



Final Decision

Demand Management Incentive Scheme

**Jemena, CitiPower, Powercor, SP AusNet and
United Energy**

2011–15

April 2009

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Shortened forms

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
capex	capital expenditure
CEC	Clean Energy Council
CPRS	carbon pollution reduction scheme
CUAC	Consumer Utility Advisory Centre
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
DNSP	distribution network service provider
DPI	Department of Primary Industries (Victoria)
EBSS	efficiency benefit sharing scheme
EDPR	Electricity Distribution Price Review
ESC	Essential Services Commission (Victoria)
GWh	giga watt hours
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National Electricity Market
NER	National Electricity Rules
NPV	net present value
OIC	Order in Council
opex	operating expenditure
RAB	regulatory asset base
RIO	Regulatory Information Order
STPIS	service target performance incentive scheme
TEC	Total Environment Centre
WAPC	weighted average price cap

1 Introduction

Chapter 6 of the National Electricity Rules (NER) allows the Australian Energy Regulator (AER) to develop and publish a demand management incentive scheme (DMIS) to provide incentives for distribution network service providers (DNSPs), Jemena, CitiPower, Powercor, SP AusNet and United Energy, to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.

This DMIS has been developed in the context of the preliminary positions framework and approach paper for DNSPs in Victoria, published on 19 December 2008.

On 19 December 2008, the AER also published an explanatory statement and proposed DMIS to apply to Jemena, CitiPower, Powercor, SP AusNet and United Energy over the 2011–15 regulatory control period. The AER received ten submissions on its proposed DMIS, which are available on the AER’s website, www.aer.gov.au.

This final decision sets out the AER’s consideration of comments raised in submissions on the proposed DMIS. In developing this final decision, consideration has also been given to the objectives of NER and National Electricity Law (NEL).

2 Requirements of the National Electricity Rules

The AER may develop a DMIS to provide incentives for DNSPs to implement efficient non-network alternatives, or to manage the expected demand for standard control services in some other way.¹

In developing and implementing a DMIS, the AER must have regard to:

- the need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for DNSPs
- the effect of a particular control mechanism (i.e. controls over prices as distinct from controls over revenues) on a DNSP's incentives to adopt or implement efficient non-network alternatives
- the extent the DNSP is able to offer efficient pricing structures
- the possible interaction between a DMIS and other incentive schemes
- the willingness of the customer or end user to pay for increases in costs resulting from implementation of the scheme.²

The distribution consultation procedures set out at rule 6.16 of the NER require the AER to publish a proposed DMIS and explanatory statement, inviting submissions and giving stakeholders and interested parties at least 30 business days to respond. The AER's proposed DMIS to apply to Victorian DNSPs and the accompanying explanatory statement were published for consultation on 19 December 2009, with submissions closing on 6 March 2009.

Within 80 business days of publishing the proposed DMIS, the AER must publish the DMIS and accompanying final decision. Any future revisions to this DMIS will also be made in accordance with the distribution consultation procedures as required by clause 6.6.3(c) of the NER.

¹ NER, cl. 6.6.3(a).

² NER, cl. 6.6.3(b).

3 Reasons for the demand management incentive scheme

The objective of the AER's DMIS is to provide incentives for DNSPs to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.³

The DMIS is not intended to be the sole, or even the primary, source of recovery of demand management expenditure. The AER considers that the primary source of funding for demand management initiatives in a regulatory control period should be the forecast operating expenditure (opex) and capital expenditure (capex) approved by the AER in the DNSP's distribution determination under chapter 6 of the NER. The DMIS is provided to DNSPs as a mechanism to encourage the consideration by DNSPs of more innovative, perhaps untested, non-network alternatives.

The AER notes that while the regulatory framework under the NER provides incentives for DNSPs to conduct demand management, it may also create some disincentives to do so. For instance, the regulatory framework provides a financial incentive for DNSPs to undertake demand management that defers capex included in the forecast approved at the time of the distribution determination, to the extent that the financial benefits of the capex deferral (the return on and of capital) outweigh the demand management expenditure required to achieve that deferral. However, non-network solutions to rising peak demand are perceived by some DNSPs to offer a lower (inherent and/or perceived) level of reliability when compared to network solutions. This has implications for a DNSP's reliability obligations and service performance, and gives rise to the need for incentives to encourage the consideration by DNSPs of non-network solutions.

The DMIS complements the existing approved capex and opex incentives for demand management, by facilitating further investigation into efficient and viable non-network strategies so that DNSPs can improve their demand management capabilities in the longer term. It is envisaged DNSPs will use this DMIS to fund the investigation of innovative, new opportunities in the field of demand management. It also allows DNSPs to implement efficient non-network alternatives, and to help manage the expected demand for standard control services, beyond that which may be readily captured in its core revenue proposal.

³ NER, cl. 6.6.3(a).

4 AER's proposed DMIS

On 19 December 2008, the AER published a proposed DMIS to apply to Jemena, CitiPower, Powercor, SP AusNet and United Energy in the regulatory control period commencing 1 January 2011. Accompanying the proposed DMIS was an explanatory statement which contained background information on demand management and non-network solutions generally, and also information setting out how the DMIS would apply in the forthcoming regulatory control period.

The proposed DMIS comprised two components:

- An ex-ante demand management innovation allowance (DMIA), to be provided as a fixed amount of revenue at the commencement of each regulatory year in the regulatory control period. The total amount recoverable under the allowance within a regulatory control period was capped at an amount broadly proportionate to the size of each Victorian DNSP's average annual revenue requirement in the current regulatory control period. This amount is distributed evenly across each regulatory year of the regulatory control period as an annual allowance. The proposed DMIS required that the DMIA be provided on a use-it-or-lose-it basis. The DMIS is provided in addition to any opex and capex allowances for demand management projects approved in the AER's distribution determination for a DNSP.
- A forgone revenue component, which allows a DNSP to recover forgone revenue as a result of successful, approved demand management initiatives under the DMIA, where these result in lower energy throughput (and hence, lost revenue) for the DNSP. This component was designed to interact with certain forms of price control under which revenue is directly determined by the throughput level (for example, a weighted average price cap, or WAPC).

In the AER's preliminary positions paper on the framework and approach for Victorian DNSPs for the 2011–15 regulatory control period,⁴ it was envisaged that both the DMIA, and the forgone revenue component, would apply to each Victorian DNSP.

The AER received ten submissions on the proposed DMIS.⁵ The AER's consideration of the issues raised in submissions is set out in section 5 of this final decision.

⁴ This paper was published for consultation on 19 December 2008. The paper detailed, amongst other things, the AER's likely approach to various matters in anticipation of the forthcoming distribution determination, including the application of the DMIS. Interested parties were invited to make submissions to this process. The AER will publish a final version of this paper on or before 30 May 2009.

⁵ Several of these submissions (including AGL, CitiPower and Powercor, DPI, Jemena, Origin, SP AusNet and United Energy) also raised issues on the AER's framework and approach process, which is due to be completed on or before 30 May 2009. Submissions that dealt only with the DMIS were received from the CUAC, the TEC and Energy Response.

5 Issues raised in submissions and the AER's response

5.1 Development of a national DMIS

5.1.1 Stakeholder comments

The Total Environment Centre (TEC) stated:

it is curious that the AER has so far apparently not seen fit to investigate the potential for a national demand management code of practice.⁶

5.1.2 AER response

The AER has indicated that it will develop a national DMIS in the future. The AER remains committed to undertaking this project as part of its role as the national economic regulator of DNSPs. As indicated during development of the Queensland/South Australia DMIS, there are currently a number of uncertainties arising from related national policy developments in this area. These include the Carbon Pollution Reduction Scheme (CPRS)⁷ and related policy development and the Australian Energy Market Commission's (AEMC) current review of demand side response.⁸ The AER notes that the second stage of the AEMC's demand side response review process has been deferred.⁹

The AER intends to monitor the development of related policy initiatives and consider them in developing a national DMIS in the future. The AER considers that it would be inappropriate to develop a national DMIS before the extent of potential changes to the policy and regulatory framework within which it will operate are known.

5.2 Development and application of a DMIS for Jemena, CitiPower, Powercor, SP AusNet and United Energy

5.2.1 Stakeholder comments

The Consumer Utility Advocacy Centre (CUAC) called for a more transparent regulatory process and noted that the AER has not made a public submission to the AEMC demand side response review process. Further, it stated that the AER has not referred to work being done by the AEMC, making it difficult for stakeholders to evaluate the proposed DMIS. CUAC noted that the outcome of the AEMC review

⁶ Total Environment Centre, *Demand management incentive schemes for Victorian distribution*, submission to the AER, 27 February 2009, p. 7

⁷ *Carbon Pollution Reduction Scheme, Green Paper*, Australian Government, July 2008 available at <http://www.climatechange.gov.au>.

⁸ *Review of energy market frameworks in light of climate change policies*, AEMC, October 2008 available at: <http://www.aemc.gov.au/pdfs/reviews/Review%20of%20Energy%20Market%20Frameworks%20in%20light%20of%20Climate%20Change%20Policies/Scoping%20Paper.pdf>

⁹ See www.aemc.gov.au.

would impact on the effectiveness of the Victorian DMIS.¹⁰ CUAC also submitted that the AER has not provided analysis as to why a DMIS is necessary or desirable for application to Victorian DNSPs.¹¹

CUAC also stated that the AER's DMIS will have limited effectiveness in Victoria because, under the current form of regulation, DNSPs have incentives to maximise energy throughput (and are effectively penalised when forecast load is not realised). CUAC stated that this incentive will remain until a change in the form of price control occurs, or until there are greater compliance requirements on DNSPs to find efficient non-network alternatives.¹²

In its submission, SP AusNet stated that the proposed DMIS is unlikely to encourage greater demand management initiatives, and, in its current form, merely provides a cost pass through mechanism. SP AusNet considers that stronger incentives are required to overcome the significant barriers which currently exist in the sector in relation to how demand management is considered and valued.¹³

5.2.2 AER response

In its preliminary positions paper on the framework and approach for Victorian DNSPs, the AER outlined its consideration of several matters concerning the development of a Victorian DMIS. Chief amongst these was recognition of the operating environment in Victoria, which currently experiences the second highest peak load in Australia. The paper noted that Victoria's peak demand arises from several contributing factors including large businesses and industry having peak loads at coincident times, and the increasing penetration and use of air conditioning in homes. The AER notes that, although Victorian DNSPs have not previously been subject to a DMIS, the Essential Service Commission of Victoria (ESCV), in its Electricity Distribution Price Review 2006-2010 (EDPR) provided a number of demand management incentives for Victorian DNSPs, such as:

- a \$600 000 allowance over the regulatory control period, to fund trials of demand management initiatives
- the commencement of a mandated AMI rollout¹⁴
- permitting DNSPs to fund non-network alternatives using cost savings from deferred capex
- the provision of information, to be included in the DNSP's Annual Tariff Reports, on current and emerging network constraints and

¹⁰ Consumer Utility Advocacy Centre, *Submission to AER demand management incentive scheme for Victorian Distribution Businesses*, 5 March 2009, p.1

¹¹ *ibid.*

¹² *ibid.*

¹³ SP AusNet, *SP AusNet response to Framework and Approach Preliminary Position Paper*, submission to the AER, 6 March 2009, p. 20

¹⁴ This process was commenced by the ESC and completed by the AER in accordance with the transfer of functions on 1 January 2009. Details of the ESC's draft decision, released in December 2008, can be found at <http://www.esc.vic.gov.au/public/Energy/Consultations/Advanced+metering+infrastructure+price+review/Advanced+metering+infrastructure+review.htm>

- the approval of licences for embedded generators, and the exclusion of embedded generation or other approved demand management initiatives from the service incentive scheme.¹⁵

The AER has to date considered it appropriate to develop a modest DMIS (for DNSPs in other jurisdictions) recognising the capacity, at the distribution level, for the reduction of peak demand and the management of expected demand for standard control services. The AER anticipates that the Victorian DMIS will provide further scope for investigation of projects and programs that will contribute to this objective. Moreover, there has been significant stakeholder support for the application of a DMIS, in some form, in Victoria.¹⁶

In consideration of the current operating environment in Victoria, the AER recognises scope for initiatives to reduce peak or general demand in Victoria, and hence will apply the DMIS for the 2011–15 regulatory control period. Further details of the AER’s consideration of the criteria under cl. 6.6.3 of the NER are contained in section 7 of this final decision.

The AER referred to work being undertaken by the AEMC in its preliminary positions paper.¹⁷ In that paper, the AER noted that the AEMC is in the process of reviewing demand side participation in the NEM. Specifically, the AEMC is reviewing the issue of sub-optimal investment in alternative demand-side solutions, compared with investments in generation and networks. The AER notes that these deliberations are underway and therefore it is not in a position to form a view on the long term impact of the AEMC’s review on the uptake of demand management initiatives. Notwithstanding that this process may result in amendments to the NER (which may affect any national DMIS that the AER develops in the future), there is no indication as to any impact the AEMC’s review might have on the effectiveness of the Victorian DMIS.

In response CUAC’s comments on the form of regulation (namely, the WAPC) impacting on the effectiveness of the DMIS, the AER has previously identified this perceived disincentive in developing the Queensland/South Australian DMIS. The AER recognises that the price cap form of control can potentially have undesirable properties, for example:

- by providing incentives for DNSPs to set prices which increase the usage of electricity, which can undermine efficient demand management practices
- creating incentives to increase connections to high-volume users, while reducing connections to low-volume customers, and
- exposing the DNSP to volume risks when electricity sales volumes fall below forecast levels (making it difficult for the DNSP to recover its costs), albeit that these risks can be managed through tariff re-balancing arrangements.

¹⁵ ESC, *EDPR 2006-2010*, p. 495-499

¹⁶ The following stakeholders indicated support for a DMIS in Victoria: AGL, CitiPower and Powercor, DPI, Jemena, SP AusNet, United Energy, Origin Energy.

¹⁷ See AER, *Preliminary positions Framework and approach paper Citipower, Powercor, Jemena, SP AusNet and United Energy Regulatory control period commencing 1 January 2011*, p. 99

Under a WAPC, the DNSP's revenue increases with the volume of electricity sales. In contrast, the costs of providing a distribution network are largely independent of overall electricity volumes and depend, more, on factors such as the number of customers in a particular area and the peak capacity that is required to deliver electricity to each customer.

However, a WAPC also provides DNSPs with the ability to manage unexpected variations in volumes by re-balancing their tariffs, and encourages DNSPs to manage their costs within the constraints of their tariff revenue.

In response to these issues, the AER has incorporated the forgone revenue component into the DMIS (part B). Part B addresses the disincentive created by the interaction of the DMIS and the WAPC (where the revenue under the form of control is directly dependant on output levels and hence encourages DNSPs to maximise their throughput and revenue).

Part B of the DMIS allows a DNSP that is subject to such a form of control to recover forgone revenue which is directly attributable to a reduction in the quantity of electricity sold due to the implementation of a demand management program approved under part A of the scheme.

The AER notes that in responses to its preliminary positions framework and approach paper for DNSPs in Victoria, all Victorian DNSPs indicated a preference for a WAPC form of control. The forgone revenue component of the DMIS will be able to interact with the WAPC to offset the incentives arising from this form of price control.

In relation to SP AusNet's comments, the AER acknowledges that the DMIS is modest in nature and consequently not as high powered in its incentive properties. This has been a considered decision by the AER and acknowledges that demand management is at an early stage of development in Australia, and that further research is required before establishing high powered incentive arrangements that will deliver economically efficient demand management.

SP AusNet proposed several additional options for inclusion in the DMIS, including:

- an uncapped DMIA (further discussion contained in section 5.9 below)
- a broader D-Factor mechanism (further discussion in section 5.6 below)
- an embedded generation incentive rate and
- shared benefits and performance incentives.¹⁸

These may have the potential to deliver economically efficient demand management and warrant further investigation as part of future research and policy development work to be undertaken by the AER. As previously noted, the AER will develop a national DMIS in the future, and will consider these and other potential incentive arrangements in consultation with stakeholders when developing the national scheme.

¹⁸ SP AusNet, op cit, p. 26

The CUAC submitted that greater compliance requirements on DNSPs, to require them to undertake demand management, are necessary to increase incentives to investigate non-network alternatives. The introduction and enforcement of such requirements are beyond the scope of the AER's role. The AER operates under the framework of the NER and the NEL which have been developed through national energy policy institutions (i.e. MCE). Under chapter 6 of the NER, the AER's primary role as economic regulator is to make distribution determinations on pricing. The AER's role also includes the potential to develop demand management incentive schemes (under cl 6.6.3). The AER does not have the power to make decisions about how DNSPs should undertake demand management initiatives (see section 5.9.2 of this final decision for further discussion on this issue).

5.3 Interaction of the DMIS with the roll-out of advanced metering infrastructure (AMI)

5.3.1 Stakeholder comments

AGL submitted that demand management opportunities which have been enabled through the utilisation and implementation of advanced metering infrastructure (AMI) should be excluded from recovery under the DMIS.¹⁹

5.3.2 AER response

The AER acknowledges that the mandated rollout of AMI by Victorian DNSPs scheduled to occur in the forthcoming regulatory control period may impact on energy throughput for DNSPs. The rollout is part a framework enabled by a Victorian Order in Council (OIC)²⁰ which governs the AMI process.

As provided for in the OIC, the AMI rollout is the subject of a separate determination process which is being undertaken by the AER. More information on the AMI process can be found on the AER's website, at www.aer.gov.au. Regarding AGL's comment, the AER notes that the DMIA assessment criteria specifies that expenditure is not recoverable under the DMIS where it has been recovered under another jurisdictional or national scheme or process.

5.4 Interaction of the scheme with other incentive mechanisms

5.4.1 Stakeholder comments

The TEC submitted that the AER should ensure that where there is conflict between other incentive schemes, such as the efficiency benefit sharing scheme (EBSS) and

¹⁹ AGL, *Framework and Approach paper*, submission to the AER, 6 March 2009, p.3

²⁰ Order in Council made by the Victorian Governor in Council under sections 15A and 46D of *Electricity Industry Act 2000* and an amending *Order* made on 25 November 2008. See <http://www.esc.vic.gov.au/NR/rdonlyres/E6147A24-3DD4-49DF-9CFD-9974E7D3487F/0/AMIOIC.pdf> for the original OIC, and <http://www.esc.vic.gov.au/NR/rdonlyres/A294A749-1C54-4431-AA59-22177E86563E/0/AMIAMendmentorderincouncil.pdf> for the amended version

the service target performance incentive scheme (STPIS), demand management be given priority and not be disadvantaged.²¹

Specifically, in relation to the EBSS, TEC stated that the AER should clarify details of provisions excluding DMIS expenditure from operation under the EBSS.²²

5.4.2 AER response

Where expenditure on demand management that has been undertaken within a regulatory control period has not been contemplated in approved opex or capex forecasts, but rather, undertaken as part of the DMIS, it may result in an increase in opex above forecast levels. Under ordinary circumstances, this could lead to a corresponding penalty under the EBSS. To address this issue, the AER will exclude identifiable opex on non-network alternatives from the actual and forecast opex amounts used to calculate carryover gains or losses under the EBSS.²³

The AER notes that only demand management undertaken under the DMIS (and subsequently approved under the DMIA criteria) will be excluded from operation under the EBSS. Demand management expenditure submitted for approval under the DMIS, but rejected on the basis that it does not relate to demand management projects or programs in accordance with the DMIA criteria, will not be recognised as demand management expenditure. If that expenditure cannot otherwise be attributed to non-network alternatives, it will not be excluded from the operation of the EBSS.

5.5 Application of forgone revenue component

5.5.1 Stakeholder comments

CitiPower and Powercor sought clarification on the interaction between the forgone revenue component of the DMIS and the form of control applicable to Victorian DNSPs.²⁴

The CUAC stated that whilst there is a perverse incentive not to implement demand management projects where they may reduce revenue, lost revenue arising from implementation of the DMIS is likely to be minimal. The CUAC submitted that forgone revenue resulting from approved expenditure under the DMIA should be passed back to consumers as cost savings.²⁵

Energy Response submitted that the forgone revenue component of the DMIS should apply to all demand management initiatives undertaken within a regulatory control

²¹ TEC, op cit, p. 9

²² *ibid.*

²³ AER, *Electricity distribution network service providers – Efficiency benefit sharing scheme*, V.1, 26 June 2008, p. 7 (section 2.3.2).

²⁴ CitiPower Powercor, *Submission to the AER's Preliminary Positions Framework and Approach Paper*, 6 March 2009, p. 4

²⁵ CUAC, op cit, p. 3

period, and should not be limited only to demand management projects funded through the DMIS.²⁶

Like Energy Response, SP AusNet stated that the forgone revenue mechanism should be available for all demand management initiatives which defer capex (that is, not just demand management initiatives executed under the DMIS).²⁷

5.5.2 AER response

The AER intends to provide information as to the interaction between the price cap form of control and the DMIS as part of the form of control section of its framework and approach paper for the Victorian 2011-15 distribution determination, which will be released on or before 30 May 2009.

The forgone revenue component was designed to mitigate the disincentive to undertake demand management, created by a price cap. Requiring DNSPs to pass back revenue recovered through this mechanism would maintain this disincentive. Consequently, the AER will not require DNSPs to pass back the forgone revenue to customers. It is noted, however, that Victorian consumers may experience net cost reductions in the medium to long term where successful demand management solutions reduce or remove the need for network augmentation.

In response to the comments by Energy Response and SP AusNet, the AER considers that the recovery of forgone revenue under part B of the DMIS should be limited to non-tariff demand management initiatives approved under the DMIS. Tariff-based demand management programs provide price signals to electricity customers at times of peak electricity demand, for example critical peak pricing trials, and DNSPs that implement such programs may receive an increase in revenues due to the higher prices charged for electricity sales. As such, tariff-based demand management programs undertaken independently of the DMIS may not result in a DNSP forgoing revenues, despite any fall in demand associated with customer responses to higher prices.

5.6 Application of a D-factor

5.6.1 Stakeholder comments

SP AusNet and the TEC submitted that that AER should consider applying a D-factor mechanism (consistent with the approach for New South Wales in the current AER distribution determination) to DNSPs in Victoria for the 2011–15 regulatory control period.

The TEC stated that investigation is required into the possibility of application of a D-factor mechanism in Victoria, as DNSPs are operating under a price cap mechanism.

²⁶ Energy Response, *Comments on the proposed DMIS: CitiPower, Powercor, Jemena, SP AusNet and United Energy Regulatory Control Period commencing January 2011*, 6 March 2009, p. 2

²⁷ SP AusNet, op cit, p.23

TEC further stated that the application of the D-factor would provide greater experience with which to apply the mechanism in other jurisdictions.²⁸

SP AusNet submitted that the mechanism has achieved some success in NSW, citing that in 2004/05 and 2005/06, NSW DNSPs spent approximately \$8.26 million on 26 demand management projects under the D-factor scheme. SP AusNet stated that NSW DNSPs had avoided \$24.23 million of planned capex and opex over the 2004/05-2005/06 period as a result of approved demand management projects undertaken in conjunction with the D-factor mechanism.²⁹

The Victorian Department of Primary Industries (DPI) stated that the AER should make available analysis that has been or will be undertaken in relation to the NSW D-factor scheme, in order to make informed input on the design of DMIS in the future.³⁰

5.6.2 AER response

The AER recognises the potential incentive properties contained in a D-factor type scheme that would encourage DNSPs to undertake demand management projects and programs under certain circumstances.

Whilst the AER is not opposed to the application of a D-factor mechanism in principle, the results of the D-factor applied in NSW are not conclusive and findings about the scheme's potential to apply in other jurisdictions cannot be made at this time. The AER has previously stated that observation and analysis of D-factor outcomes over the 2009–14 regulatory control period in NSW will provide a better platform from which to consider the effectiveness of this mechanism and its potential future application. Whilst acknowledging initial reductions in planned capex that the D-factor scheme has enabled in NSW, two years of data is not sufficient to draw conclusions or as a basis for the introduction of a D-factor scheme in other jurisdictions. However, the AER will monitor the progress of the D-factor scheme and consider it as part of the national DMIS when more conclusive evidence of the D-factor's success is available.³¹ Data collected as part of the reporting requirements under the NSW/ACT DMIS will be made publicly available.

5.7 Approval criteria under the DMIA

5.7.1 Stakeholder comments

Energy Response stated that the assessment criteria in section 3.1.3 of the DMIS do not include any obligations on DNSPs to demonstrate value for money, and submitted that two amendments to the assessment criteria are necessary, these being:

²⁸ TEC, op cit, p. 2.

²⁹ SP AusNet, op cit, p. 21.

³⁰ Department of Primary Industries, *Framework and Approach for Victorian Electricity Distribution Businesses*, submission to the AER, 10 March 2009, p. 8.

³¹ The need for further observation of the D-factor mechanism was noted by DPI, see DPI, op cit, p. 8.

- adding an overarching criteria requiring demand management projects to demonstrate value for money
- removing criterion 3, regarding research and development, as Energy Response considered that there is very little actual research and development to be done.³²

Origin Energy agreed in principle with the DMIS, and supported the allocation of funding on an ex-post basis, where the demonstrated expenditure was effective in achieving benefits in demand management.³³

Jemena raised the issue of uncertainty of recovery both in relation to forgone revenue and costs incurred under the DMIA. Jemena submitted that the ex-post allowance for both the DMIA (and consequently, the forgone revenue component) presents a risk to DNSPs and will significantly reduce their incentives to undertake demand management initiatives under the DMIS.³⁴

5.7.2 AER response

The proposed annual DMIA amounts for each Victorian DNSP range from \$200 000 (for Jemena and CitiPower), \$400 000 (for United Energy) to \$600 000 (for SP AusNet and Powercor). Consistent with the modest nature of the DMIS discussed previously, these costs represent a relatively low percentage of each DNSPs annual revenue requirement. It is not envisaged that this will impose a high burden (nor a high risk) on individual customers. Although customers are effectively funding the DMIS, costs associated with undertaking a cost benefit analysis (or similar) for each DMIS program/project would likely exceed the amount of the DMIA and create an administrative cost that would undermine the scheme. Such onerous administrative requirements would be inconsistent with the modest intent of the DMIS and may create a disincentive for Victorian DNSPs to take up initiatives under the scheme. Consequently, this requirement will not be incorporated into the Victorian DMIS.

In relation to the proposed removal of criterion 3 (which permits DNSPs to allocate all or part of the DMIA to research and development initiatives), the AER considers that the Victorian DNSPs should be able to determine the scope for further research and development on demand side management or non-network alternatives that will affect expenditure on their networks. Therefore, the AER has retained assessment criterion three in the DMIS.

In response to Origin Energy, the AER confirms that DMIA expenditure will be assessed on an ex-post basis. Origin Energy also commented that it should be '*demonstrated expenditure was effective in achieving benefits in demand management*'.³⁵

³² Energy Response, op cit, p. 2.

³³ Origin Energy, *AER Preliminary Framework and Approach Paper for Victorian Distribution Businesses in regulatory period 2011*, submission to the AER, 6 March 2009, p. 7.

³⁴ Jemena, *Preliminary positions: Framework and approach paper – Citipower, Powercor, Jemena, SP AusNet and United Energy Regulatory control period commencing 1 January 2011*, submission to the AER, 13 March 2009, p. 13.

³⁵ *ibid.*

The AER will not require DNSPs to show that demand was reduced or otherwise managed through the DMIS as a condition of cost recovery. The programs and projects likely to be undertaken under the DMIS may be innovative and potentially untested. It is unlikely that DNSPs will be able to anticipate, what, if any, reductions in demand that may occur as a result. Refusing recovery for expenditure (on an ex-post basis) on the grounds that no reductions in demand were realised would create regulatory uncertainty, undermining the scheme, and be inconsistent with the intent of the scheme.

Where demand management initiatives are demonstrably in the interest of developing and implementing efficient, non-network alternatives and management of the expected demand for standard control services, they will be eligible for cost recovery, up to the specified cap. The AER does not consider it appropriate to only allow recovery of costs where the project or program has been successful in reducing demand.

In response to Jemena's submission, the intention of the ex-post approval process in the DMIS was to establish up-front clear criteria for assessment of expenditure on demand management initiatives, and to reduce the administrative costs associated with a review process that involved both ex-ante and ex-post components. In developing the DMIS ex-post criteria, the AER aimed to provide a clear indication of how it would assess DMIA expenditure. In considering Jemena's submission, the AER maintains its view that the risk of non-recovery of costs by DNSPs is minimal, given the relative certainty provided by the ex-post assessment criteria. However, the AER is mindful that some DNSPs are unfamiliar with such a demand management scheme, and therefore may require greater certainty before undertaking programs or projects under the scheme. For those DNSPs who wish to seek additional assurance on the recovery of costs for projects and programs under the DMIS, the AER considers that an optional, in-principle up-front approval of demand management programs or projects has merit.

Such an up-front approval would occur at the beginning of each regulatory year of the regulatory control period. Under this process, the AER will endeavour to examine proposed demand management initiatives (under the DMIS) and provide an indicative assessment of whether or not these projects or programs satisfy the DMIA assessment criteria. The AER emphasises that this process will not exclude DNSPs from the ex-post assessment in accordance with the DMIA criteria, and as such, is not an alternative or a substitute for that assessment. However, where the expenditure assessed as part of the ex post review does not differ in substance or form from the expenditure proposed at the commencement of the regulatory year under the in-principle up-front approval process, the AER expects that it would approve recovery of those costs. Where expenditure differs in substance and/or form from that proposed by the DNSP under the in-principle up-front approval process, it will be scrutinised against the ex post approval criteria. The AER urges DNSPS to consider whether variations in expenditure subject to the in-principle up-front approval process would likely satisfy the ex post criteria.

DNSPs will still be subject the ex post approval process as a final step for recovery of DMIA expenditure. Providing this option will also offer somewhat greater certainty regarding the AER's consideration of the forgone revenue component of the DMIS (as raised by Jemena in its submission).

The AER is aware of potential additional administrative costs associated with an in-principle up-front approval process. For this reason, the AER intends to introduce this as a voluntary option for those DNSPs seeking greater clarity on the potential approval of expenditure under the DMIA.

The final DMIS has been amended to reflect this development. Section 3 of the DMIS now contains the following:

For DNSPs who wish to utilise it, there is an optional up-front, indicative approval process at the commencement of each regulatory year for planned expenditure under the DMIA. This involves an in-principle examination of whether proposed expenditure under the DMIS would likely satisfy the DMIA criteria under the ex post assessment. This is designed to provide greater certainty of cost recovery for DNSPs, and is not an alternative to the ex post assessment conducted by the AER.

The approval criteria contained in section 3.1.4 of the DMIS now contains additional wording as follows:

DNSPs seeking indicative up-front approval of planned expenditure under the DMIS must provide details of the proposed projects, programs, or initiatives that the DNSP wishes to have examined by the AER by 31 January in the relevant regulatory year.

The AER will then undertake an examination of the projects, programs or initiatives and provide an in-principle indication of whether the expenditure proposed under the DMIS would satisfy the DMIS criteria.

5.8 Treatment of capex under the DMIS

5.8.1 Stakeholder comments

SP AusNet noted that failing to roll capex spent under the DMIA into the regulatory asset base (RAB) would deter investigation of non-network solutions, and stated that under such an approach demand management capex would not be treated on an equal footing to network augmentation or replacement capex. SP AusNet submitted that allowing DNSPs to roll demand management capex into the RAB and retain the capex savings from network replacement/augmentation deferral would be necessary to encourage DNSPs to undertake demand management. SP AusNet considered that this is particularly the case given that the regulatory framework operates to reward DNSPs more from spending capex than opex. That is, the balance of incentives already works to deter demand management.³⁶

Energy Response submitted that if a non-network solution, once implemented, defers capex which has already commenced within the regulatory control period, an automatic approval process should be enabled for continuation of that capex in the subsequent regulatory control period.³⁷

³⁶ SP AusNet, op cit, p.22

³⁷ Energy Response, op cit, p. 2

5.8.2 AER response

The AER notes that the NER do not provide for it to pre-empt decisions on how capex will be treated at the time of future distribution determinations. That is, the AER cannot commit itself to a future decision to roll DMIS capex into the RAB, and nor can it guarantee an ‘automatic’ approval process at the beginning of future regulatory control periods as proposed by Energy Response. The assessment of capex, both actual and forecast, remains an issue to be considered at the time of the relevant distribution determination.

SP AusNet stated in its submission that demand management capex is not being treated on an equal footing as network augmentation or replacement capex. The AER acknowledges that chapter 6 of the NER provides it with the ability to only assess network augmentation and replacement capex against the capex criteria contained in cl. 6.5.7(c). Capex undertaken in accordance with the DMIS is not assessed against the capex criteria; instead it is assessed against the DMIA criteria in the DMIS. Because there is no scope for the AER to consider DMIS capex mid period against the requirements of cl. 6.5.7 of the NER, the AER cannot commit to rolling such capex into the RAB. However, the DMIS still provides certainty as to the recovery of DMIS capex costs. The AER also notes that it is open for DNSPs to, where appropriate, propose planned capex programs associated with demand management for consideration under cl. 6.5.7 as part of the distribution determination. Capex projects approved as part of the determination are rolled into the RAB.

The AER also notes the potential for double recovery of costs if DMIS capex is rolled into the RAB. Double recovery would occur where capex is fully recovered under the DMIS and is rolled into the RAB and a return on that capex is also recovered over the life of the asset(s). It is considered that DMIS capex is more akin to connections and capital contributions which are funded separately by particular customers and are not included in the RAB.

It is envisaged that the majority of expenditure under the DMIS will be in the form of opex, however, capex was included under the DMIS so as not to inhibit the scope of projects that DNSPs could undertake through the scheme.

Allowing capex under the DMIA through the DMIS criteria allows cost recovery of innovative and potentially untested demand management capex projects and programs. Through the DMIA, the DMIS offers a mechanism to recover such capex, without necessary recourse to the capex criteria in cl. 6.5.7 of the NER.

5.9 Application and amount of a DMIA

5.9.1 Stakeholder comments

The CUAC submitted that DNSPs earn more than sufficient margins to use money already collected in revenues for research and development purposes. Additional funds are not required for research and development to take place.³⁸

³⁸ CUAC, op cit, p.2

The CUAC further submitted that where the AER considers that DNSPs are not dedicating sufficient funding to research and development, it should compel business to allocate revenue to the implementation of demand management research (instead of a DMIA style allowance).³⁹

SP AusNet submitted that DNSPs do not have incentives to adopt innovative solutions because of a lack of competitive pressures to do so (as it is a regulated business). It further stated that capping a broad-based demand management scheme to the level proposed by the AER won't encourage significant innovation as the development (and testing) of new, technologically advanced equipment is costly. Hence, SP AusNet considers that the DMIA should be uncapped, as the current capped arrangement will not encourage spending in this area.⁴⁰

The TEC stated that the DMIA should be increased to 5% of the projected network capex for each Victorian DNSP as the current DMIA is insufficient to promote extensive demand management. Based on this, the TEC further stated that demand management targets should be set for each DNSP.⁴¹

5.9.2 AER response

The capped allowance is designed to provide incentives for DNSPs to investigate, trial and/or undertake efficient broad-based and peak demand management projects and programs involving capex and opex. The amount of the allowance for each DNSP is scaled to the relative size of each DNSP's average annual revenue allowance in the previous regulatory control period. The AER considers this to be a workable approach and does not consider that there is sufficient reason to depart from its position, which it has applied to DNSPs in other jurisdictions. The AER notes that, based on the DMIA amounts indicated in its preliminary positions paper for Victorian DNSPs, the cumulative amount of the DMIA for Victoria is a total of \$10 million over the 2011–15 regulatory control period. The AER considers that this amount of money provides significant scope for the investigation of demand management and non-network opportunities in Victoria over that period.

The AER has previously emphasised that the DMIS is not intended to be the primary source of recovery for demand management expenditure. Rather, the AER considers it appropriate that a DNSP recover demand management costs primarily through forecast opex and capex approved at the time of the AER's distribution determination. The AER notes both cls. 6.5.6 and 6.5.7 compel the consideration of non-network alternatives.

At this early stage of demand management development, the AER does not consider it appropriate to uncap the allowance as proposed by SP AusNet, nor to increase the DMIA to 5% of network capex as proposed by the TEC. In developing a DMIS, the AER must consider the willingness of customers to pay for increases in costs resulting from the implementation of a DMIS. Whilst an uncapped allowance may be appropriate in the future, at this stage there is insufficient information demonstrating

³⁹ *ibid.*

⁴⁰ SP AusNet, *op cit*, p. 23.

⁴¹ TEC, *op cit*, p. 4.

customer willingness to pay for an uncapped DMIA. The AER considers that a modest DMIS will facilitate the implementation of demand management initiatives by DNSPs, while minimising upward pressure on customer prices in the absence of a demonstrable willingness by customers to pay significantly for such initiatives.

The DMIA criteria allow for potential recovery for DMIS initiatives, even if they are not proven to be successful in limiting or reducing demand. A larger (or uncapped) scheme could result in customers funding an unlimited amount (under the DMIS) for initiatives that have failed to reduce demand. This places an undue risk on customers. Therefore, by capping the DMIA, the possibility of customers funding infinite amounts of unsuccessful demand management solutions is removed.

The CUAC stated that DNSPs should be required to allocate a portion of revenue to demand management research and development (as opposed to providing a DMIS). The AER cannot require this under the NER, as it is beyond the scope of the AER's powers. In any case, it is inconsistent with the incentive-based regime, which does not take the form of command-control approaches. The AER cannot compel a DNSP to undertake certain expenditure or activities with revenue it has generated through the provision of distribution services. The AER's role in encouraging demand management expenditure is limited to its power to develop incentive schemes under cl. 6.6.3 of the NER.

In response to TEC's statement that demand management targets should be set, the AER intends that the DMIS should provide flexibility to undertake untried initiatives during the course of the regulatory control period. Compelling DNSPs to comply with pre-determined targets would diminish this flexibility and potentially dilute the incentive to take up demand management under the scheme.

5.10 DMIS reporting requirements

5.10.1 Stakeholder comments

Jemena submitted that the DMIS will result in high administrative costs (citing specifically the requirement of director sign off on DMIA expenditure).⁴² Jemena proposes that, as an alternative, regular reporting by the DNSP would provide sufficient information on the progress of any DMIS initiatives approved and implemented by the DNSP.

DPI stated that the reporting requirements under the DMIS appear to focus on implementation of demand management solutions rather than also reporting on outcomes.⁴³ DPI submitted that the AER should review how Victorian DNSPs have used demand management funding in the current regulatory control period,⁴⁴ what benefits have been achieved through this expenditure, and whether these benefits

⁴² Jemena, op cit, p. 13

⁴³ DPI, op cit, p. 8

⁴⁴ Energy Response also raised the issue of current use of demand management funds, see Energy Response, op cit, p. 1

support the proposal to allocate more funding for demand management in the next regulatory control period.⁴⁵

TEC stated that it would be beneficial for the AER to develop a public database of successful and unsuccessful demand management techniques, given that experience in this area is still minimal.⁴⁶ Further, the TEC stated that the AER should undertake a benchmark investigation of all demand management actions initiated by DNSPs, and that this information should be publicly available.

5.10.2 AER response

The AER considers that DNSP director sign off is necessary for assurance that information provided to the AER has been considered and approved at the appropriate corporate level. Therefore, the requirement for director sign off will remain in the DMIS. A pro forma for this sign off appears at appendix B of the DMIS.

Under the annual reporting requirements in the DMIS, DNSPs will publicly report on demand management programs as part of the DMIA approval process. DNSPs will be required to provide information as to the nature of the expenditure, peak demand, energy consumption reductions, and efforts to identify and procure cost effective demand management. Part B of the DMIS, where applicable, allows recovery in defined circumstances of revenue forgone as a result of DMIA expenditure. For recovery of forgone revenue, the DNSP must report on the amount of demand reductions (in MW), and provide calculations of its forgone revenue and details of the basis of any estimates used in its calculations.

The AER will require that the formal application for cost recovery be made public as part of a report on demand management programs carried out by DNSPs. In addition, at the completion of the annual review, the AER will publish the amount of any approved expenditure, and its reasons for approving, or not approving, expenditure under the DMIA. As the regulatory control period progresses, this will allow the AER to collect and publish information on the nature and extent of expenditure under the DMIS. Annual reports submitted by the DNSPs in accordance with the DMIS criteria will also provide information on the effectiveness of approved initiatives, with regard to their stated objectives.

This information, which will be provided by each DNSP as part of its reporting obligations under the DMIS, will be made publicly available on the AER's website. This will allow information to be accessible to stakeholders, and other DNSPs wishing to undertake DMIA expenditure. The AER considers that there is merit in creating a public database of demand management projects and programs in the future and will investigate this as a part of the national DMIS.

Some submissions stated that DNSPs should be compelled to report on the end user benefits resulting from the implementation of the DMIS. The current DMIS reporting criteria contained in section 3.4.1.4 compels DNSPs to outline benefits achieved through the implementation of the DMIS. The AER anticipates that this will include

⁴⁵ DPI, op cit, 8

⁴⁶ TEC, op cit, p. 2

details of any customer benefits realised, where demand management initiatives result in reduced energy throughput.

DPI considers that the AER should assess how demand management allowances have been utilised by DNSPs in the current regulatory control period. There are currently no specific reporting requirements on demand management expenditure for Victorian DNSPs under the ESCV's Electricity Distribution Price Review 2006-2010. To this end the AER also notes there is no provision for an ex-post review of actual capex or opex during the current regulatory control period, irrespective of whether or not the expenditure relates to demand management, in accordance with the EDPR. Neither is there any such provision under the NER generally.

5.10.3 Projects undertaken under the DMIS

5.10.4 Stakeholder comments

The TEC stated that the AER should clarify between projects undertaken by DNSPs for the DMIS from demand management undertaken in the normal course of business.⁴⁷

5.10.5 AER response

As discussed previously, the AER does not envisage that the DMIS will be the sole source of funding for non-network alternatives in the forthcoming regulatory control period. The DMIS will work in conjunction with other demand management initiatives permitted under the NER, and broader programs such as the AMI rollout in Victoria (this was noted by United Energy in its submission).⁴⁸

The DMIS provides an incentive for DNSPs to engage in new and innovative processes, with an aim to reducing or managing the expected demand for standard control services throughout the regulatory control period. Costs associated with these initiatives may be recovered under the DMIS even where they are not successful in reducing or managing expected demand. Therefore, an opportunity exists to investigate untried approaches that may not have been appropriate for inclusion in the opex and capex proposals for assessment under cls. 6.5.6 and 6.5.7. The AER envisages that projects undertaken under the DMIS will be mainly at the research and development, or trial, stages of implementation.

Projects undertaken as part of the DNSP's normal course of business will likely be more developed non-network solutions which have been trialled and demonstrated to be successful in reducing or managing the expected demand for standard control services. These projects and programs should be included as part of the DNSPs opex and capex in its regulatory proposal. As these initiatives are subject to scrutiny under chapter 6 of the NER, they should be demonstrably successful alternatives to network solutions. Before approving opex and capex forecasts in the distribution determination, the AER will require DNSPs to satisfactorily demonstrate that efficient

⁴⁷ TEC, op cit, p. 2

⁴⁸ United Energy, *AER's Framework and Approach Paper – Regulatory control period commencing 1 January 2011*, 6 March 2009, p. 6.

non-network alternatives to capital and operating expenditure have been properly considered in the development of forecasts for the regulatory control period.⁴⁹

⁴⁹ In accordance with cls. 6.5.6(e)(5) and 6.5.7(e)(10).

6 The demand management incentive scheme

The DMIS that will be applied through the AER's distribution determination for the Victorian DNSPs consists of two parts.

Part A—DMIA

The DMIA allows the recovery of costs for demand management projects and programs throughout the regulatory control period, subject to satisfaction of defined DMIA criteria.

Part B—Recovery of forgone revenue

Part B of the DMIS will allow recovery of forgone revenue by a DNSP where there are reductions in the quantity of energy sold due to approved DMIA expenditure. This will occur where the form of control applied to a DNSP's standard control services results in a DNSP's approved regulated revenue being dependent on the quantity of electricity sold.

The operation of the DMIA takes place in four key steps.

Step 1 Amount of the DMIA

The total amount recoverable under the DMIA within a relevant regulatory control period will be capped at an amount that is broadly proportionate to the relative size of the DNSP's average annual revenue requirement in the previous regulatory control period.

Step 2 Access to the DMIA

The approved amount of the DMIA will take the form of an annual ex-ante allowance provided as additional revenue for each regulatory year of the regulatory control period. The total amount of the allowance will be distributed evenly across each regulatory year of the regulatory control period.

The maximum amount that can be spent under the DMIA in any one regulatory year is uncapped, however the total amount recoverable over the regulatory control period cannot exceed the total amount of the allowance determined in step 1. That is, within the regulatory control period the DNSP has the flexibility to select an expenditure profile that suits its needs.

Step 3 Approval of expenditure under the DMIA

At the end of each regulatory year of the regulatory control period, the AER will conduct an assessment of expenditure incurred by the DNSP in the preceding regulatory year, against the criteria established in the scheme as part of the AER's regulatory information order (RIO).⁵⁰ As a result of this assessment, expenditure will be either approved or rejected. The total amount of expenditure approved by the AER

⁵⁰ The AER's review will take place once audited data becomes available for the previous regulatory year.

over the five year regulatory control period cannot exceed the total amount of the allowance determined in step 1.

Step 4 Final year adjustment

Once data becomes available for the final regulatory year of the regulatory control period, the AER will calculate a carryover amount to account for:

- any amount of allowance unspent or not approved over the period
- the time value of money accrued/lost as a result of the expenditure profile selected by the DNSP
- if part B applies to the DNSP, the amount of forgone revenue as a result of approved demand management initiatives under the innovation allowance.

Given the time lag in data collection, the final carryover amount will be deducted from (added to) allowed revenues in the second regulatory year of the subsequent regulatory control period.

7 Consideration of factors set out in the NER

In developing its DMIS for Jemena, CitiPower, Powercor, SP AusNet and United Energy the AER must have regard to the factors prescribed in cl. 6.6.3 of the NER. These are discussed in turn below.

7.1 The need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for DNSPs

The rewards and penalties payable under a DMIS must be set at a level that ensures that the costs to consumers resulting from the associated adjustment to regulated revenues do not exceed the benefits expected to result from the implementation of the DMIS. In striking the appropriate balance, it must be recognised that the operation of such a scheme may result in cost impacts within a regulatory control period, the benefits of which are unlikely to be obtained until later periods.

The AER considers that the DMIS will help to encourage the implementation of demand management initiatives. These initiatives are likely to provide long term efficiency gains to energy users that will outweigh any short term price increases. The DMIS is designed to:

- facilitate investigation and pursuit by DNSPs of efficient, broad-based and/or innovative demand management projects and programs that have the potential to lead to the implementation of efficient non-network solutions within and beyond the regulatory control period, and
- encourage a more complete management of the demand for standard control services.

Given that peak demand is a key driver of network capital expenditure, the DMIA could also be used to implement initiatives which result in a more efficient use of existing infrastructure and a lower level of investment in new infrastructure through either deferral of, or removal of the need for, network augmentation and/or expansion expenditures. This may in turn lead to lower demand overall, lower network investment, and consequently lower customer electricity prices.

The DMIA is modest, provided on a ‘use-it-or-lose-it’ basis. At this stage, the AER does not consider this modest allowance to be overly burdensome on end users, who bear the cost of this in the long term. As information is garnered about customers willingness to pay for increased demand management projects and programs, and further research and development is undertaken, the AER may consider broadening the scope of the DMIA in a future national scheme.

The DMIA is designed to provide additional incentives for DNSPs to conduct demand management to those present within the broader regulatory framework. Consequently, increases in customer prices as a result of the scheme’s implementation are expected to be minimal. The addition of a forgone revenue recovery mechanism will in effect mirror the price outcomes that would have arisen within the regulatory control period but for the implementation of the relevant demand management project or program.

As such, it is not expected to result in any increase in prices within the regulatory control period.

7.2 The effect of a particular control mechanism (i.e. control over prices as distinct from controls over revenues) on a DNSP's incentives to adopt or implement efficient non-network alternatives

In developing the DMIS, the AER has had regard to the effects that particular control mechanisms have on the incentives or disincentives for DNSPs to undertake demand management. The AER accepts that incentives for demand management may be affected by the control mechanism applied to a DNSP's standard control services.

The AER will take into account the effect on incentives for demand management when determining the control mechanism to apply to a DNSP. Under forms of control whereby the recovery of the annual revenue requirement is at least partially dependent on the quantity of electricity sold (e.g. a price cap), a successful demand management program that causes a reduction in demand may result in less revenue to a DNSP, creating a disincentive to reduce electricity sales through demand management initiatives. To counter this disincentive, the AER may allow a DNSP subject to such a control mechanism to recover any forgone revenue due to a reduction in the quantity of electricity sold that is directly attributable to the implementation of a demand management program approved under the DMIA.

The AER will assess the effect a form of control will have on a DNSP's incentive to undertake demand management projects or programs on a case-by-case basis. A likely approach to the application of part B of the DMIS to a DNSP (where such application is appropriate) will be set out in the AER's framework and approach paper, at the time that the decision on the form of control to apply to that DNSP is considered. The AER's final decision on the application of the DMIS to a DNSP will be made in its distribution determination for that DNSP.

7.3 The extent the DNSP is able to offer efficient pricing structures

In developing its DMIS, the AER has had regard to the extent that DNSPs are able to offer efficient pricing structures, such that at a particular point in the network, the price of electricity reflects the true costs of supply at that location at a particular time. Efficient pricing structures would allow prices to reflect increases in the costs of supply of electricity during times of peak demand.

The AER considers that there is scope within the current regulatory arrangements to provide efficient pricing structures, for instance in the application of peak tariffs or time-of-use tariffs to a DNSP's large customers. However, constraints on pricing structures, in particular for small customers, continue to exist. This is partly due to the failure of price signals to reach small customers, which may be addressed by the roll-out of smart meters and associated tariff arrangements in Victoria.

The AER considers that efficient pricing structures can assist the effectiveness of demand management programs, and that the DMIA will provide further incentives for

DNSPs to conduct tariff-based demand management initiatives by providing an allowance for DNSPs to further investigate broad-based and/or peak demand management projects and programs.

7.4 The possible interaction between a DMIS and other incentive schemes

In developing the DMIS, the AER has had regard to the effect that the application of the scheme will have on the incentives created by the EBSS and STPIS, and vice versa.

The incentive created by the DMIS is for a DNSP to develop and implement efficient demand management initiatives.

Opex spent on non-network alternatives, including demand management expenditure, will be excluded from the actual and forecast opex amounts used to calculate carryover gains or losses under the EBSS. As such, DNSPs will not be penalised under the EBSS for increases in opex resulting from demand management expenditure not included in the distribution determination. Expenditure under the DMIA will also be excluded under the EBSS, and as such will not result in penalties for DNSPs under the EBSS.

As discussed in section 5.2 of this final decision, the AER is aware of the perceived disincentive to implement non-network alternatives to augmentation created by the reliability performance measures in its STPIS, such that incentives to undertake demand side management may be diminished in the absence of an adjustment to targets or an exclusion to recognise what is seen as a greater risk that targets will not be met. However, the AER considers it important that the STPIS remains neutral in its application to network and non-network measures, and maintains that the risk associated with non-network alternatives is better placed with a DNSP than with its customers. Where aspects of performance are within a DNSP's control, the associated risk should also lie with the DNSP.

The AER does not consider that the application of the DMIS will negatively interact with the incentives created by other incentive schemes, or that the EBSS and STPIS will hinder the effectiveness of the DMIS.

7.5 The willingness of the customer or end user to pay for increases in costs resulting from implementation of the scheme

In developing the DMIS, the AER has had regard to the extent to which customers are willing to pay for any increase in costs that may arise from the implementation of the scheme.

In light of this, the AER considers that a modest scheme such as the DMIS, the impacts of which on customer prices are likely to be minimal, is appropriate at this time. The scheme is expected to encourage DNSPs to undertake demand management initiatives which will provide long term efficiency gains to energy users.

Appendix A: Submissions received on proposed DMIS

The following parties provided submissions on the proposed DMIS:

- AGL
- the Consumer Utility Advocacy Centre
- CitiPower/Powercor
- Department of Primary Industries
- Energy Response
- Jemena
- Origin Energy
- SP AusNet
- the Total Environment Centre
- United Energy

Copies of these submissions are available on the AER's website at www.aer.gov.au.