

Draft decision: Demand management incentive scheme and innovation allowance

What are we proposing to change?

Our draft demand management incentive scheme is a proposed way to better encourage electricity distribution businesses to more actively manage demand on their networks.

In tandem, we are proposing to improve our complementary demand management innovation allowance. This allowance supports distribution businesses in innovatively exploring how demand management can reduce the longer-term costs of operating their networks.

What is demand management in electricity networks?

For electricity network businesses, demand management involves modifying demand on their networks to remove a constraint or a 'identified need'. Causes of constraints can be:

- peaks in demand
- aging assets and associated risks
- minimum demand and associated power quality issues
- diverse power flows and security issues

Why encourage more demand management?

Distribution businesses have generally focussed on supply to meet the demands on their networks. This involves meeting network demand by investing in expensive assets— the costs of which are passed onto consumers.

Effective demand management can defer or limit the need to invest in these assets. This can deliver substantial savings to consumers, who might otherwise pay for unused network capacity.

Demand management may also help consumers get the most out of new technologies, such as consumer battery storage and internet of things devices. These new, consumer-controlled technologies create both challenges and opportunities for electricity networks. These change how the grid works, sometimes in ways that are difficult to predict. However, demand management can help coordinate and manage these technologies so they can deliver greater value to electricity consumers.

Why a demand management 'incentive scheme'?

There are many reasons why distribution businesses have historically focussed on supply-side solutions. In some cases, this has been because demand-side solutions have historically been costlier and riskier than supply-side solutions. In other cases, this has been because distribution businesses have been more skilled or accustomed to dealing with supply-side solutions. Sometimes, this has been because regulatory incentives have led distribution businesses to prefer supply-side solutions, even when demand-side solutions might deliver more value to consumers. Often, a combination of these factors has been at play.

It is our view that our proposed demand management incentive scheme should assist the industry in taking a more balanced approach in considering solutions from both the demand-side and supply-side. Taking a broader, more holistic view should support distribution businesses in making investment choices that deliver the most value to electricity consumers.

It is important for us, the AER, to also take a holistic view. This means exploring other ways to improve the way we regulate so that distribution businesses use demand management whenever doing so is in the long term interest of consumers.

For instance, we have been encouraging price signals that better reflect the drivers of network costs. We initiated a replacement expenditure rule that will increase the transparency of network businesses' plans to retire and replace assets. We also recently released our first user-friendly Distribution Annual Planning Report template to better assist non-network business in developing demand-side solutions to address network constraints.

In addition to these improvements, an incentive scheme that rewards demand management where efficient should encourage distribution businesses to act in the long term interest of electricity consumers.

How will our incentive scheme support good outcomes?

Our proposed incentive scheme will incentivise demand management that is (or forms part of) an efficient project to address network constraints. In identifying whether a project is efficient, distribution businesses will need to test whether businesses in the demand management market can solve the network constraint in a more efficient way.

By having these requirements, our proposed incentive scheme should promote both efficiency and competition. In practice, we see distribution businesses:

- Selecting efficient projects that deliver the most value to consumers when solving network constraints, regardless of whether these projects constitute a demand-side or supply-side option.
- Asking third parties to propose demand management solutions, and forming contracts with parties that propose solutions that deliver the most value to consumers.

How will our proposed incentive scheme work?

Under our proposed incentive scheme, we will give distribution businesses a payment worth up to 50% of the expected demand management costs if they invest in efficient demand management projects. This payment helps distribution businesses to benefit from their effort to identify and contract demand management projects.

Incentive payments will be up to 50% of the costs of demand management projects assessed as efficient.

To help the incentive scheme deliver long-term savings to consumers, this incentive payment can be no more than the net benefit the project delivers to the electricity market.

Distribution businesses will estimate this net benefit using a cost-benefit analysis akin to that set out under our regulatory investment test.

The incentive payment for any project can be no higher than that project's expected net benefit.

In addition to these elements, our proposed incentive scheme also includes an overall incentive constraint. This limits the overall price impact of the incentive by capping the maximum incentive a distribution business can receive in any one year.

This reduces the potential for the incentive scheme to cost customers more than anticipated, while still providing a healthy incentive for distribution businesses to undertake efficient demand management projects.

The total incentive in any year cannot exceed 1% of the distribution business' maximum allowed revenue that year.

How will we see the results of the incentive scheme?

As part of our proposed incentive scheme, distribution businesses will provide information to help us understand how they are using demand management to deliver value to consumers. They will tell us what demand management projects they are undertaking or have contracts for, along with what outcomes these are achieving.

We will report this information, which will provide transparency on the effectiveness of the incentive scheme. This will help us understand how we might improve our incentive scheme over time.

We have balanced the need for reporting against the importance of keeping administration costs low, wherever possible. In avoiding unnecessary administration costs, we avoid discouraging distribution businesses from responding to the incentive scheme.

How are we improving our innovation allowance?

Our incentive scheme will operate alongside a demand management innovation allowance mechanism that we are developing in tandem. This will be an update to our current Demand Management Innovation Allowance ('the DMIA').

Under our revised innovation allowance, we propose to:

- Make some more funding available.
- Tighten the criteria for project eligibility to encourage more innovative projects, whilst maintaining an option for indicative project pre-approval to maintain certainty.
- Clarify project reporting requirements to place a greater emphasis on sharing project learnings across the industry and with consumers.

What can you do to help?

We welcome stakeholder input on our draft incentive scheme and innovation allowance. Concurrently, we are seeking input on our proposed rule change to the Australian Energy Market Commission. The rule change we would like to propose will allow us to apply our incentive scheme to all distribution businesses earlier. This would allow our incentive scheme to have a positive impact on consumers sooner.

We are accepting written submissions by the close of business **12 October 2017**. To promote transparent dialogue, we will publish the submissions we receive on our website, unless they are marked as confidential.

You can make a submission on the draft incentive scheme and innovation allowance mechanism by email dm@aer.gov.au or mail to:

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

After we have reviewed submissions we will hold a stakeholder forum in November to discuss them. We plan to publish the final incentive scheme and innovation allowance in December 2017.