AER Options Day

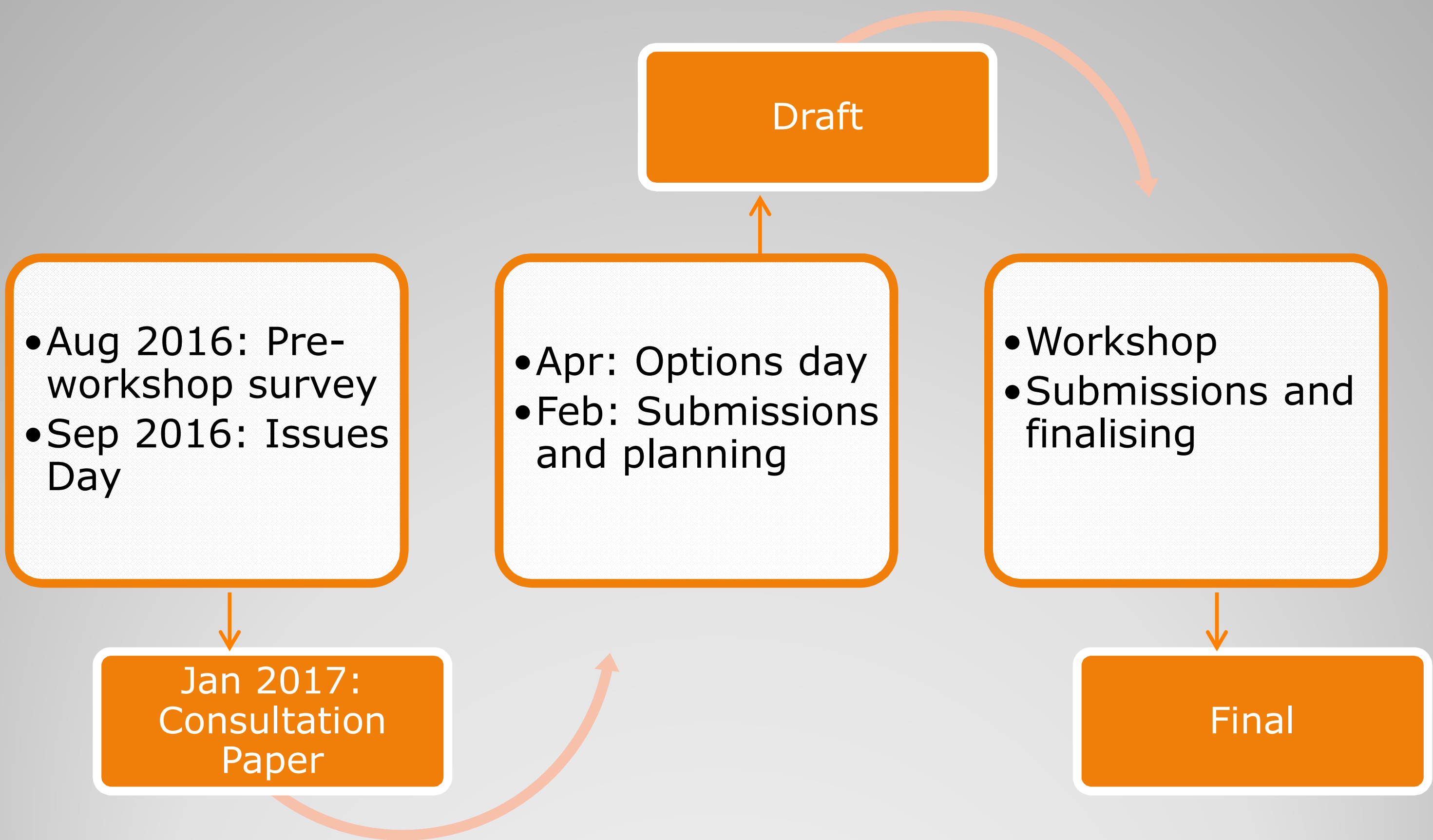
Demand management

Incentive Scheme
&
Innovation Allowance Mechanism

6 April 2017

AUSTRALIAN ENERGY REGULATOR

The consultation process



Options Day outline

- A discussion between stakeholders on 8 key questions:

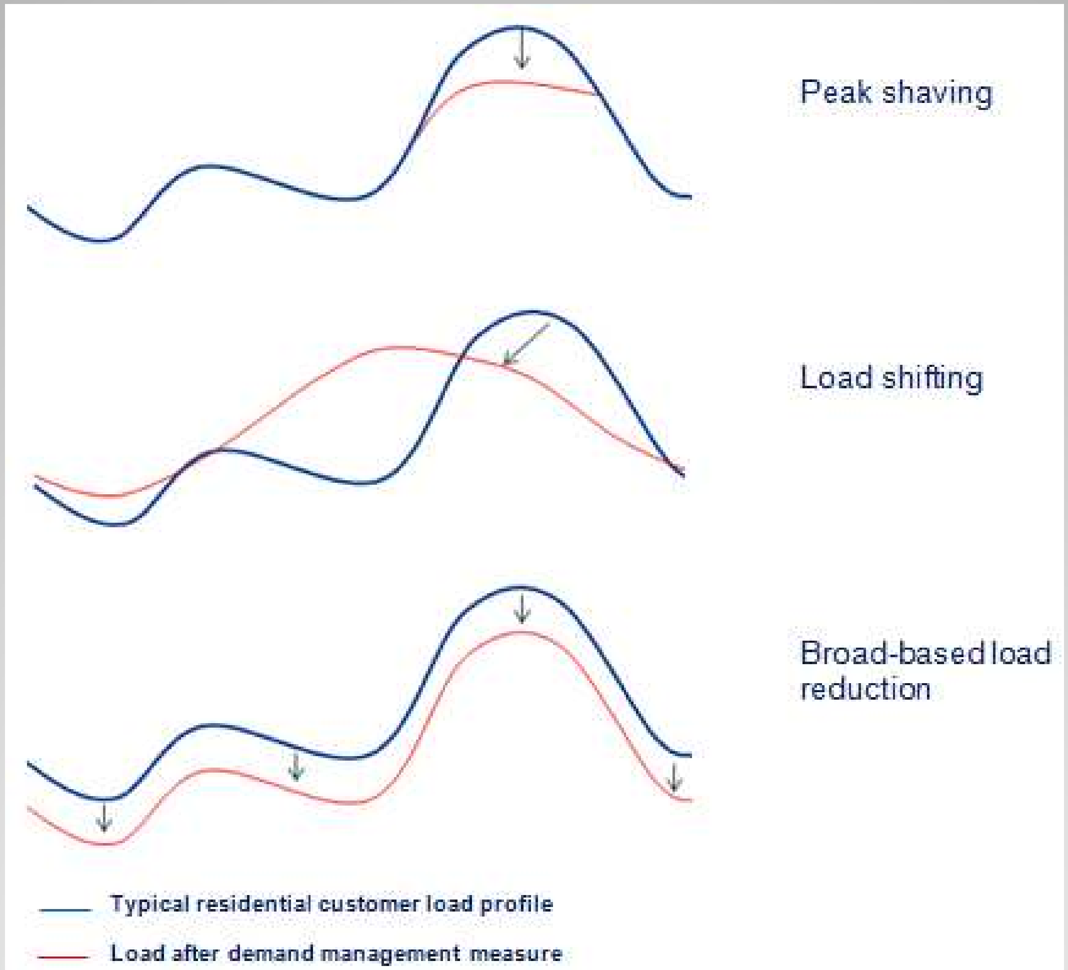
Demand Management Incentive Scheme:

1. Should we introduce a Scheme?
2. Should a Scheme include incentives or cost-recovery for supporting infrastructure?
3. Should a Scheme provide financial incentives?
4. How can we link incentives to performance?
5. How should we determine the magnitude of financial incentives?
6. How should the Scheme account for interactions with other incentives?

Demand Management Innovation Allowance:

7. Should we apply an Allowance Mechanism?
8. What type of Allowance Mechanism would best achieve the NEO?

What do we mean by DM?

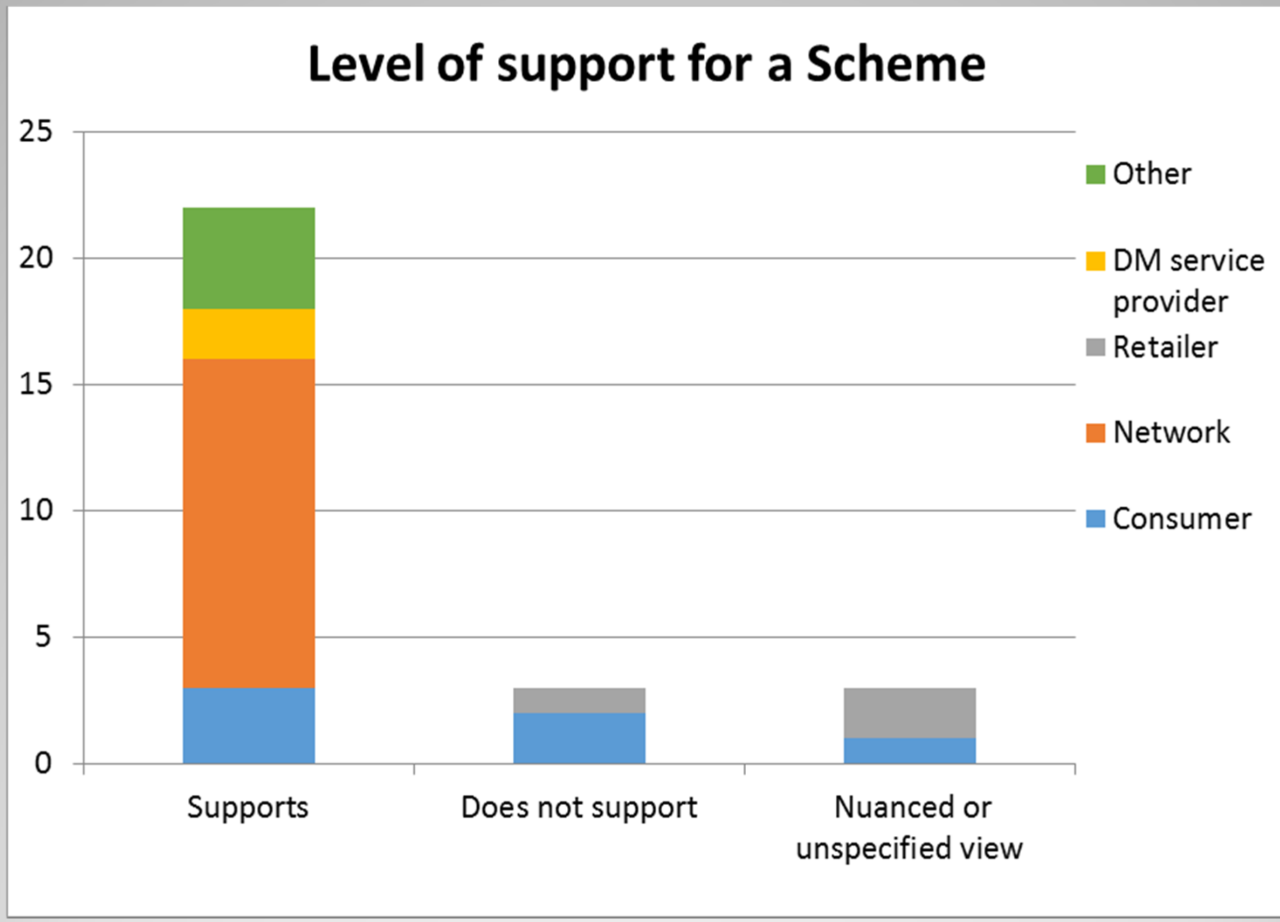


The Scheme

Objective:

to provide DNSPs with an incentive to undertake efficient expenditure on relevant non-network options relating to DM

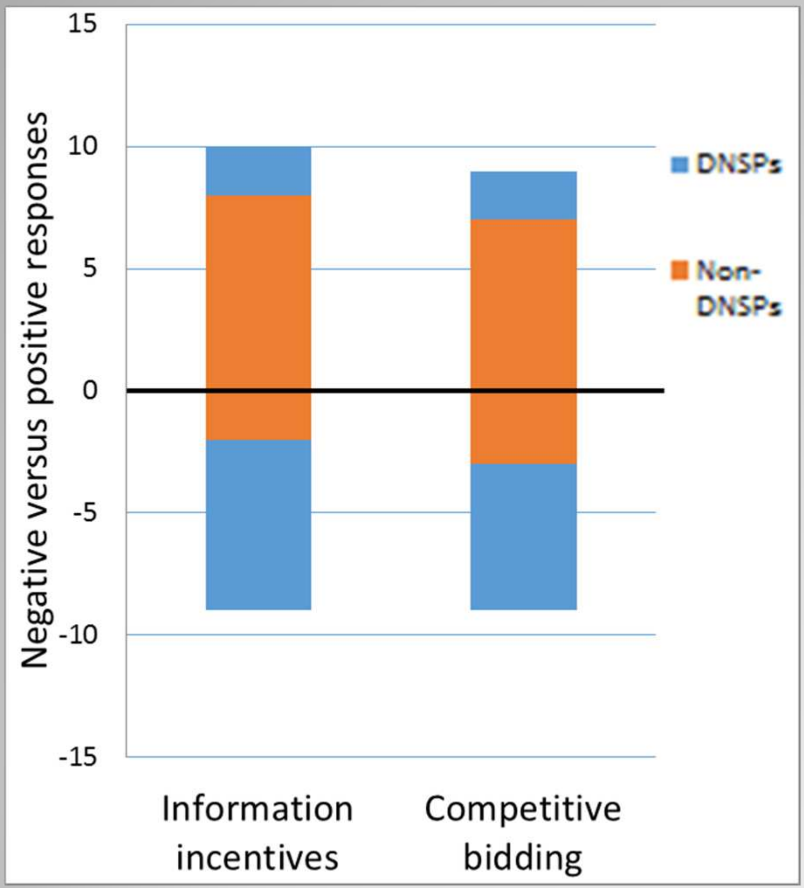
Q1: Should we introduce a scheme?



Q1: Should we introduce a scheme?

- Reasons <u>NOT</u> to introduce a Scheme:
  - Not entirely clear there is a regulatory bias against DM (CESS, ↓ augex)
  - Better to address imbalanced incentives outside the Scheme
  - Other ongoing reforms should increase DM (e.g. RIT-D, pricing)
  - May undermine efficient market development
- Reasons to introduce a Scheme:
  - Kick-start efficient DM procurement
  - Address a perceived capex bias
  - Enhance DNSP’s incentive to incorporate option value
  - Allow DNSPs to capture some value at other parts of the supply chain
- In principle: Are consumers willing to fund a Scheme to promote efficient DM?

Q2: Should a Scheme include incentives or cost-recovery for supporting infrastructure?



- The Consultation Paper discussed mechanisms to:
  - Incentivise DNSPs to provide more information to the market
  - Incentivise competitive 3rd party DM procurement
- We are inclined to continue exploring an element of these:
  - Providing DNSPs cost-recovery for setting up infrastructure to support DM market development
  - Information and standard form contracts

Q2: Should a Scheme include incentives or cost-recovery for supporting infrastructure?

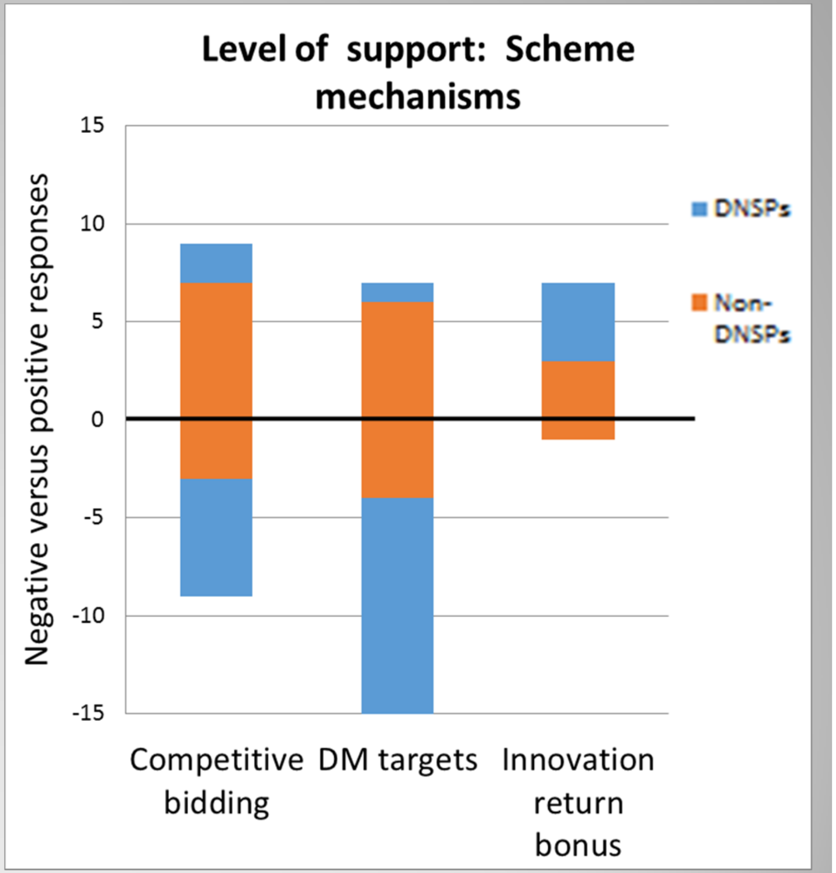
- Reasons NOT to provide cost-recovery
  - Doubles up with actions already in train
  - The regulatory allowance already covers overheads
  - Consumers could pay extra for what DNSPs would do anyway
- Reasons to provide cost-recovery
  - Minimise obstacles to efficient DM
  - Enhanced identification of future opportunities
  - Consistent and fair approach to liability
- Are consumers willing to fund development of supporting infrastructure?
- Would third party DM providers find additional supporting infrastructure useful?

Q3: Should a Scheme provide financial incentives?

- Reasons NOT to provide incentive payments
  - DNSPs already face obligations to considered efficient DM (e.g. RIT-D, DAPRs)
  - If DNSPs choose efficient options, consumers will pay extra for no gain
  - If incentive is too high, consumers overpay for the gain (net-loss)
  - Accountability potentially inadequate — can we assess value for consumers' money?
- Reasons to provide incentive payments
  - Overcomes perception of bias → consumer net-benefits
  - 'Kick-start' efficient DM procurement as BAU → dynamic efficiency
  - Linking incentive value to DM value → better valuation methods
- Are consumers willing to fund incentive payments?

Q4: How can we link incentives to performance?

- Accountability by requiring competitive procurement to find the efficient option?
  - Competitive procurement = via RIT-D or via issuing RFQs to third parties
- Performance by attaching incentive payments to deliverables, e.g.
  - \$ per kVA_{peak} delivered?
  - \$ per kVA_{peak} contracted?
  - % of demand response contract value?

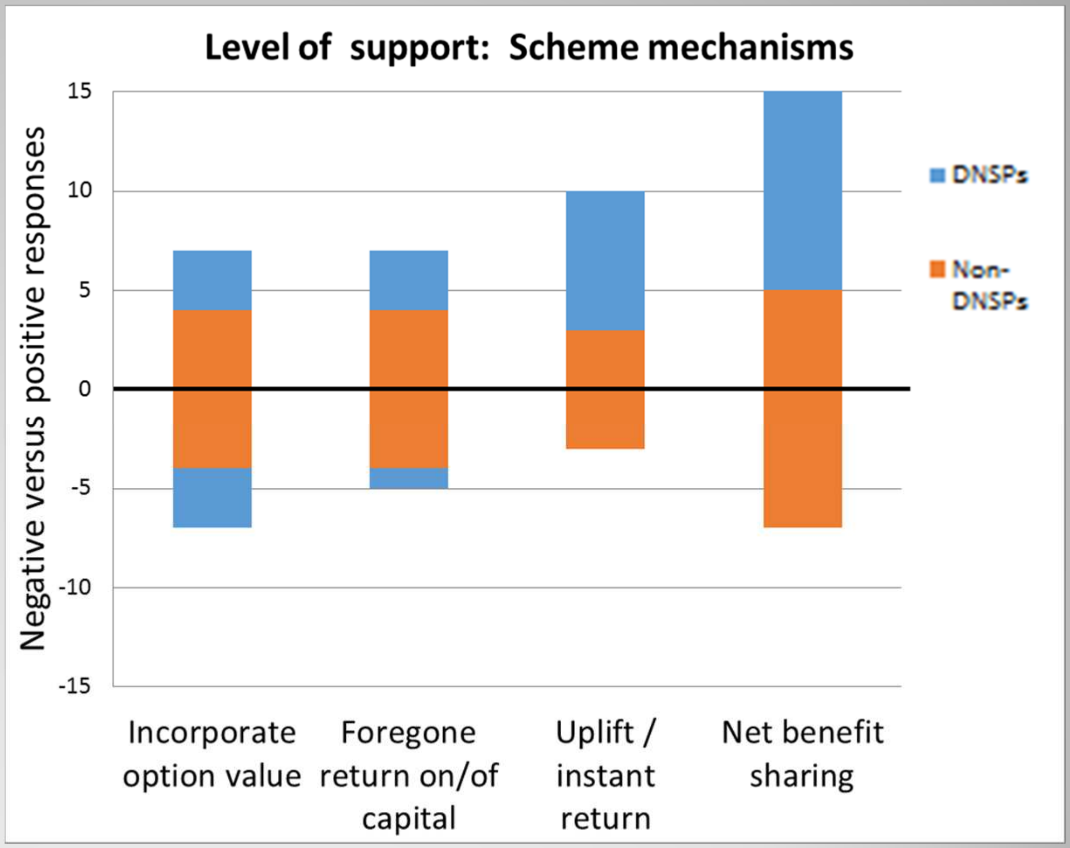


Q4: How can we link incentives to performance?

- Reasons NOT to link incentives to performance:
  - Creates additional administrative cost
  - What deliverable to incentivise:
    - \$ per kVA_{peak} delivered or contracted?
    - % of contract value might reward inflating costs?
    - Reports of outcomes?
- Reasons to link incentives to performance:
  - Competitive process provides compliance check on ‘preferred option’ by incentivising DNSPs to explore all options
  - Attaching rewards to deliverables
    - Incentivises DNSPs to generate benefits for consumers
    - Assists in verifying the Scheme’s impact on consumers
- Are stakeholders supportive of linking incentives to performance?

Q5: How should we determine the magnitude of financial incentives?

- Trade-off between basing the value on methods that:
  - Incentivise DNSPs to more fully value DM; and
  - Minimise computational burden & subjectivity
- How to ensure the incentive strong enough to kick-start efficient DM procurement whilst delivering net-benefits to consumers?

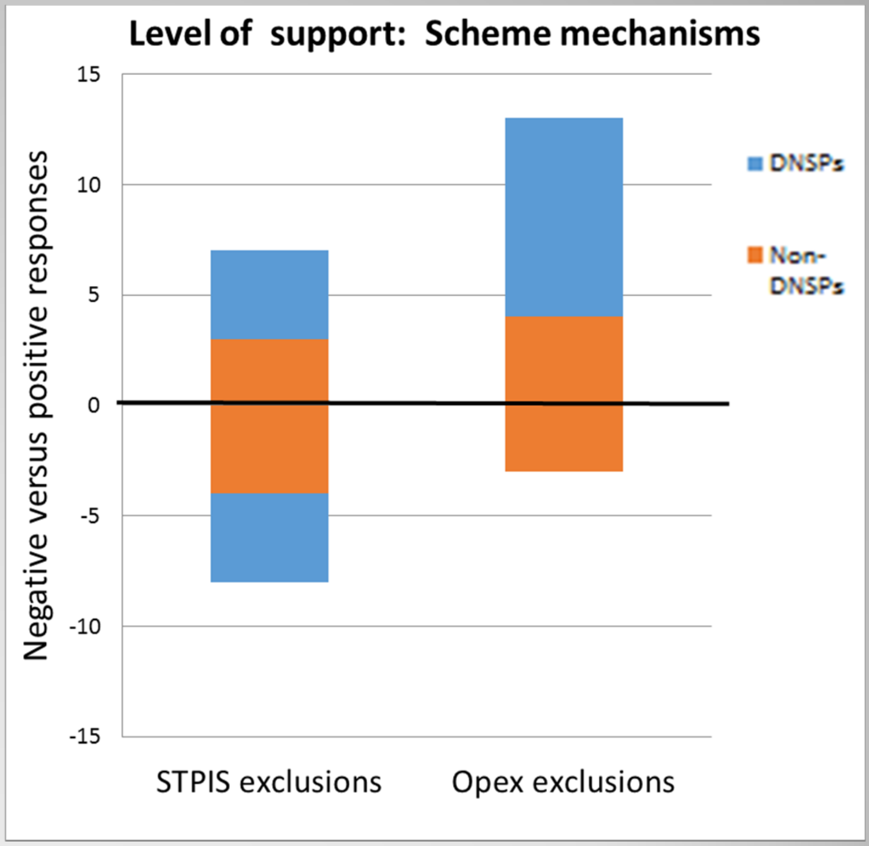


Q5: How should we determine the magnitude of financial incentives?

- Base incentives on option value?
  - Advantage: Incentivises DNSPs to account for this value
  - Disadvantage: Difficult to estimate
- Base incentives on foregone return on capex?
  - Advantage: Appropriate if there are imbalanced opex/capex incentives
  - Disadvantage: CESS reward sufficient if capex/opex incentives balanced
- Base incentives on net market benefits?
  - Advantage: Incentivises DNSPs to consider this value if they do not already internalise it indirectly
  - Disadvantage: Difficult to estimate, may already be internalised
- Base incentives as uplift on DM opex (e.g. WACC or % cost)?
  - Advantage: Simple to estimate, can combine with sanity checks
  - Disadvantage: Not explicitly linked to an 'incentive gap' we want filled
- Do stakeholders have a preferred approach?

Q6: How should the Scheme account for interactions with other incentives?

- STPIS exclusions: Consider excluding DM-related reliability losses when calculating STPIS penalties?
- Opex exclusions: Consider excluding:
    - DM R&D from the opex building block?
    - Efficient DM opex from the EBSS?



Q6: How should the Scheme account for interactions with other incentives?

- Reasons <u>NOT</u> to account for interaction:
  - Opex/capex balanced with EBSS/CESS symmetry
  - STPIS exclusions transfer reliability risk to customers
  - STPIS exclusions compromise reliability of DM options & embed views that DM is unreliable
- Reasons to account for interaction:
  - Excluding DM R&D from opex building block recognises that R&D may not be ongoing

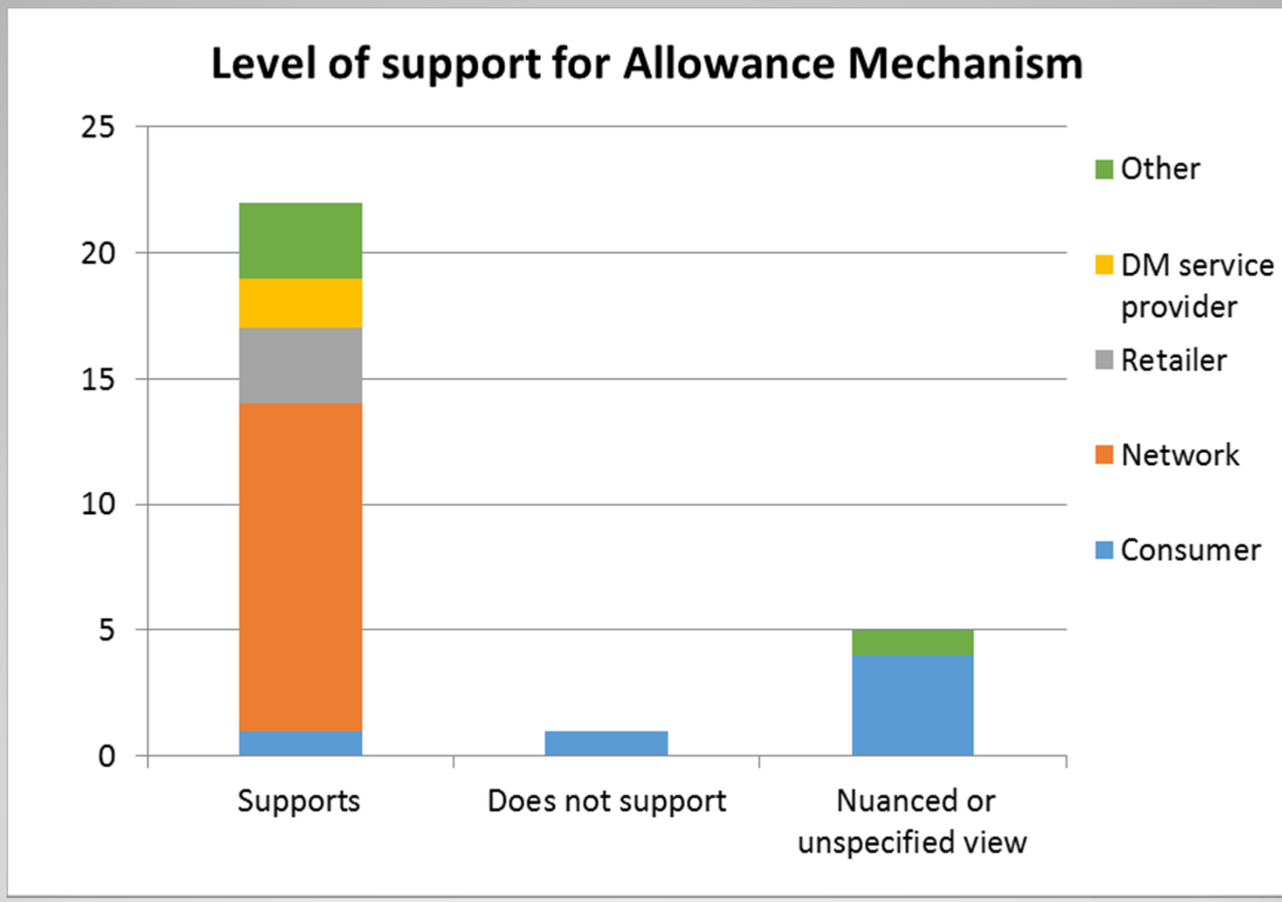
- Do stakeholders support accounting for interactions by excluding DM R&D from the opex building block?

The Allowance Mechanism

Objective:

To provide DNSPs with funding for R&D in DM projects that have the potential to reduce long term network costs

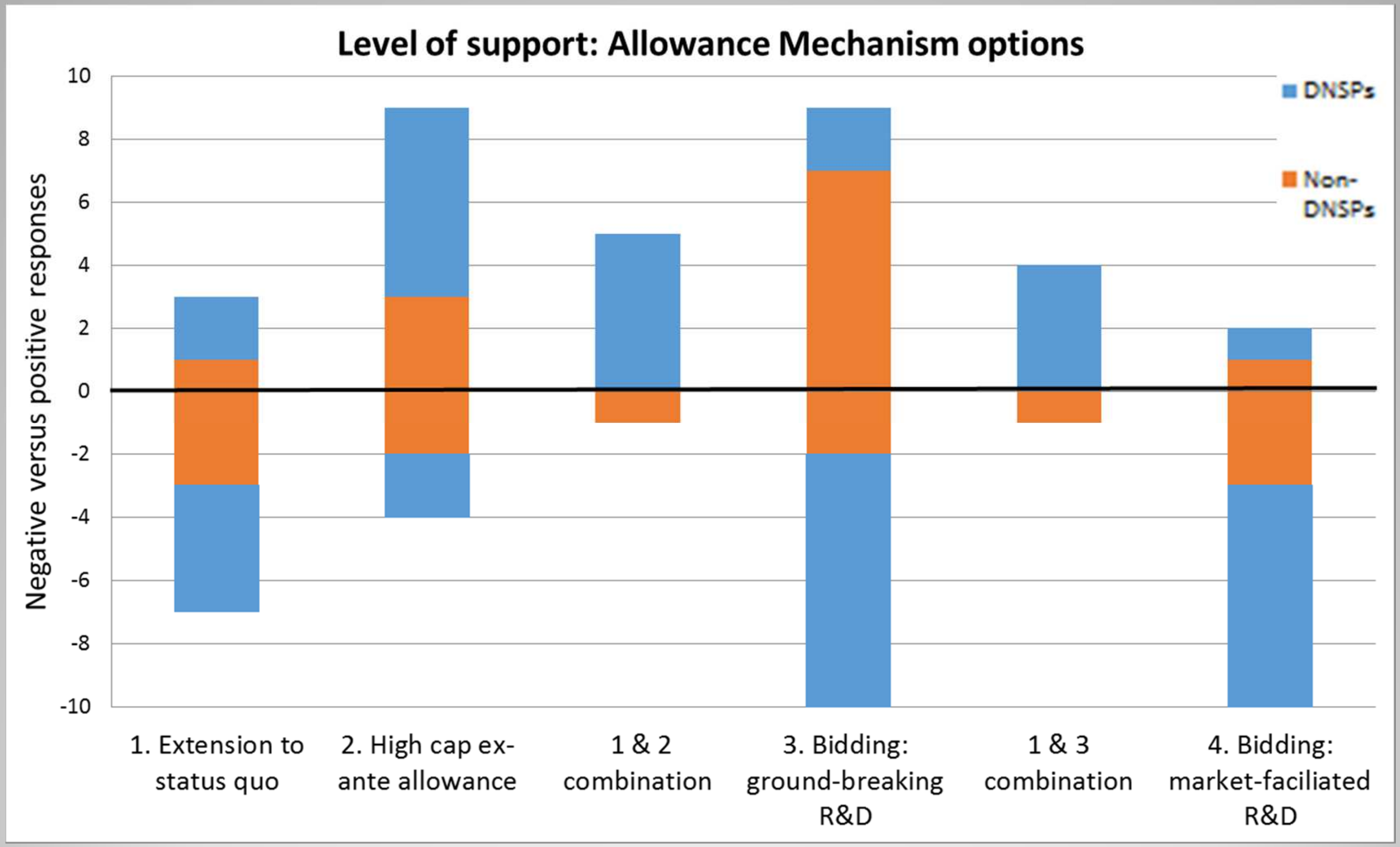
Q7: Should we apply an Allowance Mechanism?



Q7: Should we apply an Allowance Mechanism?

- Reasons NOT to apply an Allowance Mechanism:
  - More effective to source R&D funding elsewhere?
    - DMIA available to date relatively small — unclear if customers would want to pay significantly more?
  - Difficult to measure R&D's 'success' or value
  - Transfers risks onto consumers when DNSPs could already fund R&D from their regulatory allowances
- Reasons to apply an Allowance Mechanism:
  - Addresses DNSPs' weak incentive to conduct R&D even when:
    - DNSPs are in a unique position to undertake R&D on challenges facing their networks
    - Network R&D could be in the long term interest of consumers
- Are consumers willing to fund an Allowance Mechanism?

Q8: What type of Allowance Mechanism would best achieve the NEO?



- Do stakeholders have a preferred Allowance Mechanism option?

Q8: What type of Allowance Mechanism would best achieve the NEO?

- Consider an iteration of Option 3, where:
  - DNSPs can recover max $10mil R&D funding in total per year
  - DNSPs can collaborate & we encourage 3rd party partnerships
  - AER sets up panel to recommend projects meeting criteria & winning DNSPs get uplift on their regulatory allowance
- Reasons <u>NOT</u> to apply this idea:
  - Admin associated with submission process with subjective assessments
  - Some worthwhile proposals may go unfunded
- Reasons to apply this idea:
  - Introduces competitive pressure to promote effective R&D
  - Enhances knowledge-sharing and avoids project duplication
- What do stakeholders think of this type of Option?