DRAFT DECISION

Essential Energy Distribution Determination 2019 to 2024

Attachment 11 Demand management incentive scheme

November 2018

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Essential Energy for the 2019–24 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

Contents

Note ... 11-2

Contents ... 11-3

Shortened forms ... 11-4

11 Demand management incentive scheme ... 11-5

11.1 Draft decision ... 11-5

11.2 Essential Energy's proposal ... 11-6

11.3 AER's assessment approach ... 11-6

11.3.1 Interrelationships ... 11-6

11.4 Submissions ... 11-7

11.5 Reasons for draft decision ... 11-7

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CESS	Capital expenditure sharing scheme
DMIA	Demand management innovation allowance
DMIAM	Demand management innovation allowance mechanism
DMIS	Demand management incentive scheme
EBSS	Efficiency benefit sharing scheme
F&A	Framework and Approach
NER	National Electricity Rules
opex	operating expenditure
STPIS	Service Target Performance Incentive Scheme

11 Demand management incentive scheme

Under clauses 6.6.3 and 6.6.3 A of the National Electricity Rules (NER), our regulatory determination must specify how any applicable demand management incentive scheme (DMIS) and demand management innovation allowance mechanism (DMIAM) are to apply in the next regulatory control period.

This attachment sets out how we will apply the DMIS and DMIAM to Essential Energy (Essential) for the 2019–24 regulatory control period.

AER's DMIS and DMIAM

On 13 December 2017, we published a new DMIS[1] and a new DMIAM.[2] These will replace the current DMIS and demand management innovation allowance (DMIA) in the forthcoming regulatory control periods for all electricity distributors.

11.1 Draft decision

In accordance with our framework and approach (F&A) position,[3] our draft decision is to apply the new DMIS[4] and DMIAM[5] to Essential for the 2019–24 regulatory control period, without any modification.

The DMIS contains three elements:[6]

- a cost uplift on expected costs of efficient demand management projects
- a net benefit constraint, to ensure the incentive payment for any project cannot be higher than that project's expected net benefit
- an overall incentive constraint, which limits the total incentive in any year to one per cent of the distributor's allowed revenue for that year.

In accordance with the DMIS, the AER's distribution determination will provide that the cost multiplier (uplift) applicable to any eligible project will be the cost multiplier specified in the version of the DMIS that is in effect under clause 6.6.3 of the NER at the time at which the eligible project becomes a committed project.[7]

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1 AER, *Demand management incentive scheme, Electricity distribution network service providers*, December 2017.

2 AER, *Demand management innovation allowance mechanism*, *Electricity distribution network service providers*, December 2017.

3 AER, *Framework and approach - Ausgrid, Endeavour Energy and Essential Energy, Regulatory control period commencing 1 July 2019*, July 2017, pp. 71-76.

4 AER, *Demand management incentive scheme*, *Electricity distribution network service providers*, December 2017.

5 AER, *Demand management innovation allowance mechanism, Electricity distribution network service providers*, December 2017.

6 AER, *Demand management incentive scheme, Electricity distribution network service providers*, December 2017.

7 AER, *Demand management incentive scheme, Electricity distribution network service providers*, December 2017, clause 2.1(2).

The DMIAM comprises:[8]

- a fixed allowance of $200,000 (real 2017), plus 0.075 per cent of the annual allowed revenue for each regulatory year, as set out in AER's Post-Tax Revenue Model (PTRM) for Essential
- project eligibility requirements
- compliance reporting requirements.

11.2 Essential Energy's proposal

Essential proposed to adopt the approach specified in its F&A.[9]

11.3 AER's assessment approach

We are required to make a decision on how the DMIS and DMIAM are to apply to Essential.[10] We outlined our proposed approach to, and reasons for, the application of the DMIS and DMIAM in our F&A for Essential. Our draft decision has adopted the position in the F&A. We have considered materials submitted to us by Essential and by stakeholders.

11.3.1 Interrelationships

The DMIS will encourage demand management initiatives which are likely to provide long term efficiency gains to energy consumers that will outweigh any short term price increases. For instance, these initiatives might reduce the costs of investment in new infrastructure. This might occur through the deferral of, or removal of the need for, network augmentation or replacement/refurbishment expenditures, such as by more efficient use of existing infrastructure.

In applying the DMIS, we will have regard to the effect that it could have on the incentives created by the efficiency benefit sharing scheme (EBSS), capital expenditure sharing scheme (CESS) and service target performance incentive scheme (STPIS), and vice versa.

We currently operate two incentive schemes designed to encourage efficient decision making by distributors—the CESS and the EBSS. These operate symmetrically to better balance incentives between capital and operating expenditure (capex and opex), by sharing the savings and risks of each kind of expenditure between distributors and consumers.

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8 AER, *Demand management innovation allowance mechanism*, *Electricity distribution network service providers*, December 2017.

9 Essential Energy, *Regulatory Proposal, Regulatory Control Period 1 July 2019 to 30 June 2024*, April 2018, pp. 40, 43, 109.

10 NER, cl.6.3.2 (a) (3) and 6.12.1(9).

We expect the DMIS will encourage distributors to undertake more demand management activities where it is efficient to do so. Since demand management typically consists of opex rather than capex, the scheme might result in distributors receiving higher penalties or lower rewards under the EBSS. The EBSS penalties would, in isolation, severely reduce the incentive for demand management projects as they have to accept 30 per cent of the opex increase.

When the EBSS is considered in tandem with the CESS, however, efficient demand management is encouraged. The CESS will allow for 30 per cent of any savings on capex to be retained by the distributor for the regulatory control period. As all eligible projects require a reduction in costs, the increase in opex should be lower than the decrease in capex. This will effectively negate the detriment of the EBSS penalty. Moreover, given the CESS, 30 per cent of the total difference in cost, or cost savings, between the network and non-network option will be awarded to the distributor, in addition to the scheme cost uplift. This provides an incentive structure that flexibly rewards distributors for creating the greatest cost savings.

We will not exempt projects from the STPIS under the DMIS, as we consider this would negatively affect consumers in two ways. Firstly, not applying the STPIS to demand management solutions would transfer the risk of solution failure onto consumers, who have little opportunity to mitigate that risk. Secondly, exempting demand management from performance targets may increase the perception that demand management is less reliable than network solutions, furthering any potential cultural bias against demand management. This would not serve to further the objective of the DMIS scheme, which is to promote efficient investment in non-network demand management options.[11]

11.4 Submissions

CCP10 submitted that the DMIA allowances for NSW distributors for 2019–24 need to be carefully considered against recent actual expenditure. CCP10 also submitted that all incentive schemes should be reviewed cohesively to make sure that businesses are incentivised to save costs and actively pursue non-network solutions.[12]

11.5 Reasons for draft decision

The DMIS will provide incentives for the distributors and consumers to adopt more demand management measures, which should put greater downward pressure on prices, benefitting the whole community.

The DMIAM will provide funding to networks to undertake further research on demand management initiatives and to share these learnings across industry and consumers.

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11 NER, cl. 6.6.3(b).

12 Consumer Challenge Panel (CCP10), *Submission on Essential Energy 2019-24 regulatory proposal*, 8 August 2018, pp. 34-36.

Regarding CCP10's concerns, Essential will be required to provide supporting documents as required under the new DMIS and DMIAM each year to prove that the expenditures meet the minimum requirements. The AER will determine the eligibility and specific incentive payments for each project according to the criteria specified in the new DMIS and DMIAM.