Keeping It Simple

AER DMIS and DMIA Forum
20 September 2016

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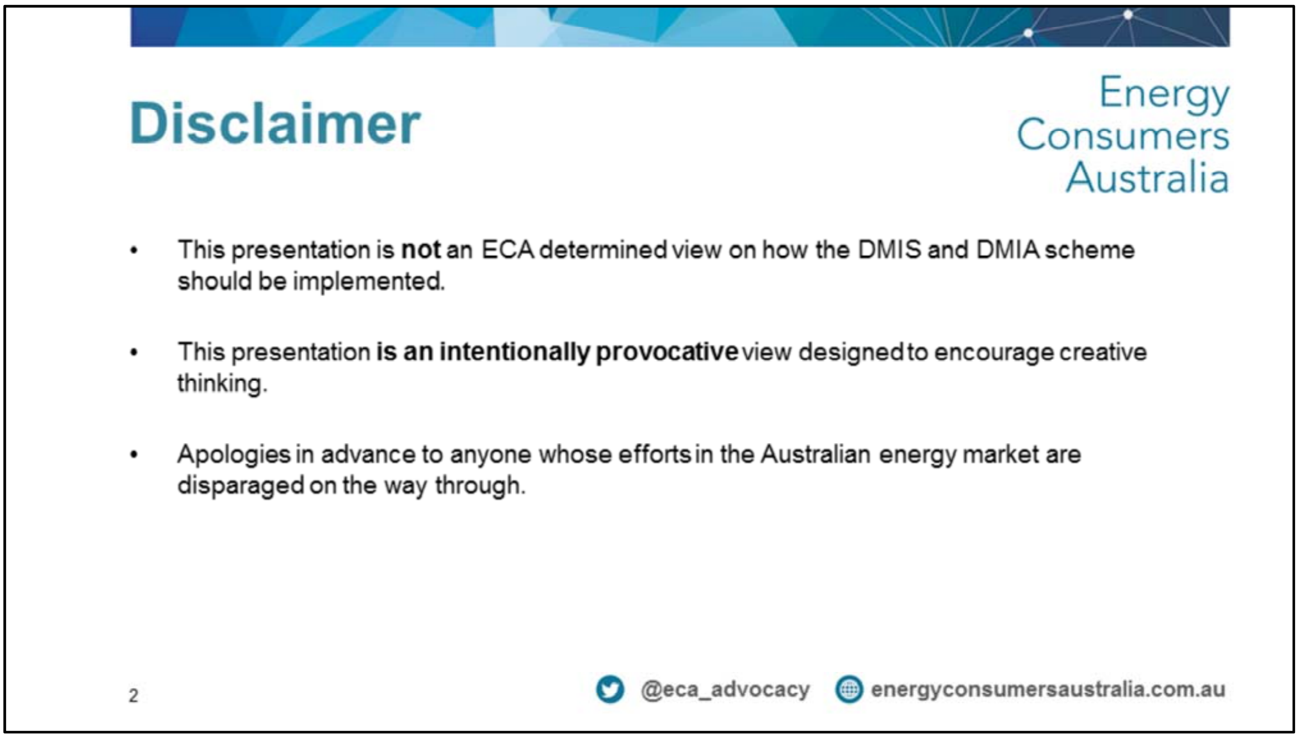

ECA also notes that we were not in a position to contribute to the initial rule development process and that some of our comments would have been better made at the rule change stage.

The Regulatory Framework

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- Are the DMIS and DMIA just the latest pieces of duct/gaffer tape?

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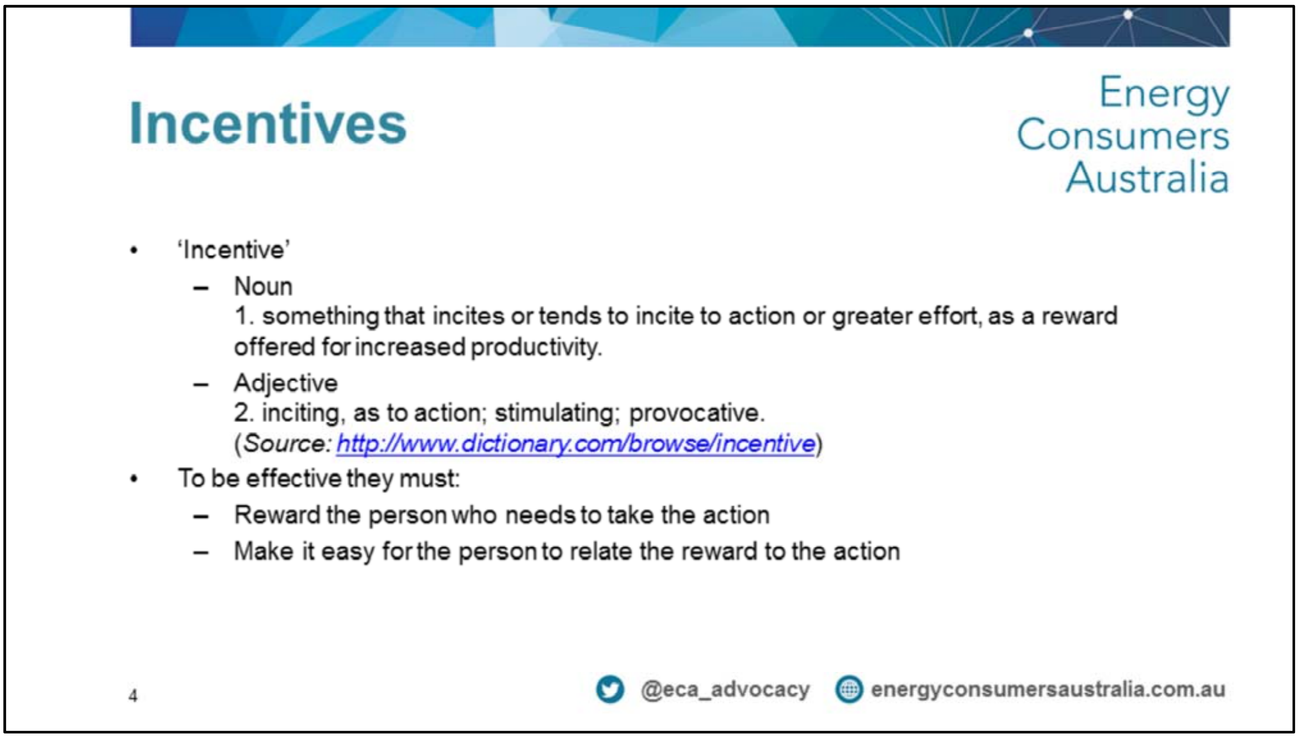
The economic regulation of networks is becoming excessively complex.

ECA does not support the proposition that DER constitutes competition to networks and that economic regulation is no longer appropriate. Indeed, grid connections are vitally important to getting he optimum use from Distributed Energy Resources.

The way the scheme works is that every time there is an issue people just find a way to pay the networks more – like the DMIS where we want consumers to pay networks for not doing something.

The scheme that supports an increase in real prices of electricity by 70-80% since 2008 is simply unsustainable.



We are talking about really complex corporate incentive schemes here.

Henry Ford once said "Nothing happens in business till someone makes a sale." That reminds us how important the sales function is. What can we learn about how sales compensation plans provide incentives.

I note that the *5 Golden Rules for Setting Sales Compensation Plans* are no different now than when one of my tasks was sales compensation management at a part of Telecom Australia. (https://shockwaveinnovations.com/2012/12/29/5-golden-rules-for-setting-sales-compensation-plans/)

Make sure the compensation plan drives behaviour that is consistent with your business strategy.
Never change the rules in the middle of the game.
Keep it simple.
Be very clear.
Do serious soul-searching before implementing caps that limit earnings beyond a certain level.

Regulatory Incentive Schemes

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- Regulatory incentive schemes reward shareholders – not managers who make decisions.
- Effectiveness of plan then depends on:
  - Extent to which shareholders understand the incentive.
  - Extent to which shareholders create matching incentive for CEOs
- Shareholders suffer from their own information asymmetry – they have less understanding of the business than managers.
- Shareholders also receive advice from investment advisers who have even less information.
- These people exhibit the same deviations from the rational agent model as do consumers – especially a reliance on heuristics.

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When designing regulatory incentive schemes that increase revenue we have to understand what the linkages are before that incentive becomes an incentive to managers.

There are lots of barriers.

The incentive for CAPEX

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- If there is a genuine bias by networks for CAPEX solutions possible reasons include:
  - Regulatory WACC is significantly higher than real cost of capital
  - Investors are so stupid they can't distinguish accounting profit from rate of return
  - CEOs earn extra Hay points in compensation planning for being responsible for more assets
  - There are genuinely more risks around Opex than Capex, especially risk of regulatory taking of future Opex requirements.
- DMIS is, at least in part, a scheme to prefer Opex over Capex solutions. Need to understand how they work in relation to the above.

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The idea that there is an incentive for Capex in networks if often stated but seldom analysed. The only theoretic proposition is due to Averch and Johnson in 1962 who concluded that a profit maximising firm subject to rate of return regulation will inefficiently favour capex over opex.

This is only one possible factor (and basically reconciles with the second point on the slide).

The point on the slide about job grading applies to the whole management team.

The objectives

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- The objective of the demand management incentive scheme is to provide distribution businesses with an incentive to undertake efficient expenditure on relevant non-network options relating to demand management (the demand management incentive scheme objective).

- The objective of the demand management innovation allowance mechanism is to provide distribution businesses with funding for research and development in demand management projects that have the potential to reduce long term network costs (the demand management innovation allowance objective).

‘Simplest’ possible DMIS

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- Revenue proposal submitted on a ‘with the DM project’ and ‘without the DM project.’
- Only question then is how much of cost saving to pass on to consumers and how much to provide to networks
- But…
  - Highly dependent on forecast accuracy
  - The deferred network expenditure would already be covered by CESS or EBSS
  - What is the right share
  - How do we do the time adjustment

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There isn’t a shortage of opportunity for networks to participate in Demand Management – the DMIS is addressing the shortness of will to do so.

Why Not?

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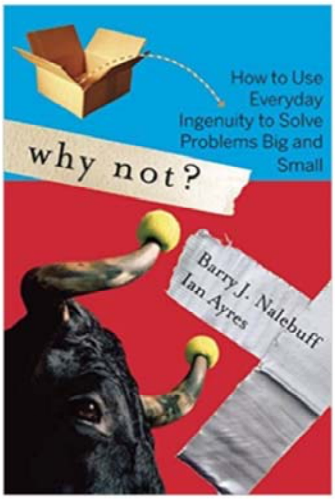

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I've already mentioned that all of us are governed by heuristics. Those heuristics often stop us thinking about solutions to problems that are out of the ordinary.

This book describes the kinds of solutions that can be found by this approach. So what happens if you ask "Why Not" for DMIS?

Even simpler DMIS?

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- Don't tie to actual deferment – just work on principle that the higher the load factor (average divided by peak – closer to 1) then we are reducing expenditure to service peak.
- Simple incentive scheme that makes a payment for increasing load factor.
- To make network plan for it rather than just benefit from it have a starting LF (LF_0) and a target LF (LF_T) set by network.
- The incentive payment for is then based on
  – $A^*(LF_A - LF_0)$ if $LF_A < LF_T$
  – $A^*(LF_T - LF_0) + B^*(LF_A - LF_T)$ if $LF_A > LF_T$

  Where B<A – which encourages firm to specify a high LF_T

DISCLAIMER: This proposition is advanced by ECA for the purposes of discussion only and is not a position we are advocating for.

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Clearly this is rewarding networks for levelising demand even where there is no constraint – but in the long run that is a good thing.

To the extent that there are up-stream benefits from peak reduction these don't necessarily only relate to areas of the distribution network that are facing a constraint….

The above scheme only works on the basis that we address the fundamental flaw hat the networks are receiving a risk weighted WACC whereas they should be receiving a risk free WACC. The means of generating above real cost of capital returns should be via incentive schemes for doing things that benefit consumers – reducing future capital costs, reducing opex and improving customer service.

So that’s it – Keep It Simple – the KISS principle