  - Translating this understanding to the proposed Pricing Principles is more challenging

Components of Cost Reflectivity

1. Sending efficient signals about **future network costs**
   - This is the LRMC component
     - Important in areas of the network with sustained growth
2. Allowing a DNSP to recover its regulated revenues so that it can recover its efficient **costs of building and maintaining the existing network**
   - The amount of revenue recovered from each tariff to reflect total efficient costs of providing services to the assigned customers
     - Allocates on basis of maintenance & safety investment as well as LRMC
     - An important cost allocation principle, helps overcome cross-subsidisation
3. Each consumer should pay for the **costs caused by its use of the network**
   - The AEMC identifies this with cross-subsidisation between tariff classes
     - We take this to support cost allocation relevant to
       - the customers chosen package of network services
       - geographic / demographic cost to serve
     - In our view, innovative pricing, such as a premium for network service insurance where customer is relatively energy self-sufficient would be consistent with this concept

Proposed Pricing Principles

- **Each tariff must be based on LRMC**
  - The network expansion driver is demand, hence LRMC logically expressed as $/kW
  - LRMC dependent on demand growth forecast, this is typically low
    - For much of the network LRMC makes a negligible contribution to the tariff
    - Method and approach in adopting LRMC will influence outcome
      - A uniform methodology and guidance would be preferable
  - Customers must be able to understand and respond to the LRMC pricing signal
    - It is not apparent that this condition can apply other than in Victoria
      - Dependence on interval metering
        - especially if customer understanding is a requirement
      - We query whether implementation in the short term is practicable
        - DNSPs required to base prices on LRMC from 2017
        - It is unclear how pricing structures will develop, how AER will determine conformance with the Rules and whether the outcomes will be acceptable to the jurisdiction

Proposed Pricing Principles

- **Revenue expected to be recovered from each tariff**
  - Must reflect efficient costs of serving assigned customers
    - Cost allocation geographic differentiated (consistent with LRMC implementation)
    - Distortion to LRMC signal to be minimized. Questions:
      - Using a demand component for recovery of residuals appears to be in conflict
      - As does use of an energy component, which is a proxy for demand
      - We conclude that a significant fixed component may be necessary

Brattle Paper
Table 23
"Introduce 3 Part Tariff, No Bill Change for Small Customers

			Charges:	Fixed	Demand	Variable
Tariff components				150 to 400	75.00	0.03
Units				$/year	$/kW/year	$/kWh
Customers (% of total)	Annual consumption (kWh)	Peak demand (kW)	Total annual bill ($)	Components of the bill ($)		
10%	3,000	4	542.31	150.00	300.00	92.31
30%	6,500	4	900.00	400.00	300.00	200.00
10%	10,000	4	1,007.69	400.00	300.00	307.69
10%	3,000	8	842.31	150.00	600.00	92.31
30%	6,500	8	1,200.00	400.00	600.00	200.00
10%	10,000	8	1,307.69	400.00	600.00	307.69
Average revenue per customer ($/yr)			1,000.00			

LRMC

Competing signal?

Proposed Pricing Principles

- **Minimise impact on customers**
  - Two key factors noted in the draft Rule – have regard to:
    - customer choice of tariff
      - It is not clear what the objective of choice would be in the proposed framework
        - Provision is not apparent
        - Should not be synonymous with avoidance
    - extent to which customers can mitigate impact via usage decisions
      - LRMC basis is required
      - Usage decisions will only influence outcomes in high LRMC geographic areas
      - Yet cost allocation may impact low LRMC geographic areas

Conclusions

- **A LRMC pricing basis may be overly constraining in the projected energy environment of flat demand**
- **A clearer ability to base tariffs on 'total efficient costs of providing services to the assigned retail customers' is preferable**
- **With changing use of the network, greater flexibility in tariff setting is necessary**
  - › Tariffs will remain consumption based, whereas the networks are developing a broader connectivity role for mixed generator / consumer customers, and provide an insurance service
  - › Broader transparency of cross-subsidisation inherent in tariffs is necessary so that DNSPs can co-optimise network and localised energy solutions
  - › There is a growing urgency for retail tariffs to directly reflect the DNSPs pricing intentions