SCER
Standing Council on Energy and Resources
Senior Committee of Officials

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

The Standing Council on Energy and Resources (SCER) has agreed to submit a rule change request to the Australian Energy Market Commission reforming the Demand Management and Embedded Generation Connection Incentive Scheme.

This rule change request has been developed based on recommendations contained in the AEMC Power of choice review. It is in line with the broad energy reform package to support investment and market outcomes in the long term interests of consumers agreed by the Council of Australian Governments and SCER in December 2012.

The rule change proposal is attached for your consideration.

Sincerely

Martin Hoffman
Chair
Standing Council on Energy and Resources Senior Committee of Officials
17 December 2013

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Reform of the Demand Management and Embedded Generation Connection Incentive Scheme

Rule change request

December 2013

1. Name and address of rule change request proponent

The Standing Council on Energy and Resources
SCER Senior Committee of Officials
Standing Council on Energy and Resources Secretariat
GPO Box 1564
Canberra ACT 2601

2. Description of the proposed rule change

The rule change proposal seeks to amend the existing National Electricity Rules (NER) governing the development and implementation of demand management and embedded generation connection incentive schemes (DMEGCIS or 'incentive scheme'). The purpose of the rule is to provide an appropriate return to distribution network service providers (DNSPs) to incentivise efficient demand management projects as well as improve clarity and certainty regarding how the scheme will be developed and implemented. This should strengthen the incentives for DNSPs to undertake demand management projects that deliver a net benefit.

Specifically the rule change request seeks to improve the effectiveness of the incentive scheme by making the following key changes to Chapter 6 of the NER:

- Explicitly separating the current DMEGCIS into a Demand Management Incentive Scheme (DMIS) and a Demand Management and Embedded Generation Connection Innovation Allowance (Innovation Allowance);
- introduce a new objective for the DMIS and new principles to guide the development and application of the scheme;
- provide scope for the AER to include the following forms of reward under the incentive scheme:
    - a payment based on a proportion of the net market benefits (and avoided or deferred network costs) produced by a demand management project; and
    - a payment as compensation for any lost profits that occur as a result of implementing a demand management option, where appropriate.
- requiring the AER to develop a guideline for how incentive payments will be determined (including guidance on the calculation of benefits available for reward and calculation of lost profits to be compensated).

The proposed rule reflects a principles-based approach to development and implementation of the incentive scheme, allowing the AER significant discretion and flexibility to develop the scheme in ways that take account of evolving knowledge and experience and adapting the scheme to the individual characteristics of network businesses.

The rule change proposal is consistent with the recommendations set out in the Australian Energy Market Commission (AEMC) Power of Choice review, completed in November 2012.

Overall the proposed rule will promote the National Electricity Objective by strengthening incentives for DNSPs to undertake efficient demand management projects that reduce the overall long term costs of supplying electricity to consumers.

A description of the proposed rule is provided at Attachment A.

3. Background to the rule change request

In December 2012, the Council of Australian Governments and SCER agreed to a broad energy reform package to support investment and market outcomes in the long term interests of consumers. This included consideration of demand side participation (DSP) in the electricity market.

As part of the implementation of reforms, SCER agreed to progress a number of rule change proposals that were recommended by the AEMC in its Final Report for the Power of Choice (PoC) review.[1]

AEMC Power of choice review

In November 2012, the AEMC published its Final Report for the PoC review.[2] The purpose of the review was to investigate and identify the market and regulatory arrangements needed across the supply chain to facilitate efficient investment in, and operation and use of, DSP in the NEM.

The PoC review identified the opportunities (information, education, and technology, and flexible pricing options) for consumers to make more informed choices about the way they use electricity. The review also addressed the market conditions and incentives required for network operators, retailers and other parties to maximise the potential of efficient DSP and respond to consumers' choices. The overall objective of the review was to ensure that the community's demand for electricity services is met by the lowest cost combination of demand and supply side options.

The AEMC made a number of recommendations to facilitate the efficient uptake of DSP in the NEM. The recommendations for reform were made across nine priority areas and included proposed changes to the NER, jurisdictional regulations and proposed action for SCER and jurisdictions to progress.

A key area of focus in the final report of the review related to distribution network incentives. As part of the reforms for this area, the AEMC recommended reform of the existing demand management and embedded generation connection incentive scheme to provide sufficient incentives for efficient DSP projects that deliver net benefits. This included providing greater clarity around an appropriate incentive for efficient DSP projects and creating a separate provision for an innovation allowance. AEMC also recommended some minor amendments to clarify that the AER can have regard to market benefits when assessing the efficiency of expenditure, and flexibility in the annual tariff process to manage potential extra volatility of DSP costs.[3]

4. Nature and scope of the issues the rule change is seeking to address

Provision for the AER to implement an incentive scheme for demand management was introduced in the NER in recognition of the fact that demand management has different characteristics to network investment and is still in a relatively early stage of evolution in terms

[1] http://www.scer.gov.au/workstreams/energy-market-reform/
[2] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012.
[3] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7.

of technologies, knowledge and processes. There are greater uncertainties and risks associated with demand management options compared with traditional network investments and capital expenditure providing for more stable returns. DNSPs are consequently likely to favour capital investments for addressing network limitations and demand growth.

SCER officials note however that this is likely to change as expertise and technologies evolve. Further, because demand management options involve much shorter time commitments relative to network expenditure, they may also offer a valuable level of flexibility. This is particularly the case where demand is becoming increasingly difficult to predict due to a greater level of engagement and demand responsiveness by consumers (for example through solar photovoltaic products, energy efficiency and more dynamic forms of pricing).

The AEMC assessed the operation and effectiveness of the current DMEGCIS (which has been used to establish one or both of an incentive scheme and an innovation allowance) in the Power of Choice review. It identified a range of reasons for why the DMEGCIS had not been effective in encouraging an efficient level of demand management in the market, including:

- The current scheme focuses on cost recovery only; it does not provide DNSPs with an opportunity to make profits on demand management projects.
- DNSPs considered the innovation allowance too small to genuinely encourage experimentation and innovation with new demand management methods.
- Any reward available to distributors for undertaking demand management projects was of relatively short duration relative to the long term returns available on network investment.
- Most significantly, DNSPs were not able to capture benefits from demand management initiatives created at other levels of the supply chain (e.g., benefits associated with reduced generation capital and operating expenditure); and
- Uncertainty as to whether demand management related expenditure would be treated differently compared to normal capital and operational expenditure under the NER (e.g. considered less prudent with respect to the expenditure objectives and criteria under 6.5.6 and 6.4.7 of the NER).[4]

Consequently, the AEMC considered the DMEGCIS did not provide sufficient incentive or certainty for distribution businesses to explore and develop efficient demand management options as an alternative to network investment. Stakeholder submissions to the AEMC Power of Choice review supported this.

5. How the rule change request intends to address the issues identified

This rule change request reflects the recommendations made in the AEMC Power of Choice review and implements a principle-based approach to development and implementation of the DMEGCIS. Such an approach is focused on relying on a high level objective and supporting principles rather than detailed prescription in the NER and is similar to the overall approach the AEMC took with regard to the network regulation rule change in 2012.[5]

[4] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7.
[5] See Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 , 29 November 2012, available on AEMC website.

This rule change request therefore proposes high level guidance for how a new demand management incentive scheme should be developed and implemented while at the same time not unduly constraining the flexibility of the AER to develop and adapt its approach as circumstances and knowledge evolves. The proposed rule provides for the specific application of the incentive scheme to be developed through consultation between the AER, DNSPs and other interested stakeholders (refer to section 4.5 of Attachment A).

The rationale for introducing an objective in the proposed rule is to provide greater certainty and clarity for DNSPs with regard to the purpose of the scheme and the circumstances under which DNSPs may earn a return on demand management projects approved under the scheme (section 2.1 of Attachment A). This is supported by principles and other amendments to the NER, which provide guidance to the AER and DNSPs for how the objective of the scheme may be achieved and seek to improve the clarity and certainty of how the scheme will be developed and operated by the AER (section 3.1 of Attachment A).

The changes proposed for a new DMIS and Innovation Allowance are set out in the description of the proposed rule (Attachment A) and are outlined below.

Strengthening financial rewards under the DMIS

Currently, the only benefits distributors are able to derive from implementing demand management projects are cost savings related to deferred or avoided distribution network expenditure. Demand management projects will typically also create benefits at other points of the supply chain, such as avoided generation costs and avoided investment in the transmission network. The current inability of DNSPs to secure a fair proportion of all benefits created by their demand management projects across the supply chain amounts to a market failure, which is likely leading to inefficient under provision of such projects.[6] This is not in the long term interests of consumers.[7]

The proposed rule seeks to address this issue by introducing a new clause that allows the AER to implement a new incentive for DNSPs based on the broader supply chain benefits created by demand management projects (refer to section 4.2 of Attachment A).

To give proper effect to the new incentive scheme, changes will be required to define what constitutes avoided distribution network costs and non-distribution network related benefits (e.g. savings in generation and transmission costs) and how these benefits should be calculated. The proposed rule introduces a requirement for the AER to develop and publish a guideline that sets out a consistent methodology/s or approach/s for identifying and calculating these benefits (section 4.11 of Attachment A). SCER officials note this requirement is consistent with the AER's role for developing guidelines for the calculation of the market benefits with regard to the regulatory investment test for distribution (RIT-D) under Section 5.17.2 of the NER. The approaches for calculation of market benefits under the incentive scheme should be consistent with how such benefits are determined under the RIT-D.[8]

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[6] The market failure in question is a DNSP's inability to receive a share of the total benefits their actions create, as is currently the general case for market benefits arising from DNSP-driven demand management projects. This market failure results in DNSPs typically underinvesting in efficient demand management projects. Hence, the underinvestment in efficient demand management is an outcome of the aforementioned market failure.

[7] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7, p 209.

[8] http://www.aer.gov.au/Better-regulation-reform-program

The proposed rule also seeks to require that, where appropriate, any methodology developed by the AER as part of the DMIS is consistent with the methodology AEMO develops for calculating market benefits in relation to the potential wholesale demand response mechanism which it has been tasked to develop as an outworking of the Power of Choice review (section 4.8 of Attachment A).

The proposed rule also seeks to address the issue of the appropriate share of market benefits that should be made available to DNSPs under the new scheme. SCER officials consider that the level of the reward available to DNSPs for demand management projects should be consistent with that available under broader incentive schemes for capital and operating expenditure in Chapter 6 of the NER and commensurate with any additional level of risks involved in developing such projects.

The current incentive schemes for operational and capital expenditure mean distribution businesses approximately retain between 20 and 30 per cent of any cost savings they make (with the remainder of the benefits being passed through to consumers). While demand management projects are subject to greater levels of risk, SCER officials propose to address this through the foregone profit component of the DMIS. This is discussed in more detail in the next section. SCER officials consider it is therefore appropriate for rewards available under the DMIS to be broadly equivalent to provisions that apply to capital and operational expenditure.

The proposed rule seeks to introduce a requirement for the rewards for market benefits available under the DMIS to be capped at no more than 30 per cent of those market benefits (section 4.5 (vi) of Attachment A). SCER officials consider that setting the cap in the NER also has the benefit of promoting certainty for DNSPs about the returns available for implementing demand management projects.

The proposed rule should contain two important safeguards to protect consumers from the provision of excessive rewards to DNSPs under the scheme. First, a requirement that demand management projects (as set out in the objective) must generate net benefits before DNSPs can secure financial rewards for such projects; and second, that the reward available to DNSPs for non-distribution network related market benefits will be capped to a maximum of 30 per cent and allocated when they are realised.

Providing long term incentives for demand management under the scheme

The AEMC noted in the Power of Choice review that some demand management projects might incur costs and deliver benefits across multiple regulatory control periods. The AEMC considered it was important that such projects, where they deliver an overall benefit to the market, were not discouraged from being implemented.[9] The proposed rule therefore seeks to introduce a principle that requires the AER to provide for long term incentives under the DMIS (section 4.5 (i) of Attachment A).

Regulatory treatment of demand management related expenditure

An important aspect of the new incentive scheme under the proposed rule is that the innovation allowance will not be used to fund business-as-usual (BAU) demand management projects,

[9] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7, p 228.

rather funding for BAU projects will come from the normal expenditure allowances approved under clauses 6.5.6 and 6.5.7 of the NER.

Consequently, the AER will be required to assess the prudency of demand management related expenditure in the same way as all other capital and operating expenditure at each regulatory reset. This reflects the broad principle that one form of capital or operating expenditure should not be favoured in its regulatory treatment over other forms, so that in all cases the incentive for distributors is to implement the lowest cost approach to addressing a network limitation (there should be no bias for favouring network versus non-network options). This obligation is outlined in section 4.13 of Attachment A.

SCER officials recognise the above principle is conditioned by the level of risk associated with different forms of expenditure, but notes this is addressed through the foregone profit mechanism discussed in other sections of this document.

A broader issue identified in the AEMC Power of Choice review was in regard to how incentives under the DMIS are likely to interact with other incentives and incentives schemes in Chapter 6 of the NER.[10] For example, the AEMC noted that incentives for efficient expenditure operate differently for capital and operating expenditure and that on balance, this favoured capital investment. Given most demand management projects are based on operating expenditure, this could lead to bias in the types of demand management projects implemented and underutilisation of demand management options to address network limitations overall.

This issue is currently being addressed by the AER as an outworking of the network regulation rule change determination in 2012.[11] It is seeking to recalibrate the incentive framework to remove any inherent biases between one form of expenditure and another. This in turn should interact positively with the new DMIS to ensure that demand management projects, many of which are characterised by operating expenditure, are not discouraged.[12]

Compensation for foregone profit

The current foregone revenue component of the DMEGCIS is intended to address the potential impacts of demand management projects on the revenues of DNSPs regulated under a weighted average price cap. These DNSPs are able to recover, for non-tariff based demand management projects, revenues that may have been lost from a lower quantity of energy sold arising as a consequence of the project. The AEMC proposed two refinements to the foregone revenue component of the scheme, however SCER officials consider that the suggestion to base the compensation amount on lost profits rather than revenues is most relevant.

The rationale for basing compensation on profits is to guard against over compensation. Profit based compensation better recognises that demand management options can drive costs lower as well as revenues and that, as a consequence, DNSPs may not necessarily be worse off where they experience loss in revenue from implementing a demand management project.

To give effect to the proposal, and provide more certainty and clarity around its implementation, SCER officials propose the AER include a methodology/s for calculation of the foregone profit

[10]Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7, pp 221-223.
[11] AEMC Rule determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, November 29 2012, available on AEMC website.
[12] AER, Better Regulation, "Expenditure incentives guidelines for electricity network service providers", Issues paper, March 2013.

component as part of the broader guideline it is required to develop regarding the calculation of market benefits (section 4.11 of Attachment A).

Tariff based measures

SCER officials considered whether tariff-based demand management projects should be included in the scope of the DMIS. With consideration of the potential risks and benefits, it was decided on balance that the rule change should be limited to non-tariff based demand management activities.

Monitoring of performance

The AEMC considered that the new scheme would require stricter performance indicators, as the new scheme would now operate in a similar manner to other incentive schemes for operational and capital expenditure in chapter 6 of the NER. A broader range of projects would now also be likely to fall under the scheme.[13]

In the long term, SCER officials would support development of more robust performance measures and standards consistent with the performance monitoring associated with other schemes. Given the current state of evolution of demand management approaches however, it may not be appropriate to be overly prescriptive with regard to the nature of the performance measures to be put in place.

SCER officials consider that while it is important that the AER monitors whether the objectives of the scheme are being met, it should have the discretion to determine what form such monitoring of performance should take and how it might be adapted over time as knowledge and understanding of demand management improves.

As a minimum however, SCER officials propose that the AER could be required to report on the effectiveness of the scheme each year and publish this report on its website. SCER officials also note that the AER is required to prepare and publish a framework and approach paper at the beginning of each regulatory reset. It comprises two stages, published at different times. The first stage outlines the AER's likely classification of the DNSPs' services and the form of control to apply to those services. The second stage sets out the likely application of the AER's incentive schemes and guidelines to DNSPs.

SCER officials consider the AER should set out how it intends to monitor the performance and effectiveness of the DMIS as part of the 2nd stage of its framework and approach paper.

The creation of a separate innovation allowance

In the Power of Choice review, the AEMC proposed to retain the innovation allowance for DNSPs, but separate it from the incentive scheme. This was to reflect the different purpose of the incentive scheme relative to the innovation allowance.[14]

The purpose of the new incentive scheme is, in effect, to encourage least cost network investment and operation by allowing DNSPs to access a proportion of the full benefits delivered by demand management options (i.e. market benefits at other points in the supply chain). The innovation allowance, on the other hand, is focused on providing a special source of funding for DNSPs to experiment and trial innovative approaches to demand management and the connection of

[13] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7, p 208-209.
[14] Australian Energy Market Commission, Power of choice review – giving consumers options in the way they use electricity, final report, AEMC, 30 November 2012, Chapter 7, pp 210-213.

embedded generators. This recognises that some approaches to demand management and the connection of embedded generation, given their current state of evolution, are highly uncertain with respect to their costs and benefits and are unlikely to be undertaken by DNSPs in the absence of additional funding.

SCER officials agree with the AEMC that facilitating testing and learning of new approaches and techniques to demand management and the connection of embedded generation will deliver benefits to consumers by reducing both network and generation related expenditures in the future. It therefore supports retaining the allowance under a separate provision in the NER, and has reflected this in the attached description of the proposed rule.

To date the innovation allowance has been small, totalling no more than $1 million a year for each distributor. The Productivity Commission draft report into network regulation argued for an increase in the size of innovation allowance. They considered that extra allowance is needed to fund trials in new time of use tariff structures and to calculate demand elasticity because both the AER and networks need more data and understanding of consumer responses in order to set appropriate cost reflective network tariffs.[15]

In the Power of Choice review, the AEMC noted that the costs of such allowances are borne by electricity consumers and that there are sources of government funding being offered for investment in clean energy technology (for example, the *Smart Grid, Smart Cities* trial). SCER officials agree with AEMC that the innovation allowance for distribution network businesses must not duplicate these arrangements.

Further, in light of the fact consumers are funding the innovation allowance, SCER officials consider that distributors should also be required to share their data, results and learnings with the AER, other networks businesses, and the market more broadly (through publication of results). This will allow for shared learning and will assist the AER in carrying out its regulatory functions. It is important that the allowance is only for activities not funded elsewhere. It is also notable that a lot of similar trials are being done in other countries, so the allowance provided should also take account of those trials and seek to avoid duplication.

SCER officials also agree that the AER should retain the discretion to determine the size of the allowance and how it should be applied. The scope of the innovation allowance should cover all forms of demand management, including embedded generation. SCER officials anticipate an innovation allowance will only be required in the short term, until such time as technology and knowledge evolves to a point where demand management options become business as usual.

6. How the proposed rule will or is likely to contribute to the achievement of the National Electricity Objective.

The National Electricity Objective (NEO) is set out in Section 7 of the National Electricity Law. The NEO states:

[15] Productivity Commission, Electricity Network Regulatory Framework - Draft Report, Melbourne, October 2012.

"The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to-

a. Price, quality, safety, reliability and security of supply of electricity; and
b. The reliability, safety and security of the national electricity system".[16]

The AEMC can only make a rule if it is likely to promote the NEO.

Efficiency is fundamental to the NEO, and comprises three elements:

- *Productive efficiency* - occurs when firms using given inputs and technologies produce the goods and services they offer to consumers at 'least cost'. Using the minimum resources required applies to both commercial and administrative processes.
- *Allocative efficiency* - occurs where resources are allocated to the uses most valued by society (which means they will deliver the greatest possible benefit to society). Allocative efficiency requires that energy services are provided, and consumption decisions are made, on the basis of prices that reflect the production cost of goods and services. It also requires that energy services are provided and priced in line with the preferences and valuations of consumers.
- *Dynamic efficiency* - ensures productive and allocative efficiencies are achieved over time, taking account of technological change and innovation. Dynamic efficiency requires firms to adapt to changing consumer preferences and productive opportunities over time. Dynamic efficiency requires that firms have sufficient incentives to invest and innovate with respect to the markets they operate in.

All three components are reflected in the NEO, as changes to NER must promote efficient operation (productive efficiency), use of (allocative efficiency) and investment in (dynamic efficiency) electricity services.

The proposed rule would contribute in particular to achieving productive and dynamic efficiency. Productive efficiency is improved by the rule change request because it will strengthen incentives for DNSPs to undertake demand management projects where they lead to an overall reduction in the cost of supplying electricity to consumers (by placing demand management options on a more equal footing with network investment). The rule change request also promotes dynamic efficiency by improving clarity and certainty with regard to how the DMIS and Innovation Allowance will be implemented and how they will operate under the NER. This will support future investment in demand management processes and projects.

7. AEMO's declared network functions

The proposed rule will not affect the Australian Energy Market Operator's declared network functions.

8. Expected costs, benefits and impacts of the proposed rule

[16] Section 7 of the National Electricity Law.

DNSPs

The implementation and administrative costs for network businesses should be relatively low. These costs are expected to be exceeded by the potential financial gains available to network businesses from implementing demand management options. These gains include an opportunity for DNSPs to earn an appropriate incentive on economically efficient projects while using those projects to lower their overall costs below forecast (providing scope for an additional incentive).

Retailers

There will be no new administrative requirements or costs for retailers under the new scheme. Retailers are likely to benefit over time from being able to offer energy products with a lower cost to supply.

End use consumers

Consumers will be required to fund the innovation allowance. However, these costs are expected to be insignificant relative to the long term cost savings brought about by increased use of demand management options arising as a consequence of both the scheme and innovation allowance. Such gains may also be immediately available to individual consumers where they offer or become involved in demand management projects (such as direct load control).

The AER

The AER will face an increase in administrative costs (expected to be small) associated with implementing the new arrangements, including development of a new methodology for calculating the market benefits associated with demand management options and calculating foregone profit allowance for DNSPs.

9. Summary of consultation

Stakeholder consultation on the issues associated with the incentive scheme arrangements was undertaken throughout the various stages of the AEMC Power of Choice review.

Submissions were received from a vast number of stakeholders during each stage of the review. There was significant support for changes recommended in the review. A summary of stakeholder submissions are provided in Appendix G of the AEMC's final report on the Power of Choice review.[17]

[17] http://www.aemc.gov.au/Media/docs/Final-Report---Appendices-3b4af0d7-bca8-42e3-a2d6-a44f8828314b-0.pdf

Attachment A – Description of proposed rule

The proposed rule would replace the existing clause 6.6.3 of the NER.

1. Introduction

1.1. This attachment is intended to provide a description of the final rule that SCER officials expect would result from this rule change request. The description is presented in the following sections:

- Scheme objective
- Scheme principles
- AER design requirements
- Demand side participation and embedded generation connection innovation scheme

2. Demand Management Incentive Scheme objective

2.1. The objective of the scheme is as follows:

> "to provide a mechanism which appropriately incentivises distribution network service providers to implement efficient non-tariff based demand management projects, where the reward is justified by net benefits and the incentives rewarded are derived from payments of foregone profits and a combination of market benefits and avoided or deferred network costs".

3. Scheme principles

3.1. The scheme must have the following principles:

i. recognise the need to incentivise networks towards implementing efficient DSP over the long term and not just the forthcoming regulatory control period.

ii. align, to the extent possible, payment of any reward available under the scheme with the timing of benefits in order to smooth the bill impact on consumers.

iii. be simple to apply, such that the incentive design should be easy to understand, implement and administer.

iv. contribute to achieving a material change that is to be reported in the amount of efficient DSP in the market.

v. non-distribution network benefits under this scheme should only be available where the Distribution Network Service Provider has been unable to negotiate a share of these benefits from the beneficiary.

vi. the share of non-distribution network benefits available for reward for pursuit of demand management projects should be no more than 30 per cent of non-distribution network market benefits created by the project (the actual percentage may vary by business and by time where the AER considers different levels of incentive are required for the Distribution Network Service Provider to pursue efficient demand side participation).

vii. as a further safeguard from potentially excessive rewards to Distribution Network Service Providers, the non-distribution network related market benefits should only be available to the DNSP when they are substantiated and realised.

4. AER design requirements

4.1. The AER shall publish an incentive scheme or schemes (scheme) to provide incentives for Distribution Network Service Providers to implement efficient demand side participation options.

4.2. The AER should design the scheme to provide two types of reward for demand management projects under the scheme:

- A payment based on a proportion of the market benefits (e.g. generation cost savings) and avoided or deferred network costs produced by a non-tariff based demand management project; and

- A payment as compensation for any foregone profit due to a reduction in throughput volumes resulting from the Distribution Network Service Provider implementing non-tariff demand management projects on its network, where appropriate.

4.3. The AER must apply the scheme in a manner consistent with the objective.

4.4. The AER has the option to include a demand management incentive scheme as part of a Distribution Network Service Provider's distribution determination. The application of the scheme can differ by Distribution Network Service Provider.

4.5. The AER must develop the scheme in accordance with the *distribution consultation procedures*.

4.6. The AER may from time to time, amend or replace the scheme but must do so in accordance with the *distribution consultation procedures*.

4.7. In developing the DSP incentive scheme, the AER must have regard to the following factors:

i. market rates for comparable DSP services.

ii. the need to include in the cost-benefit assessment the value to customers participating in the DSP project of the services derived from electricity they would have used except for that participation.

iii. the range of market benefits permitted under the regulatory investment test for distribution.

iv. the ability of DSP services to recover market benefits through fees, charges or other revenue.

v. the effect of the particular control mechanism applied to the Distribution Network Service Provider on incentives to adopt or implement efficient non-network alternatives.

vi. the extent to which the relevant Distribution Network Service Provider is able to offer efficient pricing structures, having regard to the metering technology available on its system.

vii. any possible interaction with other incentive schemes.

viii. the net benefit to customers of facing changes in pricing resulting from the implementation of the scheme.

ix. any possible interaction with other consumer demand response mechanisms being offered to customers.

4.8. Methodologies accepted under the scheme used to determine the extent of the consumer demand response should be consistent with baseline consumption methodologies approved for the demand response mechanism for the wholesale market where the circumstances are similar, except where the AER is satisfied that a different methodology is more appropriate [implementation of demand response mechanism subject to the AEMC rule change process following AEMO development of proposed rule].

4.9. The AER will be required to publish an assessment report of the effectiveness of the scheme on an annual basis. In doing so, it will develop criteria for determining how to assess the effectiveness.

4.10. The AER shall decide what information is needed from the Distribution Network Service Providers to monitor the application of the demand management incentive scheme and to verify outcomes.

4.11. The AER shall develop a guideline to support the application of scheme. That guideline shall include the following:

i. methodologies used to determine the value of non- network market benefits;
ii. methodology used to determine the foregone profit allowance for non-tariff based demand management projects; and
iii. any other matters the AER deems relevant.

4.12. The AER shall publish the scheme and guideline no later than nine months after the commencement of this rule.

4.13. The AER must design a scheme which only applies to DSP projects which:

- address an underlying network limitation in order to qualify for inclusion in the scheme; and
- meet the same expenditure approval criteria as the normal expenditure determination process as set out in chapter 6 of the NER.

4.14. The AER must design a scheme which requires a Distribution Network Service Provider to publish the results of the projects approved under this scheme in its Distribution Annual Planning Report.

5. Demand side participation and embedded generation connection innovation scheme

5.1. The AER shall publish guidelines on the innovation allowance scheme for research and development activities related to DSP.

5.2. The objective of the scheme is as follows:

To provide incentives and funding for Distribution Network Service Providers to undertake activities that will increase their knowledge regarding:

i. the ability of different approaches (both technology and pricing based) to achieve efficient demand reductions;
ii. the efficient connection of embedded generators;
iii. the costs of those approaches; and
iv. their impacts (if any) on network systems operations.

5.3. The AER must apply the scheme in a manner consistent with the objective.

5.4. The AER has the option to include a demand side participation innovation scheme as part of a Distribution Network Service Provider's distribution determination. The application of the scheme can differ by Distribution Network Service Provider.

5.5. The AER has the option to determine the amount of the innovation allowance for each distribution business (noting that these amounts could vary by business and over time).

5.6. The scheme must be simple and transparent for the AER and Distribution Network Service Providers to administer.

5.7. Businesses must provide all relevant information and data arising from pilots/trials approved under this scheme to the AER in a timely manner and make all such information available for publication unless a reason for confidentiality is established to the satisfaction of the AER.

5.8. The Distribution Network Service Provider must publish the results of the projects approved under this scheme in its Distribution Annual Planning Report.

5.9. The AER shall have regard to the ability to seek other funding for such activity, in assessing whether the Distribution Network Service Provider should qualify for an allowance under this scheme.

5.10. In applying the scheme the AER must consider the uniqueness/novelty of a proposed project, with consideration given to other domestic and relevant international activities.