Final decision: Demand management incentive scheme and innovation allowance

What is new?

We have introduced a demand management incentive scheme aimed at encouraging distribution businesses to find lower cost solutions to investing in network solutions. The incentive scheme achieves this by encouraging distribution businesses to undertake efficient expenditure on non-network options relating to demand management.

We have also improved our existing demand management innovation allowance. This is a research and development (R&D) fund to help distribution businesses discover new ways of using demand management to keep the costs down for electricity consumers in the future. Its objective is to provide distribution businesses with funding for R&D in demand management projects that have the potential to reduce long term network costs. This will fund innovative projects that have the potential to deliver ongoing reductions in demand or peak demand.

What is demand management in electricity networks?

Distribution businesses can manage demand on their networks to reduce, delay or even avoid the need to install, replace or upgrade expensive network assets. Network assets include equipment like poles, wires, transformers and substations. When used effectively, managing demand to avoid incurring these costs can reduce upward pressure on network charges, which make up about half the cost of electricity bills.

Managing demand on electricity networks can increase the reliability of supply and reduce the cost of supplying electricity. Often, electricity consumers are empowered to manage demand via price signals and enabling technology.

Price signals or financial incentives can reward consumers for using electricity in a way that allows network businesses to keep their costs down. These signals or incentives may come in the form of things like cost-reflective tariffs, congestion pricing, and rebates. Enabling technology often complements price signals by empowering consumers use electricity in a way that allows network businesses to keep their costs down. This technology may include things like advanced metering technology, demand response enabling devices, and energy monitoring aps.

Why a demand management 'incentive scheme'?

Historically, network businesses have often focused on supply-side solutions to meet the demand on their networks, without always giving due attention to the demand side of the equation. There are several potential reasons for this behaviour, including the possibility that the regulatory system encourages distribution businesses to prefer network capex over non-network options.

We have been gradually addressing drivers of this behaviour over time. For instance, we have been improving how we set allowed rates of return, recognising that historically generous returns on capital would have encouraged network businesses to prefer network options. We have also been moving network businesses to more cost reflective pricing, recognising that managing demand is difficult when electricity prices don't signal the cost of providing the service.

While we have been doing a lot of work to improve network incentives, we recognise that there is value in complementing these efforts with an incentive scheme.

Our incentive scheme is a targeted, achievable solution that forms a bridge between the current regulatory framework and a framework more focussed on efficiently pricing network services. By encouraging distribution businesses to make more efficient investment decisions, we can help distribution businesses meet consumers' demand at the lowest cost. By providing an incentive, distribution businesses will more actively seek out opportunities to use demand management efficiently. This should help develop the industry and make managing demand even more cost-effective for distributors as it becomes business-as-usual.

Our incentive scheme's benefits should have flow-on effects. As the demand management industry advances as a whole, distributors will become better at managing the risks and minimising the costs of these solutions, delivering even more consumer benefits.

How will our incentive scheme provide benefits?

The incentive scheme only encourages demand management projects that are efficient and contribute, partially or wholly, to resolving a network constraint. In deciding whether a project is efficient, we require distribution businesses to test the demand management services market. This will increase transparency, promote competition and put downwards pressure on electricity prices. This is because distribution business can only benefit from incentives if they address the network constraint in the most efficient way available.

This incentive structure should encourage best-practice network planning that will deliver value to consumer via lower electricity prices. We believe our incentive scheme will achieve this because distribution businesses will be:

- 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 solution.
- 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 incentive scheme work?

The incentive scheme has three key features: the cost uplift, the net benefit constraint, and the overall incentive constraint.

The cost uplift gives distributors an incentive of up to 50% of their expected demand management costs. The incentive is only available for efficient demand management projects.

> Incentive payments will be up to 50% of expected costs on efficient demand management projects.

To promote consumers benefiting from our incentive scheme, the size of the incentive will not outweigh the value (or net benefit) the demand management project delivers across the electricity market. This is the net benefit constraint.

To set this constraint, distribution businesses will estimate the net benefit of projects under the incentive scheme. For large projects, distributors will do this with the regulatory investment test. For small projects, they can use a simpler cost–benefit analysis.

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

In addition, the overall incentive constraint will limit the incentive's impact on short-term prices. The cap limits the total incentive that distribution businesses can receive in any one year.

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

To receive the incentive, distribution businesses must report on their projects to us. They must provide information on how they are using demand management to deliver value to consumers. They will tell us what demand management projects are underway or have contracts, along with the outcomes of these projects.

We will publish these reports on our website. We will use this information to understand what results the incentive scheme is achieving, and maybe tweak it over time.

We have tailored the reporting requirements to gather necessary information and impose a low administrative burden. This balance means that the incentive can deliver its maximum positive impact.

How are we improving our innovation allowance?

We will continue providing a demand management innovation allowance, which is an R&D fund. The innovation allowance will complement the new incentive scheme. It will increase the capacity of distribution business to invest in ideas that may eventually form parts of projects under the incentive scheme.

We have improved our current demand management R&D fund by:

- Increasing the size of the fund to encourage about 30% more R&D on average.
- Tightening the criteria for project eligibility to encourage more innovative projects.
- Clarifying the reporting requirements on projects to emphasise the sharing of project learnings across the industry and with consumers.