



**FINAL DECISION**  
**Essential Energy distribution**  
**determination**  
**2015–16 to 2018–19**

**Attachment 12 – Demand**  
**management incentive scheme**

April 2015

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AER reference: 54419

## Note

This attachment forms part of the AER's final decision on Essential Energy's revenue proposal 2015–19. It should be read with other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 - Annual revenue requirement

Attachment 2 - Regulatory asset base

Attachment 3 - Rate of return

Attachment 4 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

Attachment 9 - Efficiency benefit sharing scheme

Attachment 10 - Capital expenditure sharing scheme

Attachment 11 - Service target performance incentive scheme

Attachment 12 - Demand management incentive scheme

Attachment 13 - Classification of services

Attachment 14 - Control mechanism

Attachment 15 - Pass through events

Attachment 16 - Alternative control services

Attachment 17 - Negotiated services framework and criteria

Attachment 18 - Connection methodology

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	expenditure forecast assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model

Shortened form	Extended form
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

## 12 Demand management incentive scheme

The National Electricity Rules (NER) require us to develop and implement mechanisms to incentivise distributors to consider efficient alternatives to building more network.<sup>1</sup> To meet this requirement, and motivated by the need to improve distributors' capability in the demand management area, we implemented a demand management incentive scheme (DMIS) in our NSW/ACT distribution determinations for the 2009–14 regulatory control period.<sup>2</sup>

The current DMIS for NSW distributors includes two components—the demand management innovation allowance (DMIA)<sup>3</sup> and the D-factor.<sup>4</sup>

The DMIA is a capped allowance for distributors to investigate and conduct broad-based and/or peak demand management projects. It contains two parts:

- Part A provides for an innovation allowance to be incorporated into each distributor's revenue allowance for opex each year of the regulatory control period. Distributors prepare annual reports on their expenditure under the DMIA<sup>5</sup> in the previous year, which we then assess against specific criteria.<sup>6</sup>
- Part B compensates distributors for any foregone revenue demonstrated to have resulted from demand management initiatives approved under Part A. During the 2009–14 regulatory control period, NSW distributors were subject to a weighted average price cap (WAPC) form of control. Under this control mechanism, if a demand management project resulted in a fall in demand for direct control services, the distributor's recoverable revenues would fall as prices were fixed. For this reason, foregone revenue was recoverable under Part B of the DMIA.

Under the scheme, we return any underspend against the allowance to customers. Also, once we know the approved DMIA expenditure for each year of the current period, we compensate distributors for approved foregone revenue. We implement this as an adjustment to each distributor's innovation allowance in the following regulatory control period.

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<sup>1</sup> NER, cl. 6.6.3(a).

<sup>2</sup> The rules have since changed the name to 'Demand Management and Embedded Generation Connection Incentive Scheme' (DMEGCIS) to explicitly cover innovation with respect to the connection of embedded generation. Our current and proposed DMIS includes embedded generation. We consider embedded generation to be one means of demand management, as it typically reduces demand for power drawn from a distribution network.

<sup>3</sup> AER, *Demand management incentive scheme for the ACT and NSW 2009 distribution determinations—Demand management innovation allowance scheme*, 28 November 2008. (AER, DMIA for ACT and NSW distributors, Nov 2008).

<sup>4</sup> AER, *Demand management incentive scheme for the ACT and NSW 2009 distribution determinations—D-factor scheme*, 29 February 2008.

<sup>5</sup> The DMIA excludes the costs of demand management initiatives approved in our determination for the 2009–14 regulatory control period or under the D-factor scheme.

<sup>6</sup> AER, *DMIA for ACT and NSW distributors*, November 2008, pp. 4–5.

The D-factor scheme<sup>7</sup> acts as a counter balance to distributors' disincentive to implement demand management under the WAPC form of control. The D-factor offers compensation for both the costs and foregone revenue incurred from demand management projects for which the distributor can demonstrate a resultant reduction in both capex and demand.

## 12.1 Final decision

We have determined to continue Part A of the DMIA but we will not apply either Part B of the DMIA or the D-Factor scheme for Essential Energy in the 2015–19 regulatory control period. This is consistent with our draft decision<sup>8</sup> and our proposed approach in the Stage 2 Framework and Approach (F&A).<sup>9</sup>

The current innovation allowance amount of \$0.6 million (\$2014–15) per annum will continue in the 2015–19 regulatory control period.

## 12.2 Essential Energy's revised proposal

Essential Energy accepted our draft decision to continue applying Part A of the DMIA at the same scale as is currently applied, but to discontinue Part B of the scheme as it related to compensation for foregone revenue.

Essential Energy acknowledged the AEMC's Power of Choice review which includes an examination of distributor incentives to pursue efficient alternatives to network augmentation and anticipates new rules and principles guiding the design of a new DMIS. Regarding anticipated changes to the DMIS, Essential Energy proposed that, should the AEMC provide new rules and principles guiding the design of a new DMIS in time, we apply a revised DMIS for Essential Energy's final revenue determination, subject to consultation with Essential Energy.<sup>10</sup>

## 12.3 AER's assessment approach

The rules require us to have regard to several factors in developing and implementing a DMIS for Essential Energy.<sup>11</sup> These are:

- Benefits to consumers
  - the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme

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<sup>7</sup> From IPART's NSW distribution determinations for the 2004–09 regulatory control period.

<sup>8</sup> AER, *Draft decision: Essential Energy distribution determination 2015–19*, November 2014, Attachment 12, pp. 7 & 8 (AER, Draft Decision, November 2014).

<sup>9</sup> AER, *Stage 2 Framework and Approach paper for Essential Energy*, January 2014, p. 32 (AER, Stage 2 Framework and Approach, January 2014).

<sup>10</sup> Essential Energy, *Revised Regulatory Proposal: 1 July 2014 to 30 June 2019*, 20 January 2015, p. 79 (Essential Energy, Revised Regulatory Proposal, January 2015).

<sup>11</sup> NER, cl 6.6.3(b).



- the willingness of customers or end users to pay for increases in costs resulting from implementing DMIS.
- Balanced incentives
  - the effect of a particular control mechanism (i.e. price as distinct from revenue regulation) on a distributor's incentives to adopt or implement efficient non-network alternatives
  - the effect of classification of services on a distributor's incentive to adopt or implement efficient embedded generator connections
  - the extent the distributor is able to offer efficient pricing structures
  - the possible interactions between DMIS and other incentive schemes.

We had regard to these factors in considering the proposed approach to the DMIS for Essential Energy as set out in our draft decision<sup>12</sup> and the Stage 2 F&A for the NSW distributors<sup>13</sup> and we have again taken these factors into account in making our final decision.

## 12.4 Reasons for final decision

Consistent with our decisions for the transitional regulatory control period and our draft decision, we will not apply the Part B foregone revenue component of the DMIA or the D-factor in the 2015–19 regulatory control period due to the move to a revenue cap.<sup>14</sup> However, as the D-factor operates on a two-year lag, Essential Energy will be able to recover the costs and foregone revenues of applicable demand management projects relevant to the 2009–14 regulatory control period in the 2015–19 regulatory control period.

Considering a significant proportion of Essential Energy's allowance remains for the current regulatory control period<sup>15</sup>, we have determined that the current innovation allowance amount of \$0.6 million (\$2014–15) per annum will continue in the 2015–19 regulatory control period.

Our Stage 2 F&A and draft decision stated that our intention to develop and implement a new DMIS for the 2015–19 regulatory control period was dependent on the progress of the rule change process arising from the AEMC's Power of Choice review.<sup>16</sup> On 19 February 2015, the AEMC commenced consultation on the rule change. Submissions closed on 19 March 2015. The AEMC is currently considering the rule amendments.

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<sup>12</sup> AER, Draft Decision, November 2014, Attachment 12, p. 9.

<sup>13</sup> AER, *Stage 2 Framework and Approach*, January 2014, pp. 33–35.

<sup>14</sup> AER, Draft Decision, November 2014, Attachment 12, p. 9.

<sup>15</sup> AER, *Applications by DNSPs for Demand Management Innovation Allowance for 2013 calendar year (Victorian DNSPs) and 2012–13 financial year (all other DNSPs)*, April 2015, p. 4.

<sup>16</sup> AER, *Stage 2 Framework and Approach*, January 2014, p. 32. AER, Draft Decision, November 2015, Attachment 12, p. 9. For information regarding the AEMC's Power of Choice Review, see <http://www.aemc.gov.au/Major-Pages/Power-of-choice>. The AEMC received a proposed rule change from COAG Energy Ministers and the Total Environment Centre.

The Total Environment Centre (TEC) accepted the position we adopted in our draft decision to await the outcomes of the AEMC's review before considering reform of the current DMIS but suggested that we consider introducing measures to promote the effective use of demand management initiatives. Such measures included requiring businesses to report annually, providing businesses with specific metrics or performance indicators and the development of a demand management guideline.<sup>17</sup>

The Public Interest Advocacy Centre (PIAC) also agreed that revision of the DMIS would ideally follow the AEMC's review, however, given delays in the rule change process and the importance of demand management to consumers, recommended that we urgently revise the current scheme such that it applies to the current determination.<sup>18</sup> The Ethnic Communities' Council of NSW Inc. supported the recommendations made by the PIAC.<sup>19</sup>

EnerNOC submitted that our position was 'to prioritise process over outcomes'. It stated that Ausgrid's proposed Demand Management Benefit Sharing Scheme (DMBSS) 'is good enough to serve as an interim scheme until it is replaced by an AEMC-consulted one for the next regulatory cycle' and that this interim incentive could be limited to NSW distribution businesses since these are the businesses for which the D-factor currently applies.<sup>20</sup>

Regarding the innovation allowance amount, TEC submitted that we should consider providing Essential Energy with a \$1 million minimum allowance rather than cap the allowance provided it is accompanied by a robust measurement, verification and reporting mechanism.<sup>21</sup> PIAC also recommended that we consider whether there is a case for increasing Essential Energy's innovation allowance and reviewing the DMIA criteria, particularly to fund proposed pilots and trials.<sup>22</sup>

Regarding forms of price control and the D-factor, TEC and CCP accepted it is appropriate to remove the D-factor in light of the move to a revenue cap.<sup>23</sup>

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<sup>17</sup> Total Environment Centre, *Submission to the AER on the Draft Determination on NSW DB's Regulatory Proposals 2014–19*, February 2015, pp. 2-3 & 5-6.

<sup>18</sup> Public Interest Advocacy Centre Inc., *Submission to the Australian Energy Regulator's Draft Determination for Ausgrid, Endeavour Energy and Essential Energy*, 13 February 2015, pp. 51-52.

<sup>19</sup> Ethnic Communities' Council of NSW Inc., *Submission concerning the NSW Distribution Networks Revised Revenue Proposal 2014–19*, 11 February 2015, pp. 5-6.

<sup>20</sup> EnerNOC, *Submission on 2015–19 draft decisions and revised proposals for NSW DNSPs*, 13 February 2015, p. 3.

<sup>21</sup> Total Environment Centre, *Submission to the AER on the Draft Determination on NSW DB's Regulatory Proposals 2014–19*, February 2015, p. 11.

<sup>22</sup> Public Interest Advocacy Centre Inc., *Submission to the Australian Energy Regulator's Draft Determination for Ausgrid, Endeavour Energy and Essential Energy*, 13 February 2015, p. 49.

<sup>23</sup> Total Environment Centre, *Submission to the AER on the Draft Determination on NSW DB's Regulatory Proposals 2014–19*, February 2015, p. 6.

Consumer Challenge Panel, *Submission to the AER: Responding to NSW draft determinations and revised proposals from electricity distribution networks*, 16 February 2015, p. 54.

In response to submissions and consistent with our draft decision, we do not intend to pre-empt consultation on the AEMC's review of the current demand management arrangements by commencing a separate consultation process on a new DMIS before the outcomes of the review are finalised. Quite apart from the unnecessary complications and inefficiencies that a parallel policy process would create, the confines of a distribution revenue review make it ill-suited to driving regulatory reform.

We acknowledge the need to reform the existing demand management incentive arrangements and the importance of demand management in deferring the need for network augmentation by alleviating network utilisation during peak usage periods. The move to a revenue cap form of control removes any disincentive for distributors to reduce the quantity of electricity sold by pursuing demand management initiatives. More robust obligations to consider non-network alternatives in order to satisfy RIT-D requirements provide distributors with opportunities to improve and expand their demand management programs.

Beyond increasing opportunities, we recognise the importance of strengthening demand management incentives in order to defer network augmentation. However, we do not consider it appropriate to develop an alternative incentive structure in parallel to the AEMC's review through Essential Energy's regulatory proposal. The AEMC will be able to consider how any changes to the NER can be implemented in the 2015–19 regulatory control period through transitional arrangements.

For these reasons, we have adopted the position proposed in the Stage 2 Framework and Approach and our draft decision and approved DMIA allowances consistent with their current scale. We will consider the introduction of a revised DMIS as soon as practicable following the AEMC's rule change process.

Essential Energy proposed a number of demand management costs as part of its total forecast capital expenditure and operating expenditure building blocks. Our decision on Essential Energy's demand management related capex and opex building blocks can be found in attachments 6 and 7 respectively.