DRAFT DECISION

Ergon Energy
Distribution Determination
2020 to 2025

Attachment 11
Demand management incentive scheme and innnovation allowance

October 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Ergon Energy for the 2020–2025 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

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Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

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Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CESS	Capital expenditure sharing scheme
DM	demand management
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 and innovation allowance

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.

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.

This attachment sets out how we will apply the DMIS and DMIAM to Ergon Energy for the 2020–25 regulatory control period.

11.1 Draft decision

In accordance with our framework and approach (F&A),[3] our draft decision is to apply the new DMIS[4] and DMIAM[5] to Ergon Energy for the 2020–25 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, our distribution determination will provide that the cost multiplier (uplift) applicable to any eligible project will be the cost multiplier specified in the current version of the DMIS that is in effect at the time 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*, Final framework and approach, Energex and Ergon Energy, Regulatory control period commencing 1 July 2020*, July 2018, pp. 73-75.

[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 $200000 (real 2017), plus 0.075 per cent of the annual allowed revenue for each regulatory year, as set out in our Post-Tax Revenue Model (PTRM) for Ergon Energy
- project eligibility requirements, and
- compliance reporting requirements.

In our final distribution determination, we will determine the amount of the DMIAM allowance for Ergon Energy for the 2020–25 regulatory period, based on the final PTRM for Ergon Energy.

11.2 Ergon Energy's proposal

Ergon Energy proposed to adopt the approach specified in the F&A.[9]

Ergon Energy proposed its demand management plan for 2020–25 in the context of its overall approach to planning and developing strategies for an intelligent grid and for its tariffs and customers. Ergon Energy contended that its customer and stakeholder engagement has informed its proposed DM activities.[10]

Regarding the DMIAM, Ergon Energy has not identified specific projects for 2020–25 but stated that its projects will have the following focus areas:[11]

- Managing two-way energy flows—managing reverse flows from widespread installation of solar PV that have impacted on the network
- Efficient investment decision-making—implementing advanced forecasting and network modelling, and resolving network capacity issues
- Incentivising customer efficiency—implementing more cost-reflective financial signals, and enhancing interactions with customers
- Active customer response enablers—developing a new system for customer demand response
- Transforming supply at the fringe of the grid—studying options for supplying electricity in remote areas

In selecting projects for DMIAM funding, Ergon Energy asserted that the projects will:[12]

- be evaluated through its strategy asset safety and performance innovation framework

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

9 Energex and Ergon Energy, *An Overview: Our Regulatory Proposals 2020-25*, January 2019, p. 41.

10 Energex and Ergon Energy, *Demand Management Strategy and Plan 2020–25*, January 2019, p. 1.

11 Energex and Ergon Energy, *Demand Management Strategy and Plan 2020–25*, January 2019, p. 21, Table 9.

12 Energex and Ergon Energy, *Demand Management Strategy and Plan 2020–25*, January 2019, p. 22.

- be subject to its standard project governance framework
- meet the DMIA criteria and objectives,

and that it will share its findings with industry and customers so they can benefit from project learnings.

Ergon Energy intends to apply for the maximum DMIAM allowance of $200000 plus 0.075 per cent of its approved revenue under the distribution determination.

With regard to the DMIS, Ergon Energy referred to its application[13] to the AER for the early implementation of the scheme—that is, commencing before the start of the next regulatory period on 1 July 2020. The AER approved Ergon Energy's proposal for early application of the new DMIS, with an effective start date of 15 December 2018.[14]

Ergon Energy stated that, under the new DMIS, it will apply for incentives equivalent to 50 per cent of DM incentives paid to customers for:

- Target Area[15] incentives, and
- any new generation contracts negotiated during the 2020–25 period.[16]

According to Ergon Energy, it will align its existing demand management processes with the requirements of the new DMIS.

11.3 Assessment approach

We are required to make a decision on how the DMIS and DMIAM are to apply to Ergon Energy.[17] We outlined our proposed approach to, and reasons for, the application of the DMIS and DMIAM in our F&A for Ergon Energy.

Our draft decision has adopted the position in the F&A. We have considered materials submitted to us by Ergon Energy and by stakeholders.

11.3.1 Interrelationships

The DMIS will encourage demand management initiatives that 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 deferring or removing the need for network

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13 Energy Queensland, *Request for early application of the revised DMIS*, 27 September 2018.

14 AER, *Final determinations - Early application of the Demand Management Incentive Scheme - AusNet Services, Ergon and Energex*, 11 December 2018.

15 Target Areas are network areas where augmentation or replacement expenditure is less than $5 million and incentives are offered to encourage demand reductions where these are required. (Energex and Ergon Energy, *Demand Management Strategy and Plan 2020–25*, January 2019, p. 5.)

16 Energex and Ergon Energy, *Demand Management Strategy and Plan 2020–25*, January 2019, p. 22.

17 NER, cll. 6.3.2(a)(3) and 6.12.1(9).

augmentation or replacement expenditure due to more efficient use of existing infrastructure.

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

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

As explained in our final decision for the new DMIS, we consider that the symmetrical operation of incentives under the CESS and EBSS should balance out any negative impacts that distributors may experience under any one of these schemes. For instance, as distributors spend more on opex, they may exceed their targets under the EBSS and receive a smaller incentive or higher penalty as a result. However, since the DMIS only incentivises efficient demand management projects, we would expect that reductions in capex gained from project deferral or avoidance would exceed any increase in opex under the demand management project. In this scenario, benefits under the CESS would outweigh any detriment provided under the EBSS.[18] Hence, we expect the DMIS will encourage distributors to undertake more demand management activities where it is efficient to do so.

We will not exempt DMIS projects from the STPIS as we consider this would negatively affect consumers in two ways. First, exempting demand management solutions from the STPIS would transfer the risk of failure onto consumers, who have little opportunity to mitigate that risk. Second, 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 support the objective of the DMIS scheme, which is to promote efficient investment in non-network demand management options.[19]

11.4 Submissions

We received one submission with a comment on the Queensland distributors' use of demand management measures. Origin Energy, in commenting on network tariff reform, believes that managing demand through tariffs is currently not fully effective, and therefore more non-tariff DM measures should be taken. Origin stated that:

> There also needs to be recognition that effective smart demand response technology that enables greater energy management is not yet sufficiently

[18] AER, *Explanatory statement, demand management incentive scheme, Electricity distribution network service providers*, December 2017, p. 60.

[19] NER, cl. 6.6.3(b).

> available or economic for the vast majority of residential customers. In the absence of a material penetration of appropriate technology in the correct network locations, the effectiveness of cost reflective tariffs will be muted. Under these conditions, we believe incentive-based demand management initiatives may provide a more effective outcome in the short-term.[20]

We note that Ergon Energy has taken this into consideration in its demand management strategy. In proposing its DM plan for 2020–25, Ergon Energy explained that its overall approach to demand management includes consideration of both cost-reflective tariffs and non-tariff DM projects. Ergon Energy's 'broad-based initiatives' provide tariff-based incentives for households that connect to control load tariffs (such as for hot water systems and pool pumps) or participate in the Peak Smart air-condition program (to reduce demand during summer peak). Non-tariff based DM includes Target Area initiatives (see footnote 15), DM development activities such as optimising load controls and developing capability to trial innovative DM solutions, and DMIAM projects.[21]

11.5 Reasons for draft decision

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

Along with the new DMIS, the AER has improved the DMIAM. The improved allowance provides more funding to networks to undertake further research on demand management initiatives and to share these learnings across industry and consumers.

We note Ergon Energy has not identified specific projects under the new DMIAM. However, it has identified focus areas for potential projects, as discussed in section 11.2 above.

Ergon Energy will be required each year to provide supporting documents as required under the new DMIS and DMIAM to prove that its 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.

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20 Origin Energy, *Re: QLD Regulatory Proposal 2020-25*, 31 May 2019, p. 3.

21 Energex and Ergon Energy, *Demand Management Strategy and Plan 2020–25*, January 2019, pp. 4-9.