Final Decision

Demand management incentive schemes for the ACT and NSW 2009 distribution determinations

February 2008

Contents

Shortened forms

AER	Australian Energy Regulator
capex	capital expenditure
CEC	Clean Energy Council
COAG	Council of Australian Governments
CRA	Charles River Associates (Asia Pacific) Pty Limited
DNSP	distribution network service provider
ESCOSA	Essential Services Commission of South Australia
EMRF	Energy Market Reform Forum
ICRC	Independent Competition and Regulatory Commission (ACT)
IPART	Independent Pricing and Regulatory Tribunal (NSW)
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	national electricity market
NER	National Electricity Rules
opex	operating expenditure
TEC	Total Environment Centre

1 Introduction

In December 2007 the Australian Energy Regulator (AER) published a preliminary positions paper titled *Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009–14*. Chapter two of the preliminary positions paper set out the AER's preliminary positions as to demand management incentive schemes to be applied in the ACT and NSW 2009–14 regulatory control period. The paper invited submissions from interested parties in response to the preliminary proposed position, of which the AER received nine submissions.

This decision sets out the AER's consideration of comments raised in relation to the proposed preliminary position on demand management incentive schemes that will apply in the ACT and NSW in the 2009–14 regulatory control period. It has been prepared by the AER under clause 6.6.3 of the transitional Chapter 6 rules.

The AER's demand management incentive schemes, attached at appendixes C and D set out the AER's decisions on the way in which the demand management incentive schemes will operate for the 2009–14 regulatory control period.

The AER is responsible for regulating the revenues of distribution network service providers (DNSPs) in the National Electricity Market (NEM) in accordance with the National Electricity Rules (NER), which were notified in the South Australian Gazette on 20 December 2007. This decision and corresponding schemes apply to Country Energy, EnergyAustralia and Integral Energy (collectively referred to in these documents as 'the NSW DNSPs') and ActewAGL.

Within the NER, Chapter 6 deals with the classification and economic regulation of distribution services, while Chapter 6A deals with the economic regulation of transmission services. The Ministerial Council on Energy (MCE) has determined that transitional arrangements will apply in the preparation and assessment of the ACT and NSW 2009 distribution determinations. The transitional arrangements for the 2009 distribution determinations for the ACT and NSW are set out in appendix 1 to Chapter 11 of the NER. Clause references in appendix 1 are numbered commencing with a six. This decision and the accompanying schemes will only apply to the 2009–14 regulatory control period.

The NER distinguishes between the rules in Chapter 6 and Chapter 11 by referring to the Chapter 6 rules as 'general Chapter 6 rules,' and Chapter 11 rules as 'transitional Chapter 6 rules.' The AER has followed this convention in this decision and its appendixes when referring to the two sets of rules.

2 Rule requirements

The demand management incentive schemes, attached at appendixes C and D of this decision, have been adopted and developed by the AER for application to the ACT and NSW 2009 distribution determinations, in accordance with clause 6.6.3 of the transitional Chapter 6 rules:

> **6.6.3 Demand management incentive scheme**
>
> (a) The AER may develop and publish an incentive scheme or schemes (demand management incentive scheme) to provide incentives for Distribution Network Service Providers to implement efficient non-network alternatives or to manage the expected demand for standard control services in some other way.
>
> (b) In developing and implementing a demand management incentive scheme, the AER must have regard to:
>
> (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 Distribution Network Service Providers; and
>
> (2) the effect of a particular control mechanism (i.e. price – as distinct from revenue – regulation) on a Distribution Network Service Provider's incentives to adopt or implement efficient non-network alternatives; and
>
> (3) the extent the Distribution Network Service Provider is able to offer efficient pricing structures; and
>
> (4) the possible interaction between a demand management incentive scheme and other incentive schemes; and
>
> (5) the willingness of the customer or end user to pay for increases in costs resulting from implementation of the scheme.
>
> (c) The AER may, from time to time and with the agreement of each affected Distribution Network Service Provider, amend or replace any scheme that is developed and published under this clause.
>
> (d) Nothing in this clause limits the content of an efficiency benefit sharing scheme.
>
> (e) The AER must publish a written statement, when it publishes its first demand management incentive scheme (if any), setting out how it proposes the demand management incentive scheme will operate for the next distribution determination. The statement may be included in the first demand management incentive scheme or may be published separately.
>
> (f) The AER may carry out such consultation in connection with the preparation of the demand management incentive scheme as the AER thinks appropriate and may take into consideration any consultation carried out before the commencement date.
>
> (g) If a demand management incentive scheme applicable to a NSW or ACT Distribution Network Service Provider is not published by the AER before 1 March 2008 or the date that is one month after the commencement date (whichever is the later), no demand management

incentive scheme may be applied to the Distribution Network Service Provider in its distribution determination for the regulatory control period 2009-2014.

(h) Nothing in this clause affects the application of the D-factor carry forward referred to in clause 6.4.3(a)(8) and clause 6.4.3(b)(8).

3 Reasons for demand management incentive schemes

Demand management refers to any strategy to address growth in demand and/or peak demand. Network owners can seek to undertake demand management through a range of mechanisms, such as incentives for customers to change their demand patterns, operational efficiency programs, load control technologies, or alternative sources of supply (such as distributed or embedded generation).

In some circumstances demand management can provide efficient alternatives to network augmentations, by deferring the need for investment to relieve network constraints. This can have positive economic impacts through reducing inefficient peaks and encouraging the efficient use of network assets, resulting in lower prices for consumers and external benefits for the environment or the market.

There are several factors in the market and regulatory framework which may prevent an efficient level of demand management being undertaken by DNSPs. These include barriers to information present within pricing practices, and within the form of regulation and market structure. Service and reliability standards obligations may also be barriers to efficient demand management.

The purpose of applying a demand management incentive scheme is to reduce the barriers to demand management in the market and regulatory framework to encourage DNSPs to undertake an efficient level of demand management in response to rising demand on their networks.

There are currently no demand management incentive schemes operating in the ACT.

In NSW, the Independent Pricing and Regulatory Tribunal (IPART) applied a D-factor adjustment in the weighted average price cap at the 2004 distribution determinations. The key driver for introducing the D-factor was the change in the form of regulation, from a revenue cap to a weighted average price cap in the 2004 determinations. This was seen to diminish the incentives for NSW DNSPs to pursue demand management.

In deciding to apply demand management incentive schemes for the ACT and NSW 2009 distribution determinations, the AER is making a number of assumptions about demand management and the regulatory environment in the ACT and NSW. The AER considers these assumptions include:

- that rising peak demand, leading to constraints within distribution networks is a material problem for DNSPs and consumers of electricity
- that efficient demand management has the potential to address distribution network constraints, providing long-term benefits to DNSPs, as well as long-term benefits for consumers associated with lower electricity prices
- that the number of demand management programs currently carried out by ACT and NSW DNSPs may be below the efficient level

- that as a demand management market in Australia develops, DNSPs will increase their implementation of demand management programs, and the implementation costs may decrease
- that demand management programs have costs and benefits that may extend beyond the five year regulatory control period
- that the weighted average price cap applied to NSW DNSPs may create perceived disincentives for DNSPs to conduct demand management
- that the NSW D-factor operates to offset some of the perceived disincentives to conduct demand management within the weighted average price cap
- in the 2009–14 regulatory control period there may be national initiatives to address demand management on a broad scale, such as the roll–out of interval meters or introduction of a carbon trading scheme.

Performance reporting and continued operation of demand management incentive schemes

The AER recognises that its decision to apply demand management incentive schemes in the ACT and NSW over the 2009–14 regulatory control period is being made even though there is uncertainty about the costs and benefits of demand management. The demand management incentive schemes applied in the 2009 ACT and NSW distribution determinations will assist the AER to gather information about demand management, and test the effectiveness of the demand management incentive schemes. Information gathered from the operation of these schemes over the 2009–14 regulatory control period will assist the AER when considering the application of demand management incentive schemes in future determinations.

The AER will seek information about demand management programs carried out by the DNSPs through the reporting requirements under each demand management incentive scheme applied during the ACT and NSW 2009–14 regulatory control periods.

The operation and results of the demand management incentive schemes that the AER will apply in the ACT and NSW 2009–14 regulatory control periods will be assessed during, and at the conclusion of the regulatory control period. The decision to apply demand management incentive schemes in the ACT and NSW in the 2014 determinations will be made at the time of the 2014 determinations, and will depend on the outcomes achieved by the schemes over the 2009–14 regulatory control period. The AER will also reconsider and evaluate the assumptions, outlined above, that it has relied upon in deciding to apply demand management incentive schemes for the transitional period in the ACT and NSW.

However, to ensure appropriate incentives remain for the duration of the 2009–14 regulatory control period for the NSW D-factor scheme, the AER will honour relevant expenditure undertaken in this period that will be recovered in the first two years of the 2014–19 regulatory control period due to the lag in the D-factor mechanism.

4 AER preliminary positions

The AER's December 2007 preliminary positions paper, titled *Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009–14*, set out the AER's preliminary position as to the demand management incentive schemes that would apply in the ACT and NSW during the 2009–14 regulatory control period. The positions in the paper were made based on stakeholders' submissions on an earlier issues paper of the same title, released in November 2007.

In its preliminary positions paper, the AER proposed:

- to continue the D-factor scheme in NSW, in the form currently applied by IPART, over the 2009–14 regulatory control period

- to apply a learning-by-doing fund to the ACT and NSW 2009 distribution determinations, to encourage DNSPs to undertake broad based demand management which may provide long-term benefits to consumers.

4.1.1 Continuation of the D-factor in NSW

Key considerations that led to the AER's preliminary position to continue the D-factor as it was applied by IPART in NSW over the 2004–09 regulatory control period include:

- strong support from stakeholders for the continuation of the mechanism

- modest claims to date for demand management programs carried out under the D-factor indicate that it may need more time to develop as an incentive mechanism

- the continued perception that the weighted average price cap may provide disincentives to conduct demand management, which was used by IPART as a reason for the introduction of the D-factor.

4.1.2 Learning-by-doing fund

Key considerations that led to the AER's preliminary position to apply a modest learning-by-doing fund in the ACT and NSW over the 2009–14 regulatory control period include:

- strong support from stakeholders for a mechanism that provides incentives for DNSPs to undertake efficient demand management that is broad-based, innovative, and while not specifically targeted at capex deferral, may provide long-term reductions in demand across DNSPs' networks.

- modest claims to date for demand management programs carried out under the D-factor, which indicate that there may be a need for an additional demand management incentive mechanism in NSW.

- recognition that there may be broad–based demand management programs that are not targeted at specific capex deferral, that are not covered by IPART's D-factor, and that have the potential to generate efficient outcomes through the greater utilisation of existing network assets. The AER considered that such broad–based demand management programs may not provide DNSPs with immediate benefits from capex deferral, and a learning-by-doing fund may be necessary to generate incentives to conduct these programs.

Note that where the preliminary positions paper referred to the AER's learning-by-doing fund, this demand management incentive scheme is now known as the demand management innovation allowance. This change was made to recognise that the scheme operates as a mechanism for DNSPs to recover the costs of innovative and/or broad–based demand management programs and that these costs are met through revenues supported by customers.

5 Issues raised in submissions and the AER response

The AER received eight submissions from stakeholders on its November 2007 preliminary positions paper that addressed the AER's proposed demand management incentive schemes for application in the ACT and NSW over the 2009–14 regulatory control period. Submissions were generally supportive of the AER's decision to continue the D-factor in NSW as it was applied by IPART in its 2004 distribution determinations. The main issues raised in submissions related to the magnitude of the AER's proposed learning-by-doing fund, which is now the demand management innovation allowance.

5.1 Assurance of recovery for demand management schemes in the 2014–19 regulatory control period

5.1.1 Issues raised in submissions

Integral Energy's submission requested that the proposed demand management scheme include an assurance of the recovery of costs for demand management projects implemented in the final regulatory years of the 2009–14 regulatory control period, should there be a decision not to continue the schemes into the 2014–19 regulatory control period.

5.1.2 AER conclusion

The AER agrees to the recovery in the 2014–19 regulatory control period, of the approved costs of demand management programs carried out under the NSW D-factor in the final regulatory years of the 2009–14 regulatory control period. This is reflected in the D-factor scheme attached at appendix C.

5.2 Demand management incentive schemes and long-term costs and savings of demand management

5.2.1 Issues raised in submissions

The Total Environment Centre (TEC) submitted that the D-factor to be applied in NSW should be extended to allow the recovery of the long-term costs of low–cost demand management programs that may not lead to the reduction of a specific capacity constraint. It submitted that DNSPs should be able to recover demand management program implementation costs up to a default long-term avoided distribution cost, along with associated foregone revenue for the remainder of the regulatory control period.

The TEC also submitted that the AER should allow the long-term savings generated by demand management programs to be carried forward, across regulatory control periods.

5.2.2 AER considerations

The AER considered that the intent of the TEC's submission on extending the NSW D-factor to cover the long-term costs of low–cost, broad–based demand management programs, has been met by the demand management innovation allowance, which will operate in addition to the IPART initiated D-factor.

One aim of the AER's demand management innovation allowance is to allow the recovery of the costs associated with demand management programs that may deliver long-term load reductions that do not lead to the alleviation of a specific network constraint. The AER will allow the recovery of implementation and foregone revenue costs associated with such demand management programs, up to the amount determined for each DNSP within its demand management innovation allowance.

The AER notes the TEC's recommendation that the long-term capex deferral benefits of demand management programs should be able to be carried over from one regulatory control period to the next. The AER considers that, without the application of demand management incentive schemes, DNSPs have existing incentives within the ex ante framework to conduct demand management programs that provide long-term capex deferral benefits.

In addition to these incentives, in NSW the D-factor provides positive financial incentives for DNSPs to conduct efficient demand management, and the demand management innovation allowance provides a further incentive for DNSPs to conduct broad–based demand management which may not give DNSPs immediate benefits from capex deferral, but may provide longer-term benefits to DNSPs and consumers.

The AER considers that the operation of the D-factor, the demand management innovation allowance and incentives present within the regulatory framework provide sufficient incentives for DNSPs to conduct demand management. The AER does not consider that there is a need to extend the D-factor to allow the recovery of long-term costs of demand management.

5.2.3 AER conclusion

Consistent with its preliminary positions paper, the AER will apply the D-factor to NSW DNSPs in the form it was applied by IPART in the 2004–09 regulatory control period. The AER will also apply a demand management innovation allowance to the ACT and NSW DNSPs, as is outlined in appendix D of this decision.

5.3 Interaction with the AER's efficiency benefit sharing scheme

5.3.1 Issues raised in submissions

EnergyAustralia, Integral Energy and the Clean Energy Council (CEC) submitted that the AER's efficiency benefit sharing scheme must exclude spending on demand management.

5.3.2 AER considerations

The AER notes the incentive effects related to the interaction of demand management incentive schemes and the AER's efficiency benefit sharing scheme. Specifically, the AER notes that expenditure on demand management may increase opex which could lead to a corresponding and unintended penalty under the efficiency benefit sharing scheme.

5.3.3 AER conclusion

The operation of the AER's efficiency benefit sharing scheme in relation to demand management programs is outlined in the AER's efficiency benefit sharing scheme to apply to the ACT and NSW 2009 distribution determinations. The AER considers that the appropriate tool for providing incentives for DNSPs to undertake demand management is through the demand management incentive scheme. To minimise the impact of the efficiency benefit sharing scheme on the incentives to undertake efficient demand management programs, the AER will exclude demand management costs from the efficiency benefit sharing scheme.

5.4 Balanced ex post review of capex

5.4.1 Issues raised in submissions

The TEC and the CEC submitted that the AER should ensure a balanced prudence review of past and projected capex is carried out, involving a thorough assessment of the opportunities for deferring capex. The TEC submitted that the AER should require DNSPs to demonstrate their best efforts to procure cost effective demand management.

5.4.2 AER considerations

The AER notes that clauses 6.5.7(c)–6.5.7(e) of the transitional Chapter 6 rules require a review of DNSPs' capex proposals at the time of the AER's determinations. In particular, the AER notes that clause 6.5.7(e)(10) requires the AER to consider the extent a DNSP has considered, and made provision for, efficient non–network alternatives, in deciding whether the total forecast capex reasonably reflects the capital expenditure criteria, outlined in clause 6.5.7(c).

5.4.3 AER conclusion

The AER will carry out a review of DNSPs forecast capex at the time of its distribution determinations, in accordance with clauses 6.5.7(c)–6.5.7(e) of the transitional Chapter 6 rules which includes consideration of actual capex undertaken during any preceding regulatory control period.

5.5 Demand management allocation

5.5.1 Issues raised in submissions

The CEC submitted that to stimulate DNSPs' investment in demand management measures, the AER should stipulate a minimum default annual demand management expenditure amount that is incorporated into the first regulatory year of DNSPs' price determinations. The CEC recommended that an amount of around 1 to 2 per cent of DNSPs' annual revenues should be provided for DNSPs to spend on demand management, and if the expenditure is not undertaken then this allocation should be recovered through a negative D-factor in the annual price setting process. The CEC submits that this would provide DNSPs with a one–off increase in revenue to be spent on demand management, and may address perceived risk and cash flow difficulties associated with the D-factor.

5.5.2 AER considerations

The AER notes that the CEC's recommendation may provide further positive incentives for DNSPs to conduct demand management as a priority, in particular as the recommended mechanism involves the DNSPs facing a negative D-factor should they not carry out demand management.

The AER considers that this recommendation involves a significant addition to the proposed schemes, and would increase the costs to users for at least the duration of the 2009–14 regulatory control period. The AER considers such an amendment, which might place the revenue of a DNSP at risk,[1] could not be applied without affording the DNSPs and customers adequate opportunity to respond. With regulatory proposals imminent, the AER does not consider it appropriate to apply this further funding allocation for the 2009 distribution determinations. However, the AER notes that it will be considering and consulting on such recommendations during the development of the national demand management incentive schemes.

5.5.3 AER conclusion

The AER will not specify a demand management expenditure allocation at the time of the ACT and NSW 2009 distribution determinations.

5.6 Demand management reporting

5.6.1 Issues raised in submissions

The TEC's submission recommended that the AER publish annual demand management reviews to encourage mutual learning and allow the comparison of different policies and approaches between jurisdictions.

The TEC also submitted that the AER should seek to inform the demand management market by requiring DNSPs to annually publish detailed information about the current capacity of the networks, current and projected demand and possible demand management options. It also submitted that the AER should ensure consistent DNSP demand management performance reporting, and that such reports should be publicly available.

The CEC's submission recommended that the AER gather and report reliable, consistent and comprehensive data on demand management activity by DNSPs across Australia.

5.6.2 AER considerations

The AER notes that DNSPs will be required to report on demand management programs carried out as part of the AER's annual reporting process, and as part of the D-factor and demand management innovation allowance approval processes. However, the AER notes that there may be benefits in increasing DNSPs' demand management reporting requirements, in terms of developing a market for demand management.

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[1] The CEC's proposal recommends that the AER undertake an ex post assessment of the DNSPs' expenditure on demand management, which could result in a negative D-factor being applied in the annual price setting process if a DNSP's expenditure was determined to be imprudent.

5.6.3 AER conclusion

The AER has amended the reporting requirements in the learning-by-doing fund within the preliminary positions paper (now the demand management innovation allowance), to require DNSPs' reports for cost recovery under the scheme to be made public, in recognition of the benefits that such reporting may provide to the emerging demand management market in the ACT and NSW.

The AER may also propose annual publishing of the D-factor and demand management innovation allowance results over the 2009–14 regulatory control period, and will consider increasing DNSPs' reporting of demand management projects and potential opportunities for demand management. The AER will consider applying these requirements as part of the DNSPs' annual reporting process, following consultation with DNSPs throughout the determination process.

5.7 Interpretation of clause 6.5.7(e)(10)

5.7.1 Issues raised in submissions

EnergyAustralia submitted that the AER's interpretation of clause 6.5.7(e)(10) in the preliminary positions paper is incorrect.

> **6.5.7 Forecast capital expenditure**
>
> (c) The AER must accept the forecast of required capital expenditure of a Distribution Network Service Provider that is included in a building block proposal if the AER is satisfied that the total of the forecast capital expenditure for the regulatory control period reasonably reflects:
>
> > (1) the efficient costs of achieving the capital expenditure objectives; and
> >
> > (2) the costs that a prudent operator in the circumstances of the relevant Distribution Network Service Provider would require to achieve the capital expenditure objectives; and
> >
> > (3) a realistic expectation of the demand forecast and cost inputs required to achieve the capital expenditure objectives.
> >
> > *(the capital expenditure criteria)*
>
> (d) If the AER is not satisfied as referred to in paragraph (c), it must not accept the forecast of required capital expenditure of a Distribution Network Service Provider.
>
> (e) In deciding whether or not the AER is satisfied as referred to in paragraph (c), the AER must have regard to the following ('*the capital expenditure factors'*):
>
> > (10) the extent the Distribution Network Service Provider has considered, and made provision for, efficient non-network alternatives.

The AER stated on page 19 of its preliminary positions paper that:

> "This clause requires DNSPs to demonstrate to the AER that in making capital expenditure forecasts they have had specific regard to demand management alternatives to capital expansion for each planned capital expansion project."

EnergyAustralia submitted that clause 6.5.7(e)(10) does not impose any obligations on DNSPs to demonstrate that they have had specific regard to demand management alternatives, but rather imposes an obligation upon the AER to consider the extent to which a DNSP has considered such alternatives.

5.7.2 AER considerations

The AER notes EnergyAustralia's comment regarding the effect of clause 6.5.7(e)(10). The AER considers that this paragraph may not expressly place an obligation upon DNSPs to demonstrate that they have had specific regard to demand management alternatives to capital expansion for each capital expansion project.

However the AER must consider the extent the DNSP has considered, and made provision for, efficient non–network alternatives in deciding whether the total forecast capex reasonably reflects the capital expenditure criteria in clause 6.5.7(c). Unless the ACT and NSW DNSPs demonstrate to the AER their consideration of demand management alternatives for each planned capital expansion project, the AER may not be satisfied under clause 6.5.7(c), and as such, may not accept the DNSPs' forecast of required capex, as stated in clause 6.5.7(d). Given this, a DNSP should ensure that it puts forward the details of its consideration of efficient non–network alternatives as part of its regulatory proposal. This information is necessary to inform the AER's assessment of a DNSP's forecast of required capex against the capital expenditure criteria.

5.7.3 AER conclusion

Clause 6.5.7(e)(10) requires the AER to consider the extent the DNSP has considered, and made provision for, efficient non–network alternatives in deciding whether the total forecast capex reasonably reflects the capital expenditure criteria in clause 6.5.7(c).

5.8 Use D-factor if revenue cap is precluded

5.8.1 Issues raised in submissions

The TEC recommended that the AER should apply an incentive mechanism which decouples revenue from electricity sales, or provides a 'lost revenue adjustment' where it is not possible to apply a revenue cap. It submitted that only when an efficient level of demand management has been attained should the continued provision of such compensation support mechanisms be reviewed.

5.8.2 AER considerations

The AER will apply an average revenue cap to ActewAGL and a weighted average price cap to NSW DNSPs for the 2009–14 regulatory control period. The AER notes that it is limited in its decisions on the form of control regulation to apply to direct control services by clauses 6.2.5(c1)(1) and 6.2.5(c1)(2) of the transitional Chapter 6 rules, which requires the control mechanisms to be substantially the same as that which was applied by the ICRC and IPART in the 2004–09 regulatory control period. The AER's decisions on the form of control mechanisms for direct control services in the ACT and NSW for the 2009 distribution determinations are outlined in its guideline on the control mechanisms for direct control services.

The AER's decision to apply IPART's D-factor in NSW over the 2009–14 regulatory control period is based on its recognition that weighted average price cap regulation may create disincentives to conduct efficient demand management. The D-factor mechanism provides a 'lost revenue adjustment' for demand management, allowing DNSPs to recover the foregone revenue resulting from approved non–tariff demand management programs.

5.8.3 AER conclusion

The AER will apply IPART's D-factor to NSW DNSPs over the 2009–14 regulatory control period, as proposed in its December 2007 preliminary positions paper.

5.9 Proposals to expand the D-factor

5.9.1 Issues raised in submissions

The TEC recommended that the AER stipulate an annual ex ante fund, equivalent to around 2 to 4 per cent of capex, within the D-factor. The TEC recommended that this fund should be provided on a 'use it or lose it' basis, meaning that if DNSPs do not take up demand management programs and claim the associated costs under the fund, they will not be able to recover any amounts under the fund, and will effectively lose their access to the fund. The TEC recommended that such an allowance should be subject to an ex ante assessment by the AER that would ensure the planned demand management programs represent genuine efforts to develop effective demand management. It suggested that such a mechanism should be applied to stimulate learn-by-doing demand management investment, and that the effectiveness of the mechanism should be reviewed at the end of the regulatory control period.

EnergyAustralia's submission expanded on its earlier submission of December 2007, in response to the AER's November 2007 issues paper addressing demand management incentive schemes to apply to the ACT and NSW 2009 distribution determinations. EnergyAustralia's December 2007 submission outlined a possible expansion of IPART's D-factor formula to include the costs of learn-by-doing and broad based demand management programs. EnergyAustralia suggested that under this approach, the D-factor allowance would be expanded to include these two kinds of demand management not covered by IPART's D-factor, which would then be subject to a pre–determined cap somewhere in the order of 1 per cent of revenue, or $10 million per annum.

EnergyAustralia submits that the magnitude of the impact on customer prices of its proposal would be small, and that the proposal may allow for the AER to determine a higher cap in the earlier regulatory years of the regulatory control period to give earlier signals for projects that could deliver cost effective demand management options under the normal D-factor.

The CEC recommended that the AER should incorporate the cost recovery of the learning-by-doing fund (now the demand management innovation allowance), into the D-factor structure in NSW. The CEC recommended that the demand management innovation allowance could be treated as a category within the broader D-factor. The CEC also recommended that the D-factor should be expanded to include cost recovery for demand management measures outside of network constrained areas, up to a long-term avoided distribution cost which reflects the long-term average value of avoidable network investment.

5.9.2 AER considerations

The AER notes the TEC's recommended mechanism, and EnergyAustralia's proposed approach to the expansion of IPART's D-factor, are very similar to the AER's demand management innovation allowance which will apply to the 2009 ACT and NSW distribution determinations.

In particular, similar to the proposal suggested by the TEC, the AER's demand management innovation allowance stipulates an annual expenditure for each DNSP to be spent on innovative and/or broad–based demand management investments. The demand management innovation allowance requires that to obtain the stipulated allowances, DNSPs must undertake demand management programs and make claims for the associated costs, to be approved by the AER. If DNSPs do not carry out any demand management programs approved under the allowance, they will lose the allowance. The AER notes that the demand management innovation allowance is to be reassessed at the end of the 2009–14 regulatory control period.

The AER notes that the application of EnergyAustralia's proposal may allow the AER scope to increase the cap on broad–based demand management in regulatory years one, two and three of the regulatory control period, which would give earlier signals to the demand management market than a constant allowance over the regulatory control period as is provided under the demand management innovation allowance. However, the AER considers that such foreseen demand management programs may be allowed as opex at the time of the AER's distribution determination, as was pointed out on page six of EnergyAustralia's submission.

The TEC submits that the stipulated allowance for its proposed ex ante fund should be in the order of 2 to 4 per cent of forecast capex. The AER's consideration of the magnitude of the demand management innovation allowance is discussed in section 5.11 of this decision.

The AER notes the CEC's recommendation that incorporating the cost recovery of the demand management innovation allowance into the NSW D-factor may provide greater efficiency in the cost recovery processes of the D-factor and the demand management innovation allowance. However, the AER considers that given the complexity of the NSW D-factor, the best option is to retain it in its original form.

The AER considers that, given the options available it is not appropriate to expand the D-factor. The AER considers its demand management innovation allowance is a similar, yet simpler way of adding an incentive for DNSPs to conduct efficient, innovative, broad–based demand management that is not covered by the D-factor. The AER considers that the D-factor mechanism is complex, to which the application of EnergyAustralia's, the TEC's or the CEC's proposals would add additional complexity. The AER also notes that its demand management innovation allowance can be applied across both the ACT and NSW DNSPs, addressing the desire for regulatory consistency across jurisdictions.

5.9.3 AER conclusion

As proposed in its preliminary positions paper, the AER will not amend the NSW D-factor from that which was applied by IPART in its 2004 distribution determinations.

5.10 Application of a scheme similar to that adopted by ESCOSA

5.10.1 Issues raised in submissions

The Energy Market Reform Forum (EMRF, an affiliate of the Major Energy Users Inc), Country Energy and Integral Energy submitted that the AER should apply a demand management incentive scheme similar to that which was applied by the Essential Services Commission of South Australia (ESCOSA) at the time of its 2005 distribution determination.

ESCOSA provided an allowance of $20 million for a range of pilot demand management initiatives over its 2005–10 Distribution Price Determination.[2] Allowances for demand management are treated as operating expenditure, and are not imputed into demand forecasts, capex or the regulatory asset base.[3] The classification of these initiatives as opex is a decision based on their ‘pilot nature’.[4]

ESCOSA’s demand management framework was based on a cost–benefit analysis undertaken by Charles River Associates (Asia Pacific) Pty Limited (CRA) which outlined power factor correction, standby generation, residential direct load control and aggregation as potentially applicable demand management for the South Australian market.[5] South Australia’s sole DNSP, ETSA Utilities, is required to work closely with ESCOSA on the demand management program, and is subject to specific reporting requirements for each initiative.[6]

ETSA Utilities’, Integral Energy’s and Country Energy’s submissions suggested that the AER should consider the details and magnitude of its learning-by-doing fund (now the demand management innovation allowance) at the time of making its final determinations. Submissions recommended that the AER should consult with DNSPs and stakeholders to determine a more prescriptive, targeted demand management innovation allowance than that was proposed within the AER’s preliminary positions paper.

5.10.2 AER considerations

Clause 6.6.3(g) of the transitional Chapter 6 rules require the AER to publish any demand management incentive schemes by 1 March 2008. As such, the AER does not

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2 ESCOSA *2005-2010 Electricity Distribution Price Determination Part A: Statement of Reasons* April 2005, pp. 53 and 60.

3 ibid. pp. 53 and 60.

4 ibid. p. 54.

5 CRA Assessment *of Demand Management and Metering Strategy Options* August 2004 pp.76-83.

6 ESCOSA *Demand Management and the Electricity Distribution Network – Draft Decision* September 2004 pp. 27-28.

have scope to delay the release of its demand management innovation allowance beyond 1 March 2008.

The AER notes that ESCOSA's scheme was designed for the high summer peaking loads in South Australia following an extensive stakeholder consultation process. The AER considers the scheme is highly prescriptive, as it sets out specific demand management programs to be passed though as opex by a single DNSP. The ESCOSA scheme was developed specifically to address the conditions in South Australia. Without a detailed review of conditions in the ACT and NSW it may not be appropriate to impose such a scheme in the ACT and NSW.

At the time of preparing its December 2007 preliminary positions paper, the AER closely considered schemes that were applied by jurisdictional regulators across Australia, including ESCOSA's scheme. The AER considers that a number of the projects prescribed within ESCOSA's scheme may be able to be funded within the D-factor scheme, to be applied by the AER in NSW over the 2009–14 regulatory control period. The AER notes that while in order for DNSPs to gain demand management program cost recovery under the D-factor, the programs are typically required to be targeted at specific and quantifiable capex deferral, the AER considers that the kinds of programs to be funded under the D-factor may be similar to those funded under ESCOSA's scheme, such as direct and voluntary load control, and critical peak pricing programs.[7] Should NSW DNSPs be able to demonstrate to the AER, on a case by case basis, that there is a causal link between the deferral of planned network augmentation and efficient demand management programs, the programs will be eligible for cost recovery under the D-factor.

The AER notes that ESCOSA's scheme provides cost recovery for certain broad–based and pilot–natured demand management programs, which may not be covered by the NSW D-factor. However, the AER's demand management innovation allowance will provide cost recovery for such programs, and as such, the AER considers that the combination of its demand management innovation allowance and the IPART D-factor mechanism provides a good balance of incentives for efficient demand management.

The AER notes that while ESCOSA's scheme is capped $20 million over the regulatory control period, the D-factor is an uncapped mechanism. The D-factor allows DNSPs to recover the implementation costs, up to the value of the avoided distribution costs, plus foregone revenue costs of efficient demand management programs.

Accordingly, the AER considers that it is not necessary to apply a scheme such as that applied by ESCOSA in addition to the D-factor in NSW.

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7 The AER notes that the IPART D-factor mechanism allows the recovery of foregone revenue costs of certain broad or system wide demand management programs that may target a region rather than a customer. This is highlighted in the CEC's submission on the AER's preliminary positions paper, available on the AER's website, www.aer.gov.au. However, the D-factor scheme requires that DNSPs establish a clear causal link between the demand management programs and the deferral of planned network expenditure in order to recover the foregone revenue resulting from the programs. This is set out in IPART's Guideline on the Calculation of Foregone Revenue which forms appendix B of the AER's *Demand management incentive schemes to be applied in the NSW 2009-2014 distribution determinations—D factor*, in appendix C of this decision.

5.10.3 AER conclusion

Consistent with the proposals in its preliminary positions paper, the AER will apply its demand management innovation allowance, set out in appendix D, to the ACT and NSW DNSPs, and IPART's D-factor scheme to the NSW DNSPs.

5.11 Magnitude of the demand management innovation allowance

5.11.1 Issues raised in submissions

EnergyAustralia, Integral Energy, ETSA Utilities, the EMRF, the TEC and the CEC submitted that the AER's proposed learning-by-doing fund (now the demand management innovation allowance), is too small and needs to be increased.

EnergyAustralia submitted that the allowance should be increased to 1 per cent of DNSP revenues, or $10 million per annum. EnergyAustralia's submission outlined five examples of demand management projects that it has carried out or initiated in the 2004–09 regulatory control period, which it submits would not be covered by the amounts proposed for DNSP recovery under the AER's demand management innovation allowance. It also submits that the magnitude of the proposed allowance's impact on customers' prices would be very small, and that its feedback from stakeholders supports a view that customers would be willing to contribute at a significantly higher level to achieve positive outcomes in demand management.

Integral Energy submitted that given the nature of the likely projects that might be implemented, the proposed allowance may encourage only limited investment in demand management. It submitted that, at a minimum, the AER's demand management innovation allowance allocated to its network should be increased to $1 million, as was provisionally allocated to EnergyAustralia.

The EMRF submitted that the allowance should be increased in line with ESCOSA's scheme, in particular in light of the expected reported $10 to $12 billion capex programs by NSW DNSPs for the 2009 distribution determinations.

The TEC submitted that the AER's demand management innovation allowance should be increased to 2 per cent of each DNSP's capex.

The CEC submitted that the AER should increase the cap on the demand management innovation allowance at least tenfold.

5.11.2 AER considerations

The AER notes the general view expressed in stakeholders' submissions that its demand management innovation allowance is too small and needs to be increased.

The AER's reasons for applying a learning-by-doing fund (now the demand management innovation allowance), were set out in its November 2007 preliminary positions paper. Principally, the allowance was designed to provide incentives for DNSPs to conduct efficient, broad–based and/or innovative demand management programs, in addition to the existing demand management incentives present within the regulatory and energy policy framework. In NSW, the demand management innovation allowance is expected to facilitate better use of the D-factor through allowing cost recovery for innovative demand management measures, which may in the future be recovered through the D-factor, or may provide network augmentation deferral benefits for DNSPs independent of any incentive scheme.

The AER notes that there are existing incentives for DNSPs to conduct demand management within the regulatory and policy framework. DNSPs may recover demand management costs that are forecast at the time of the AER's determination via opex, as well as through the D-factor in NSW.

The AER also notes the impact of clause 6.5.7(e)(10) of the transitional Chapter 6 rules requires the AER to consider the extent DNSPs have considered, and made provision for, efficient non–network alternatives in deciding whether their total forecast capex reasonably reflects the capital expenditure criteria in clause 6.5.7(c). The AER considers that in view of clauses 6.5.7(c) and 6.5.7(e)(10), a DNSP should ensure that it puts forward the details of its consideration of efficient non-network alternatives as part of its regulatory proposal.

The demand management innovation allowance is administratively simple, and has very few reporting requirements to enable the majority of the allowance to be spent on implementing demand management programs.

The AER considers that, given its reasons for implementing the demand management innovation allowance, and the existing incentives for DNSPs to conduct demand management outlined above, the increases in the allowance suggested by EnergyAustralia, the EMRF, the TEC and the CEC are excessive. This is particularly in light of the AER's assumption that there may be national initiatives to address demand management in the 2009–14 regulatory control period. The AER considers that demand management programs expected to cost in the order of $5 to $10 million per annum should be able to be planned for recovery under opex at the time of the AER's determination.

However, the AER acknowledges EnergyAustralia's submission which outlined the costs of certain broad–based and/or innovative demand management programs that may not be able to be covered by the amounts proposed for the demand management innovation allowance in the AER's preliminary positions paper. The AER considers that it may be necessary to provide modest increases to the amounts provided under the allowance, to enable the implementation of efficient demand management programs, such as those outlined in EnergyAustralia's submission.

5.11.3 AER conclusion

The AER will apply a fivefold increase to the amounts provided under the demand management innovation allowance from those which were proposed in its preliminary positions paper. This decision has been made in recognition of EnergyAustralia's submission that the allowances proposed are not large enough to cover a range of broad–based demand management programs that the scheme aims to promote. The AER considers that an increase to:

- $1 million per annum for EnergyAustralia

- $600 000 per annum for Country Energy
- $600 000 per annum for Integral Energy
- $100 000 per annum for ActewAGL

over the 2009–14 regulatory control period is appropriate. The amounts allowed for recovery under the scheme remain broadly proportional to the size of DNSPs' revenues, and the anticipated costs of efficient broad–based demand management programs. The AER's demand management innovation allowance scheme is outlined in appendix D of this decision.

5.12 Demand management innovation allowance criteria

5.12.1 Issues raised in submissions

EnergyAustralia submitted that the AER's limitations, or criteria, for its demand management innovation allowance misunderstand the fundamental requirements of an allowance and would limit the value of the initiative. Specifically, EnergyAustralia submitted that the AER's criteria on the demand management innovation allowance:

- to programs that are innovative and
- target broad–based demand reductions across the DNSPs' networks,

be expanded to programs that are:

- innovative, have the potential, if successful, to be repeated as commercially efficient projects in other locations or sectors, but where related capital deferrals cannot be specifically identified or
- intended to reduce peak demand on the network system, but most appropriately implemented in a broad–based framework and therefore not related to changes in specific investment needs.

The CEC submitted that the eligibility criteria for the demand management innovation allowance should be amended from:

1. Demand management programs should not be based on addressing specific network constraints, as constraint based demand management costs are recovered under the D-factor scheme in NSW.
2. Programs implemented must be unable to have costs recovered under other state or federal schemes.
3. Demand management programs to be recovered under the scheme should be innovative, and target broad based demand reductions across the DNSPs' networks.
4. Recoverable programs may be tariff or non–tariff based, however the foregone revenue of tariff based demand management will not be recoverable under the scheme.

to:

1. Demand management programs should not be recoverable under other categories of the D-factor.
2. Costs recovered must not be recovered under any other state or federal schemes.
3. Demand management programs should be innovative.
4. Recoverable programs may be tariff or non–tariff based, however the foregone revenue of tariff based demand management will not be recoverable under the scheme.

The CEC submitted that the changes to the criteria proposed in the AER’s preliminary positions paper would allow a greater number of demand management programs to be implemented. Specifically, the CEC submitted that the change to criterion 1 would allow demand management where the outcomes in energy savings and reduced peak demand or network constraints are either hard to forecast in advance, hard to quantify afterwards, or both. The CEC submitted that the change to criterion two would allow the scheme to complement funding from a range of sources, while preventing ‘double–dipping’ to over–recover specific costs, and the amended criterion three would encourage DNSPs to develop measurement and verification processes at the pilot program stage of demand management programs so that future stages can be recovered through the D-factor process.

5.12.2 AER considerations

The AER considers that the criteria on its demand management innovation allowance are imposed primarily to provide direction for DNSPs in deciding the kinds of efficient demand management programs to implement. The AER considers the limitations should provide the DNSPs with some certainty that their costs will be approved by the AER for recovery under the demand management innovation allowance.

The AER notes that the criteria for the demand management innovation allowance in the AER’s preliminary positions paper may not be sufficiently clear. The AER does not intend the demand management innovation allowance to be limited to programs that are both innovative and broad–based, but rather may be either innovative and/or broad–based. Subsequent to its submission on the AER’s preliminary positions paper, EnergyAustralia has indicated that it is satisfied for the AER’s demand management innovation allowance scheme to state that it is limited to programs that are innovative and/or broad–based.

The AER notes EnergyAustralia’s suggestions for the demand management innovation allowance criteria, however notes that the AER’s decision to maintain modest cost recovery limits on the demand management innovation allowance requires that the scheme remain administratively simple. The AER considers that EnergyAustralia’s proposed changes to the criteria are focussed on specific programs which may result in fewer demand management programs qualifying under the scheme.

The AER has considered the CEC’s proposed amendments to the demand management innovation allowance criteria, and considers that the proposed changes to criterion 1 and 2 may provide greater clarity for DNSPs seeking demand management cost recovery under the scheme. The AER considers the criteria should ensure the scheme promotes efficient broad–based and innovative demand management that is not covered by the NSW D-factor or other demand management incentive schemes. The criteria aim to avoid DNSPs over–recovering the costs of demand management programs, and to broaden the types of demand management programs carried out.

The AER considers that the change to criterion 3 suggested by the CEC does not provide adequate direction for DNSPs in determining which demand management programs to implement under the demand management innovation allowance.

5.12.3 AER conclusion

The AER has decided to change the assessment criteria for its demand management innovation allowance from that which was proposed in its preliminary positions paper, to:

1. demand management programs claimed under the scheme should not be recoverable under categories of the D-factor
2. costs recovered under the scheme must not be recovered under any other state or Australian government schemes
3. demand management programs to be recovered under the scheme should be innovative, and/or target broad–based demand reductions across the DNSPs' networks
4. recoverable programs may be tariff or non–tariff based, however the foregone revenue of tariff based demand management will not be recoverable under the scheme

The AER's criteria on its demand management innovation allowance scheme to be applied in the ACT and NSW 2009–14 regulatory control period, are set out in appendix D of this decision.

5.13 Demand management innovation allowance approval process

5.13.1 Issues raised in submissions

The CEC submitted that the AER's proposed ex post approval process for the demand management innovation allowance imposes an inappropriate element of risk for DNSPs carrying out demand management under the scheme. The CEC recommended that the AER approve demand management programs in advance, and conduct a limited ex post assessment which involves checking that the programs undertaken have complied with any conditions for approval established by the AER at the prior approval stage.

5.13.2 AER considerations

The AER notes the risks imposed upon DNSPs seeking to undertake demand management under the demand management innovation allowance, and considers that the CEC's recommended prior approval approach to assessment of programs may serve to mitigate some of these risks. The AER notes, however, the importance of ensuring the funds available under the scheme are not eroded by high administrative costs.

5.13.3 AER conclusion

The AER has decided to amend the demand management program approval process for the demand management innovation allowance from that which was proposed in its preliminary positions paper. The preliminary positions paper outlined an ex post approval process by which DNSPs would be required to provide a report to the AER on the demand management programs implemented, including:

- aims of the demand management programs
- outline of their implementation
- implementation costs
- foregone revenue (in the case of non–tariff demand management programs)
- outcomes of the programs.

The AER has decided to amend the assessment process for demand management programs carried out under the demand management innovation allowance, to be conducted in two stages:

1. A prior approval stage, carried out at the time of DNSPs' annual price reviews, in which DNSPs can apply for the AER's approval of demand management programs before they are carried out.

   This stage aims to provide a level of certainty for DNSPs wishing to carry out demand management under the allowance, that the AER will approve their demand management program's cost recovery at the completion of the program. This will involve the AER identifying a series of requirements, which may be unique to each application under the scheme, that it will check at the end of the demand management program to ensure that DNSPs have conducted the demand management programs efficiently. For demand management programs that are to be carried out over several years, the DNSPs may identify annual interval targets for cost recovery carried out each regulatory year. If specific annual targets are not known at the time of prior approval, DNSPs may apply to recover the annual allowance at the end of the program, however DNSPs must be able to identify annual spending on the program.

2. An ex post approval process, also to take place at the time of the DNSPs' annual price reviews, which will involve the AER checking that the completed demand management program meets the requirements set out by the AER in the prior approval process.

   The AER will review the DNSPs' cost recovery application, and the outcomes of the program, to the extent known. The AER will require that this final application for cost recovery is made public as part of a report on the demand management programs carried out by DNSPs.

Applications for the AER's demand management innovation allowance will be assessed annually at the time of the DNSPs' pricing review, and costs for approved demand management programs will be recovered in the regulatory year following their implementation through an adjustment in the weighted average price cap in NSW, and through pass through within the ACT's average revenue cap. To be eligible for recovery under the scheme, the AER requires that DNSPs provide a public report at the completion of the program which includes:

- an overview of the demand management program, setting out the features of the program that can be considered innovative and/or broad–based
- aims of the demand management program
- outline of its implementation
- implementation costs
- a statement certifying that the costs of the demand management program have not been recovered under another scheme
- foregone revenue (in the case of non–tariff demand management programs)
- outcomes of the program.

The AER's approval process for demand management programs under the demand management innovation allowance is outlined in the scheme attached at appendix D of this decision.

5.14 Other matters raised by the TEC

5.14.1 Issues raised in submissions

The TEC made a number of recommendations in its submission on the AER's preliminary positions paper addressing issues which are beyond the scope of the AER's decisions on demand management incentive schemes to apply in the ACT and NSW over the 2009–14 regulatory control period. Such recommendations include:

- the AER should seek to align network incentives with consumer and public interest, by avoiding short-term incentives associated with price/revenue control, long-term incentives associated with prudence review and the incorporation of capex into the capital base and mechanisms for sharing efficiency benefits between shareholders and consumers, and through network and system development and planning requirements
- the AER should decouple DNSP profit from electricity sales
- the AER should apply revenue caps to decouple network profit from electricity sales

- the AER should apply adjustment factors to insulate DNSPs from large divergences of actual peak demand from forecast peak demand by, for example, linking revenue caps to economic growth

- federal, state and territory governments should apply complementary transitional measures to accelerate demand management

- the Australian government should put an appropriate price on greenhouse gas emissions

- federal, state and territory governments should clarify government policy intent regarding efficient demand management.

5.14.2 AER considerations

The AER's role, with respect to demand management, is as an economic regulator of electricity distribution. Its primary role is to apply and ensure compliance with the NER. It is limited in its actions and decisions by the NER.

Clause 6.2.5 (c1) of the transitional Chapter 6 rules states:

> **(c1) The control mechanism for:**
>
> (1) subject to subparagraph (3), standard control services provided by a NSW Distribution Network Service Provider in the regulatory control period 2009-2014:
>
> > (i) must be substantially the same as that determined by the IPART for the corresponding prescribed distribution services provided in the regulatory control period 2004-2009;

The AER does not have jurisdiction to change the form of control for direct control services in NSW from a price cap to a revenue cap, as is recommended by the TEC. The AER's decisions on the form of control for direct control services in the ACT and NSW to apply in the 2009 distribution determinations is outlined in its guideline on the control mechanisms for direct control services. The AER's decisions and consideration of issues relating to the efficiency benefit sharing scheme is outlined in the AER's final decision on the efficiency benefit sharing scheme to apply to the ACT and NSW 2009 distribution determinations.

The AER's role is limited to examining and making determinations under the NER. Several of the recommendations made by the TEC deal with policy considerations.

5.14.3 AER conclusion

The issues addressed within the recommendations above are beyond the scope of the AER's demand management incentive schemes.

6 Consideration of factors set out in the rules

In preparing its demand management incentive schemes, the AER has had regard to the five factors outlined in clause 6.6.3(b) of the transitional Chapter 6 rules:

6.6.3(b)(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 AER considers that continuing the D-factor in NSW and applying a modest demand management innovation allowance over the 2009–14 regulatory control period will encourage DNSPs to undertake demand management programs, without significantly increasing electricity costs to consumers. The AER considers that applying a demand management innovation allowance for the ACT and NSW electricity distribution determinations may encourage the implementation of efficient demand management programs which provide long-term efficiency gains to energy users that may outweigh any short-term price increases.

The AER notes that stakeholders' submissions expressed general support for the continuation of the D-factor in NSW, and the application of a learning-by-doing fund (now the demand management innovation allowance), in the ACT and NSW over the 2009–14 regulatory control period.

6.6.3(b)(2)—The effect of a particular control mechanism (i.e. price – as distinct from revenue – regulation) on a DNSP's incentives to adopt or implement efficient non–network alternatives.

In NSW, the AER considers that the application of the D-factor offsets some of the perceived disincentives for demand management within the weighted average price cap. While the AER notes that the modest D-factor results could indicate that the scheme is taking some time to develop the intended incentives, the AER considers that continuing the D-factor during the 2009–14 regulatory control period will allow the scheme more time to develop.

The AER considers that the average revenue cap in the ACT may provide some incentives for ActewAGL to conduct demand management. To date there has been limited demand management activity in the ACT. Accordingly the AER considers it is appropriate to provide further demand management incentives, such as the demand management innovation allowance.

6.6.3(b)(3)—The extent the DNSP is able to offer efficient pricing structures.

To date there has been modest demand management undertaken in the ACT or NSW, and there is therefore little information available to the AER and stakeholders regarding efficient costs for demand management. While the AER considers that a national roll–out of interval meters may be considered for determination by COAG by or during the 2009–14 regulatory control period, it considers that there are currently limitations for the distributors to send signals to the market about constraints on the network through price. The AER considers that the application of a D-factor in NSW and the demand management innovation allowance in the ACT and NSW may be necessary, in particular to allow DNSPs to trial tariff based demand management programs which will provide information on efficient pricing for demand management, and on the customer reactions to price signals.

6.6.3(b)(4)—The possible interaction between a demand management incentive scheme and other incentive schemes.

The AER acknowledges that the D-factor incentive mechanism may interact with the incentives created by other schemes, in particular the efficiency benefit sharing scheme. To minimise the impact of the efficiency benefit sharing scheme on the incentives to undertake demand management programs the AER will exclude demand management costs from the efficiency benefit sharing scheme.

The AER considers that the application of a modest and administratively simple demand management innovation allowance scheme will be unlikely to negatively interact with the incentives created by other incentive mechanisms.

6.6.3(b)(5)—The willingness of the customer or end user to pay for increases in costs resulting from implementation of the scheme.

The AER considers that to date, the D-factor has resulted in very small increases in customer prices, and considers that the limit on demand management program implementation cost recovery under the D-factor to being equal to the avoided distribution costs of the demand management, appropriately limits future customer price rises. The AER considers that continuing the D-factor may allow DNSPs to trial projects that will provide information on customer willingness to pay for efficient demand management, which is currently limited.

The AER considers its modest demand management innovation allowance will enable DNSPs to conduct efficient demand management trials of a more experimental nature, which will provide greater information on customer willingness to pay, without resulting in significant customer price increases.

The AER notes the general support among stakeholders, including strong support from the EMRF, for the continuation of the D-factor and the application of a demand management innovation allowance. In addition, EnergyAustralia submitted that it has received feedback from stakeholders that supports a view that customers would be willing to contribute to achieve positive outcomes in demand management.

7 AER decisions

This chapter of this final decision and the D-factor and demand management innovation allowance schemes, set out in appendixes C and D of this decision, fulfil the AER’s obligations under clause 6.6.3(e) of the transitional Chapter 6 rules. This decision and these demand management incentive schemes only apply to the following businesses:

- In the ACT:
  - ActewAGL
- In NSW:
  - Country Energy
  - EnergyAustralia
  - Integral Energy

7.1 The D-factor scheme in NSW

The AER will continue the application of the D-factor scheme in NSW for the 2009–14 regulatory control period, as it was applied by IPART in its 2004 determinations.

The D-factor scheme to be applied by the AER is outlined in appendix C and is identical to that set out in IPART’s *Guidelines on the Application of the D-factor in the Tribunal’s 2004 NSW Electricity Distribution Pricing Determination* (IPART’s D-factor guidelines). IPART’s guidelines represent the results of a demand management consultation group established to develop principles and guidelines on:

- avoided distribution costs
- foregone revenue
- loss management investments
- network planning.

IPART’s D-factor guidelines were developed as part of an extensive stakeholder consultation process at the time of the 2004 distribution determination, and incorporate the views of DNSPs at that time. The AER considers IPART’s D-factor guidelines, as applied by IPART in the 2004–09 regulatory control period, have provided an appropriate basis for the AER’s D-factor scheme for the 2009–14 regulatory control period.

The AER notes EnergyAustralia’s submission to IPART, proposing a methodology for the calculation of avoided distribution costs for partial demand management solutions. The AER considers that IPART’s assessment of the proposed methodology is appropriate, including the assessment that to alter IPART’s D-factor guidelines to include EnergyAustralia’s proposed methodology is unnecessary.

The AER has mirrored IPART's response to the proposed methodology, and will take account of IPART's D-factor guidelines when assessing DNSPs' applications. As IPART indicated in its final assessment of the D-factor methodology, the AER proposes to remain flexible as to how the D-factor scheme is applied in certain situations. The *Preliminary Assessment of EnergyAustralia's methodology under the D-factor mechanism of the 2004 Distribution Pricing Determination* is attached at appendix C of this decision.

7.2 Demand management innovation allowance scheme

The AER will apply a demand management innovation allowance in the ACT and NSW in the 2009–14 regulatory control period.

The operation of the AER's demand management innovation allowance is outlined in appendix D of this decision.

Appendix A: Submissions

The following interested parties provided submissions on the AER's preliminary position on demand management incentive schemes to apply in the ACT and NSW 2009–14 regulatory control period:

- ActewAGL
- Clean Energy Council
- Country Energy
- EnergyAustralia
- Energy Markets Reform Forum
- ETSA Utilities
- Integral Energy
- Total Environment Centre

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

Appendix B: AER's written statement setting out how it proposes the demand management incentive schemes will operate for the next distribution determination

This statement constitutes the written statement the AER is required to publish as part of this demand management incentive scheme in accordance with clause 6.6.3(e) of the transitional Chapter 6 rules.

The AER will apply two demand management incentive schemes to the ACT and NSW DNSPs in the 2009 distribution determinations. These schemes are:

- A D-factor scheme to apply to Country Energy, EnergyAustralia and Integral Energy, as it was applied by IPART in the 2004–09 regulatory control period. This scheme is attached at appendix C of this decision.

- A demand management innovation allowance to apply to ActewAGL, Country Energy, EnergyAustralia and Integral Energy. This scheme is attached at appendix D of this decision.

These two demand management incentive schemes will be applied in the 2009–14 regulatory control period, and to the extent that both schemes involve a lag between the approval of demand management programs and the subsequent impact on network prices, will have financial implications for the 2014–19 regulatory control period. That is:

- The D-factor scheme operates on a two year lag. The AER will honour the recovery of relevant expenditure undertaken as part of the D-factor scheme in the final two regulatory years of the 2009–14 regulatory control period, to be recovered in the first two regulatory years of the 2014–19 regulatory control period. As such, the AER's D-factor scheme, applied in the 2009–14 regulatory control period, will have a financial impact on the first two regulatory years of the 2014–19 regulatory control period.

- Approval for cost recovery of demand management programs under the demand management innovation allowance occurs on an annual ex post basis. Expenditure on demand management programs carried out in the final regulatory year of the 2009–14 regulatory control period may be approved for cost recovery in the first regulatory year of the 2014–19 regulatory control period. As such, the AER's demand management innovation allowance, applied in the 2009–14 regulatory control period, will have a financial impact on the first regulatory year of the 2014–19 regulatory control period.

Appendix C: The D-factor scheme

Appendix C is the D-factor scheme to apply to the NSW 2009 distribution determinations, attached.

Appendix D: The demand management innovation allowance scheme

Appendix D is the demand management innovation allowance scheme to apply to the ACT and NSW 2009 distribution determinations, attached.