



# Cost Reflective Tariff Setting Approaches

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# Is Tariff-Making a Science?

- No, if you can handle fractions you can calculate tariffs.
- There are a large number of ways to calculate a set of tariffs.
- But determining cost reflective tariffs that are fair and reasonable is no simple task;
- Some people talk about marginal costs as the solution to all problems. But marginal costs are only a small fraction of all costs and the difficulty is how you allocate the other costs; and
- Others advocate a purely accounting approach and might ignore demand response.

# Many Ways to Skin a Cat

- One-part tariff, two-part tariffs, multi-part tariffs, postage-stamp tariffs, tariffs reflective of distances, Ramsey pricing, Cost of Service tariffs, you name it!
- Is a certain way to design tariffs better? No, what is best depends on the particular situation;
- Are all these methods good? No, some of them provide bad economic signals no matter what;
  - One-part tariffs put the incorrect burden of fixed costs on customers;
  - Postage-stamp tariffs subsidize those that are located farther and cause the most costs to the provision of the services;
  - Marginal cost pricing can get funny results, such as negative tariffs in the England and Wales natural gas network; etc.

# What is the Meaning of Cost Reflective Tariffs?

- Ratepayers pay what it costs to provide a regulated service to them:
  - No cross-subsidies from one type of customer to another; and
  - No generalized subsidies; and
  - No conflicts between economic efficiency and cost causation versus principles of equity and fairness;
- Regulatory regimes in all countries and all political jurisdictions (at least those that wish to have well-functioning regulated industries) rely on a cost recovery plus investment return concept, which underlies all of the different forms of price regulation. [Lesser and Giacchino, p. 39];
- How to get cost reflective tariffs:
  - Regulatory accounts;
  - Application of regulatory principles in tariff making;
  - Fair allocation mechanisms for common costs;
  - Demand study that links prices and quantities; and
  - Right design for the utility involved.

# Alternative Ways to Fund Regulated Services

- Rely on tax dollars to subsidize the regulated services:
  - Shifts the weight from ratepayers to taxpayers;
  - Those who pay taxes might not even get regulated services;
  - Utilities revenues might come second (or third) to other activities; and
  - The financial health of the utility depends on tax collection efforts;
- Cross-subsidize and unfairly treat customers: wrong economic signal that increases (decreases) quantity demanded for some above (below) what they should demand; and
- Tariffs could be cost-reflective and a few customers might be subsidized directly: it is always best to fund them than to lower rates not affecting the quantity demanded.

# How to Make Tariffs and Who Should Pay

- Cost reflective tariffs are a must to provide the right economic signals;
- Cost reflective tariffs are calculated using a set of procedures (calculate the revenue requirement using regulatory accounting and following regulatory principles, allocate common costs fairly and use a demand study to determine billing determinants);
- How cost reflective tariffs are designed depends on each situation;
- Ratepayers not taxpayers should pay for the services they consume;
- If there is a policy decision to subsidize, do it without affecting the economic signals:
  - Avoid cross subsidy;
  - Do not rely on taxes; and
  - Use direct subsidies without reducing tariffs/prices.



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