Draft
Demand Management
Innovation Allowance Mechanism

Electricity distribution network service providers

August 2017
1 Nature and authority

1.1 Introduction
(1) In accordance with the requirements of clause 6.6.3A of the NER, this publication sets out the AER’s demand management innovation allowance mechanism for distribution network service providers.

1.2 Authority
(1) Clause 6.6.3A of the NER requires the AER to develop the mechanism in accordance with the distribution consultation procedures.

1.3 NER requirements
(1) Clause 6.6.3A of the NER requires the AER develop a mechanism consistent with the demand management innovation allowance objective.

(2) The demand management innovation allowance objective is to provide distributors with funding for research and development in demand management projects that have the potential to reduce long term network costs (the allowance objective).

(3) In developing, and applying, any mechanism, the AER must take into account the following:

(a) the mechanism should be applied in a manner that contributes to the achievement of the allowance objective;

(b) demand management projects should have the potential to deliver ongoing reductions in demand or peak demand, and be innovative and not otherwise efficient and prudent non-network options that a distributor should have provided in its regulatory proposal;

(c) the level of allowance;

   i) should be reasonable, considering the long term benefits to retail customers;

   ii) should provide funding that is not available from another source, including under a relevant distribution determination; and

   iii) may vary by distributor and over time;

(d) the allowance may fund demand management projects which occur over a period longer than a regulatory control period;

(4) Any mechanism developed and applied by the AER must require distributors to publish and report on the nature and results of demand management projects that are the subject of this allowance.

(5) The AER:

   (a) must develop and publish the mechanism; and
(b) may, from time to time, amend or replace the mechanism developed and published under clause 6.6.3A of the NER; in accordance with the distribution consultation procedures.

1.4 AER Objectives

(1) The AER’s objectives for this mechanism are that it:
   (a) contributes to the achievement of the NEO.
   (b) is consistent with the principles in clause 6.3.3A of the NER.

1.5 Confidentiality

(1) The AER’s obligations regarding confidentiality and the disclosure of information provided to it by a distributor are governed by the Competition and Consumer Act 2010, the National Electricity Law and the NER including the confidentiality guidelines. The confidentiality guidelines are binding on the AER and each distributor.

1.6 Definitions and interpretation

(1) In this mechanism, the words and phrases presented in bold have the meaning given to them in:
   (a) the glossary, or
   (b) if not defined in the glossary, the NER.

(2) Any example, figure or explanatory box in this mechanism is for guidance only.

1.7 Processes for revision

(1) The AER may amend or replace this mechanism from time to time in accordance with clause 6.6.3A (e) of the NER and the distribution consultation procedures.

1.8 Version history and effective date

(1) A version number and an effective date of issue will identify every version of this mechanism.
2 The demand management innovation allowance mechanism

(1) This mechanism provides a distributor with an annual, ex-ante allowance in the form of a fixed amount of additional revenue at the commencement of each regulatory year of the regulatory control period.

(2) In the second regulatory year of the subsequent regulatory control period, when the distributor's expenditure under this mechanism for the regulatory years of the preceding regulatory control period are known, a single adjustment will be made to recover the amount of any underspend, and of any unapproved expenditure, from the distributor.

(3) When a distributor receives funding under this mechanism, it must submit annual reports on its activities, expenditures, projects and programs undertaken in a regulatory year to the AER for publication in accordance with the compliance requirements set out in clause 2.3.

(4) The AER will consider the mechanism's outcomes through an annual review process.

(5) By the end of the first month of each regulatory year, a distributor may apply for an up-front, indicative approval for planned expenditure under this mechanism as set out in clause 2.2.2.

(6) The steps involved in the operation of this mechanism are as follows:

   (a) The AER will determine how this mechanism will apply to a distributor, including the cap on the allowance available under this mechanism, in accordance with clause 2.1.

   (b) The distributor must identify eligible projects against the AER's project criteria in accordance with clause 2.2, and must implement these projects.

   (c) The distributor must submit annual compliance reports in accordance with clause 2.3.

   (d) The AER will calculate, determine, and apply any carryover amount in accordance with clauses 2.4 and 2.5.
### Figure 1: Outline of mechanism operation

<table>
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<th>Application of the mechanism</th>
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<td>AER’s distribution determination specifies how the mechanism applies to a distributor for the regulatory control period. AER sets the allowance cap.</td>
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<th>Project eligibility</th>
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<td>Distributor identifies research and development projects in demand management that comply with the project criteria. It may seek the AER’s indicative approval of whether a project is likely to comply.</td>
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<tr>
<th>Compliance reporting</th>
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<tr>
<td>Distributor reports on the previous regulatory year, including expenditure on demand management research and development, the expected outputs of current projects, and the actual outputs of completed projects.</td>
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<tr>
<th>AER use of compliance report</th>
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<tr>
<td>AER approves expenditure and publishes a performance report on how distributors used the mechanism and publishes project-specific reports on its website.</td>
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<th>Application of carryover amount</th>
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<tr>
<td>AER determines and applies any carryover amount from underspending the allowance as deduction from the distributor’s MAR in the subsequent regulatory control period.</td>
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### 2.1 Application of the mechanism

(1) The **AER** will determine how this **mechanism** will apply to a **distributor** for a **regulatory control period** through the following process:

(a) The **AER’s framework and approach paper** for a **distributor** will set out whether the **AER** intends to apply this **mechanism** to that **distributor’s** forthcoming distribution determination under clause 6.8.1(b)(2)(vi) of the **NER**.

(b) A **distributor’s regulatory proposal** must:

i) Include a description, including relevant explanatory material, of how it proposes this **mechanism** should apply for the relevant **regulatory control period**; and

ii) Detail how its proposed approach would satisfy the requirements of the National Electricity Law and **NER**.
(c) The AER’s distribution determination for the distributor will set out how this mechanism is to apply to the distributor in the relevant regulatory control period under clause 6.12.1(9) of the NER.

(2) Without otherwise limiting clause 2.1(1)(c), the AER must apply this mechanism to the distributor in a distribution determination in the following manner:

(a) The AER must calculate and determine the maximum amount of the allowance under this mechanism for the regulatory control period. This amount must be calculated and determined as the sum of:

i) $200,000 (in 2017 dollars, where the AER accounts for inflation using CPI) for each regulatory year in the regulatory control period; and

ii) 0.075% of the distributor’s MAR as determined in that distribution determination at the time the distribution determination is first made.

(b) The AER must set out, in the distribution determination, how the carryover of any underspend of the allowance under this mechanism will be applied in accordance with clause 2.5.

Example 1:

0.075% of a distributor’s MAR was $4.8 million (real dollars at time t), in its distribution determination made at time t, under subclause 2.1(2)(a) of this mechanism. Given this, the AER would grant a distributor a total allowance of $5 million (being the sum of $4.8 million and $200 000) over the regulatory control period.

Under subclause 2.1(2)(a) of this mechanism, the AER might determine to provide this allowance in five instalments of $1 million (real dollars at time f) — one in each regulatory year of the regulatory control period.

The amount spent under this mechanism in any one regulatory year is at the distributor’s discretion. However, the total amount recoverable over the five regulatory years cannot exceed $5 million (real dollars at time f). The distributor would have the flexibility to select an expenditure profile that suits its circumstances, subject to remaining within the approved cap.

2.2 Identifying eligible projects

(1) An eligible project is a project that is eligible to receive funding under this mechanism. To be an eligible project, a project must satisfy the project criteria.

2.2.1 Project criteria

(1) An eligible project must:

(a) be a project or program for researching, developing or implementing demand management capability or capacity;

(b) be innovative, in that the project or program:
i) is based on new or original concepts;

ii) involves technology or techniques that differ from those previously implemented or used in the NEM; or

iii) is focused on customers in a market segment that significantly differs, from those previously targeted by implementations of the relevant technology, in relevant geographic or demographic characteristics that are likely to affect demand; and

(c) have the potential, if proved viable, to reduce long term network costs.

(2) A project or program is not an **eligible project** if any part of the costs of the project or program are:

i) recoverable under any other jurisdictional incentive scheme;

ii) recoverable under any state or Australian Government scheme; or

iii) otherwise included in forecast capital expenditure or operating expenditure approved in the distributor’s distribution determination.

### 2.2.2 Option for indicative up-front consideration by the AER

(1) A distributor may apply for the indicative up-front consideration of a project or program under this **mechanism** by the AER.

(2) To apply for indicative up-front consideration, a distributor must provide details of the proposed project or program under this **mechanism**, including details of the distributor’s proposed expenditure on the project or program, to the AER before the end of the first month of the **regulatory year** in which the distributor proposes to first incur expenditure on the project or program.

(3) The AER will provide an in-principle indication of whether the proposed project or program (including the proposed expenditure on the project or program) is likely to satisfy the **project criteria**.

### 2.3 Compliance reporting

(1) For each **regulatory year**, a distributor must submit a **compliance report** to the AER no later than 4 months after the end of the **regulatory year** to which the **compliance report** relates.

(2) The distributor must submit each **compliance report** in a form suitable for publication.

(3) Each **compliance report** must include, for the **regulatory year** to which the **compliance report** relates:

(a) the amount of the allowance spent by the distributor;

(b) a list and description of each **eligible project** on which the allowance was spent; and

(c) a summary of how and why each **eligible project** complies with the **project criteria**.
(d) For each eligible project on which the allowance was spent, and in a form that is capable of being published separately for each individual eligible project, a project specific report that identifies and describes:

i) The nature and scope of the eligible project;

ii) The aims and expectations of the eligible project;

iii) How and why the eligible project complies with the project criteria;

iv) The distributor’s implementation approach for the eligible project;

v) The distributor’s outcome measurement and evaluation approach for the eligible project;

vi) The costs of the eligible project:
   1. incurred by the distributor to date as at the end of that regulatory year;
   2. incurred by the distributor in that regulatory year; and
   3. expected to be incurred by the distributor in total over the duration of the eligible project.

vii) For ongoing eligible projects:

   1. a summary of project activity to date;
   2. an update of any material changes to the project in that regulatory year; and
   3. reporting of collected results (where available).

viii) for eligible projects completed in that regulatory year:

   1. reporting of the quantitative results of the project;
   2. an analysis of the results; and
   3. a description of how the results of the eligible project will inform future demand management projects.

ix) any other information required to enable an informed reader to understand, evaluate, and potentially reproduce the demand management approach of the eligible project.

(e) Where an eligible project has extended across more than one regulatory year of the regulatory control period, details of the actual expenditure on each such project or program in each regulatory year of the regulatory control period to date.

(f) A statement signed by a director of the distributor certifying that the costs of each demand management project:

i) are not recoverable under any other jurisdictional incentive scheme;

ii) are not be recoverable under any state or Australian Government scheme; and
iii) are not otherwise included in forecast capital expenditure or operating expenditure approved in the AER’s distribution determination for the regulatory control period under which the mechanism applies, or under any other incentive scheme in that distribution determination.

(4) The confidentiality guidelines apply to the information contained in compliance reports. If the distributor’s compliance report contains confidential information, the distributor must also provide a non-confidential version of the report in a form suitable for publication. The AER may publish the compliance report (or the non-confidential version of the compliance report, if applicable) on its website, including by publishing a separate report for each eligible project as contemplated by clause 2.3.3(d) above.

2.4 AER review and determination

(1) The AER will review the expenditure a distributor has incurred in each regulatory year in relation to this mechanism to ensure compliance with the project criteria.

(2) For each regulatory year, the AER will determine, and inform the distributor of, the amount of the allowance recoverable by the distributor in accordance with this mechanism as at the end of that regulatory year.

(3) The total amount of expenditure determined by the AER as recoverable by the distributor for a regulatory control period will not exceed the cap of the allowance recoverable determined under clause 2.1.

2.5 Application of carryover

(1) Once all relevant information (including the content of each compliance report) for a regulatory control period becomes available after the end of the regulatory control period, the AER will calculate any carryover amount, \( C \) to account for:

   (a) any amount of allowance unspent or not approved over the regulatory control period; and

   (b) the time value of money accrued or lost as a result of the expenditure profile that the distributor selected.

(2) At the end of the regulatory control period with \( N \) regulatory years, the AER will calculate a carryover amount, \( C \) to be deducted from the distributor’s MAR in regulatory year \( 2 \) of the subsequent regulatory control period, in accordance with equation 1.

**Equation 1: Carryover amount, \( C \) for subsequent regulatory control period**

\[
C = - \left[ \sum_{t=1}^{N} \frac{R_t - A_t}{(1 + r_t)^t} \right] \times \prod_{t=1}^{N+2} (1 + r_t)^t
\]

Where:

- \( t \) is a regulatory year. It takes the value of an integer between 1 and \( N+2 \), where \( N \) is the number of regulatory years in the distributor’s regulatory control period for which the carryover is being calculated.
- $R_t$ is the ex-ante revenue allowance under this mechanism for regulatory year, $t$.

- $A_t$ is the expenditure approved ex-post under this mechanism for regulatory year, $t$.

- $r_t$ is the allowed rate of return in regulatory year, $t$. In equation 1, $t$ can take the value of 1 to $N+2$, with 1 referring to the first regulatory year of the regulatory control period in which the expenditure was incurred, and $N+2$ referring to the second regulatory year of the subsequent regulatory control period.

(3) For clarity, equation 1 calculates the carryover amount, $C$, so the distributor is revenue neutral (that is, net present value = 0) to the profile of expenditure approved by the AER over the regulatory control period.\(^1\) That is, equation 1 can be rearranged as follows:

$$C + \left[ \sum_{t=1}^{N} \frac{R_t - A_t}{(1 + r_t)^t} \right] \times \prod_{t=1}^{N+2} (1 + r_t)^t = 0$$

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\(^1\) This includes an adjustment to account for the time value of money in the first two years of the subsequent regulatory control period.
# Glossary

<table>
<thead>
<tr>
<th>Shortened form</th>
<th>Extended form</th>
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<tbody>
<tr>
<td>AER</td>
<td>Australian Energy Regulator</td>
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<tr>
<td>allowance objective</td>
<td>the demand management innovation allowance objective, as defined in the NER</td>
</tr>
<tr>
<td>confidentiality guidelines</td>
<td>the document published by the AER entitled &quot;Confidentiality Guideline, November 2013&quot;, as amended or replaced by the AER from time to time.</td>
</tr>
<tr>
<td>compliance report</td>
<td>the compliance report required under clause 2.3(1) of this mechanism</td>
</tr>
<tr>
<td>CPI</td>
<td>the headline Consumer Price Index, calculated as the weighted average of eight capital cities</td>
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<tr>
<td>demand management</td>
<td>network demand management - that is the act of modifying the drivers of network usage.</td>
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<tr>
<td>distributor</td>
<td>distribution network service provider</td>
</tr>
<tr>
<td>eligible project</td>
<td>has the meaning given in clause 2.2(1)</td>
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<tr>
<td>MAR</td>
<td>Maximum Allowed Revenue, as defined in the NER</td>
</tr>
<tr>
<td>mechanism</td>
<td>Demand Management Innovation Allowance Mechanism</td>
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<td>NEM</td>
<td>National Electricity Market, as defined in the NER</td>
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<td>NEO</td>
<td>National Electricity Objective as defined in the National Electricity Law</td>
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<td>NER</td>
<td>National Electricity Rules</td>
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<tr>
<td>non-network option</td>
<td>as defined in chapter 10 of the NER</td>
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<tr>
<td>project criteria</td>
<td>the criteria set out in clause 2.2(1) of this mechanism</td>
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