Draft Demand Management Innovation Allowance Mechanism

Electricity distribution network service providers

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AUSTRALIAN ENERGY REGULATOR

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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

Application of the mechanism

AER's distribution determination specifies how the mechanism applies to a distributor for the regulatory control period. AER sets the allowance cap.

Project eligibility

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.

Compliance reporting

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.

AER use of compliance report

AER approves expenditure and publishes a performance report on how distributors used the mechanism and publishes project-specific reports on its website.

Application of carryover amount

AER determines and applies any carryover amount from underspending the allowance as deduction from the distributor's MAR in the subsequent regulatory control period.

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 *t*) — 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 *t*). 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 managemen**t 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:

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

[1] This includes an adjustment to account for the time value of money in the first two years of the subsequent regulatory control period.

3 Glossary

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