

Beyond Cost Recovery

Setting Tariffs for Financial, Economic and Social Goals

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Purpose of Tariffs

- Markets set prices
- Governments set tariffs
- Tool for managing a public service

Two Messages

- Tariffs can do more than raise revenue.
- Tariffs must be explicit and specific about their goals.

Common Goals for Tariff Setting

- Good Governance (GG)
- Financial Sustainability (FS)
- Distributive Justice (DJ)
- Economic Efficiency (EE)
- Fair Pricing (FP)
- Some goals conflict—need to resolve conflicts

Good Governance

- Transparency
- Predictability
- Simplicity

Financial Sustainability

- Sufficient revenues to sustain utility
- Revenues cover costs

Distributive Justice

- Help the poor satisfy basic needs
- Identify basic needs

Economic Efficiency

- There are no free ways to improve welfare
- Ensure tariffs reflect economic costs of providing service

Fair Pricing

- No established definition
- Consumers pay the net social cost associated with the use of the service

Tariff Setting

- Choose goals
- Find pricing rules
- Resolve conflicts among rules

Tariff Structure

- Example 1: GG + FS
 - all tariffs should reflect the GG goal
 - FS goal may be achieved by charging average cost (AC)

$$AC = \frac{\text{Required Revenue}}{\text{Output}}$$

- Fully Distributed Cost approach used in some developed countries

Tariff Structure

- Example 2: GG + FS + DJ
 - lifeline block in tariff
 - rebate on electricity bills of poor consumers
 - subsidized access to power grid

Tariff Structure

- Example 3: GG + FS + DJ + EE
 - tariff charged reflects marginal cost of production
 - production cost varies by time of use (peak/off-peak); also by season and region
 - implement time-of-use (TOU) tariffs, especially for large consumers
 - TOU tariffs cause demand to shift from peak to off-peak
 - the shift improves system load factor and reduces future investment requirements
 - if TOU tariffs do not recover financial costs, introduce fixed charge

Tariff Structure

- Example 4: GG + FS + DJ + EE + FP
 - allocate fixed charges, if any, by consumer class

Ideal Tariff Structure

- User charge:
(variable per kWh)
 - peak use
 - off-peak use
 - other time periods, if applicable
- Fixed charge:
(flat rate)
 - independent of usage
 - varies by consumer class
- Rebate:
(flat rate)
 - targeted at poor consumers
 - may be combined with subsidized access

Additional Information

- Dole, D., 2003. "Setting User Charges for Public Services: Policies and Practice at the Asian Development Bank." ERD Technical Note No. 9, Economics and Research Department, Asian Development Bank, Manila.

<http://www.adb.org/Documents/ERD/TechnicalNotes/tn009.pdf>

- Dole, D., 2004. "Beyond Cost Recovery: Setting User Charges for Financial, Economic and Social Goals." ERD Technical Note No. 10, Economics and Research Department, Asian Development Bank, Manila.

<http://www.adb.org/Documents/ERD/TechnicalNotes/tn010.pdf>