Compliance Bulletin No. 10

Determing whether proposed replacement capital expenditure constitutes a RIT-D project

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AUSTRALIAN ENERGY REGULATOR

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
DNSP	Distribution network service provider
Guidelines	RIT-D application guidelines
NEL	National Electricity Law
NER	National Electricity Rules
Repex	Replacement capital expenditure
RIT-D	Regulatory investment test for distribution
RIT-T	Regulatory investment test for transmission

1 Introduction

The Australian Energy Regulator (AER) is responsible for monitoring compliance by registered participants and other persons with the National Electricity Law (NEL), the National Electricity Rules (NER) and associated regulations. The AER aims to work cooperatively with participants to help them understand their obligations under the NER to achieve compliance.

When a distribution network service provider (DNSP) is undertaking a large investment, it may be required to apply a cost-benefit analysis to select the best way to meet the need for that investment. Clause 5.17 of the NER outlines the regulatory investment test for distribution (RIT-D) procedures for that analysis. The purpose of the RIT-D is to identify all credible options for meeting the needs of the DNSP's network and select the one with the highest net economic benefit, thereby delivering efficient investment outcomes.[1] A DNSP must apply the RIT-D for all RIT-D projects, except in the circumstances outlined in clause 5.17.3(a) of the NER.[2]

In 2017, a rule determination by the Australian Energy Market Commission (AEMC) gave effect to extend the RIT-D to include replacement capital expenditure (repex) decisions.[3] This rule change sought to improve transparency of repex decisions in circumstances where technological changes mean that, in some cases, non-network solutions are becoming more viable alternatives to replacing network assets.

As required under clause 5.17.2(a) of the NER, the AER developed and published the RIT-D application guidelines (Guidelines).[4] The Guidelines provide guidance and worked examples in the application of the RIT-D.

We have identified an apparent misunderstanding by some DNSPs in the application of the RIT-D for investments relating to repex projects of an ongoing nature. In particular, we have observed that some DNSPs are not applying the RIT-D where they propose to make changes to these projects, resulting in increases in capex that may exceed the RIT-D threshold. This compliance bulletin sets out our expectations of when a RIT-D is required in these circumstances. While we have not observed a similar misunderstanding in electricity transmission, the principles discussed in this compliance bulletin equally apply to transmission network service providers applying the regulatory investment test for transmission (RIT-T) procedures.

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1 NER, cl. 5.17.1(b). The NEM is the "National Electricity Market".

2 A RIT-D project is a project the purpose of which is to address an identified need, as defined in NER cl. 5.10.2.

3 AEMC, *Replacement expenditure planning arrangements*, Rule determination, 18 July 2017, p. 12.

4 AER, *Final RIT-D Application Guidelines,* 14 December 2018.

2 Regulatory framework

This section describes the AER's functions and responsibilities with respect to compliance and summarises the provisions of the NER relevant to this compliance bulletin.

2.1 Role and functions of the AER

One of our roles is the economic regulation of electricity transmission and distribution services in the National Electricity Market under the NEL and the NER. We are also responsible for ensuring compliance with and enforcing the NER. As part of these responsibilities, we develop the RIT-D and have a compliance and monitoring role over its operation and application.

We have detailed our methods for compliance and enforcement in the *AER Compliance & Enforcement policy*.[5] Where possible, we seek to foster a culture of compliance by assisting businesses to understand the obligations created by the NEL and NER. We will do this by publishing compliance bulletins and guidance notes as well as engaging directly through forums and meetings to identify and address issues of concern. It is not our role, however, to provide legal advice to businesses about their obligations.

2.2 Clarification of relevant rules and guidelines

2.2.1 Circumstances where a RIT-D must be applied

Under the NER, a DNSP must apply the RIT-D to all RIT-D projects unless an exemption under clause 5.17.3(a) applies.

A 'RIT-D project' means:[6]

(a) a project the purpose of which is to address an identified need identified by a Distribution Network Service Provider; or

(b) a joint planning project that is not a RIT-T project.

The NER broadly defines an 'identified need' as, relevantly, 'the objective that [the DNSP] seeks to achieve by investing in the network in accordance with the Rules…'.[7]

A RIT-D does not need to be applied in the following situations:[8]

(1) to address an urgent and unforeseen network issue that would otherwise put the network or the reliability of the network at risk [clause 5.17.3(a)(1)];

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5 See https://www.aer.gov.au/publications/corporate-documents/aer-compliance-enforcement-policy.

6 NER, cl. 5.10.2.

7 NER, Chapter 10.

8 NER, cl. 5.17.3(a)

(2) where the estimated capital cost of the most expensive potential credible option to address the identified need is less than $5 million [clause 5.17.3(a)(2)] (as varied in accordance with a cost threshold determination);[9]

(3) where the cost of addressing the identified need is to be fully recovered through charges other than standard control services or prescribed transmission services [clause 5.17.3(a)(3)];

(4) where the identified need can only be addressed by expenditure on a connection asset which provides services other than standard control services or prescribed transmission services [clause 5.17.3(a)(4)];

(5) where the project is related to the maintenance of existing assets and is not intended to augment a network or replace network assets [clause 5.17.3(a)(5)]; or

(6) where the expenditure relates to protected event EFCS investment and is not intended to augment a network [clause 5.17.3(a)(7)].

2.2.2 AEMC rule change to include repex

Prior to the AEMC's 2017 rule change, the NER exempted from the RIT-D process capital expenditure relating to the "refurbishment or replacement of existing assets and is not intended to augment a network".

In its rule change request, the AER considered that in the backdrop of low demand growth and increasing viability of non-network options, the NER did not provide sufficient transparency on network asset replacement decisions by DNSPs.[10]

In its 2017 rule determination, the AEMC stated that:[11]

> Replacement capital expenditure incurred after [18 September 2017] must go through the regulatory investment test process, where the cost of the most expensive option to address the network need is above the cost threshold ($6 million for transmission and $5 million for distribution).

Following the AEMC's determination, clause 5.17.3(a)(5) of the NER was amended, providing for an exemption where the RIT-D project is related to the "maintenance of existing assets and is not intended to augment a network or replace network assets." Accordingly, all repex decisions are the subject of the RIT-D process unless specifically exempt.

The AEMC clarified that all repex projects were included within the scope of the RIT-D, noting that:

> The Commission's view is that all replacement expenditure above the existing capital cost thresholds should be subject to the current regulatory investment test processes with no

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9 The current RIT-D cost threshold is $6 million. See AER, *Final determination – cost thresholds review*, 19 November 2021.

10 AEMC, *Replacement expenditure planning arrangements, Rule determination*, 18 July 2017, p. 7.

11 AEMC, *Replacement expenditure planning arrangements, Rule determination*, 18 July 2017, p. iii.

> exception. Importantly, this approach means that all network capital investments are treated the same.[12]

and

> any program of capital expenditure that includes a number of possible cost items that all go to address one need are considered together for the question of whether the regulatory investment test threshold is met.[13]

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12 AEMC, *Replacement expenditure planning arrangements, Rule determination*, 18 July 2017, p. 67.

13 AEMC, *Replacement expenditure planning arrangements, Rule determination*, 18 July 2017, p. 68.

3 Scope of repex for which a RIT-D may apply

3.1 Guidelines do not limit what constitutes a RIT-D project

In its Guidelines on what constitutes a RIT-D project, the AER provides the following high-level example:[14]

> For the purpose of applying this guidance, an asset replacement program to address an identified need is a proactive program to replace multiple assets of the same type as part of one plan to meet a network investment objective.
>
> …
>
> For completeness, asset replacement programs for the purpose of the above guidance differ from ongoing efforts to reactively replace multiple small assets, such as ongoing work to replace poles that have failed inspection or serviceability tests. We would expect that this latter type of expenditure would be captured in the revenue allowance as business-as-usual (BAU) replacement expenditure.

Some DNSPs may seek to categorise repex decisions as either 'reactive' or 'proactive' network investments to determine whether the RIT-D process must be applied. For clarity, these concepts are not incorporated within the NER and are not determinative as to whether an exemption under the NER applies. Nor does the NER exclude from the RIT-D process network investments reflecting expenditure already accounted for in revenue allowances. It is critical that DNSPs assess their repex plans against the requirements of the NER, rather than against high level examples in the Guidelines when determining whether the RIT-D process must be applied.

Under the NER, a DNSP should undertake a RIT-D if, in response to an identified need (for example, an objective to maintain the reliability of the network) it introduces or materially alters a repex project and the aggregate incremental forecast costs under that project exceed the RIT-D cost threshold. Those forecast costs may arise at the same time (i.e. if the individual replacements under that project occur at the same time) or at different times (i.e. if the project occurs over a longer planning period or is ongoing in nature).[15]

As referred to in the Guidelines, the individual replacement of a network asset executed under an ongoing project (for example, an individual pole replaced under a pole inspection program) is unlikely to require a RIT-D. This is because, against the requirements under the NER, the cost threshold with respect to the replacement of that individual network asset is unlikely to be exceeded.

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[14] AER, *Application guidelines – Regulatory investment test for distribution*, December 2018, pp. 11–12.

[15] AEMC, *Replacement expenditure planning arrangements, Rule determination*, 18 July 2017, p. 68.

We encourage DNSPs to review the circumstances of any repex network investment (whether it is a new repex project or a material change to an existing ongoing project) against the precise requirements of the NER. Further guidance is provided below.

3.2 Changes to ongoing repex projects may require a RIT-D

The AER has concerns that DNSPs are making changes to the scope of their ongoing repex projects,[16] but not undertaking the cost-benefit analysis required under the RIT-D process with respect to those changes. Just as the introduction of an ongoing repex project may require RIT-D analysis, so should any subsequent changes to those projects that have cost consequences exceeding the RIT-D cost threshold. If a DNSP makes a change to an existing ongoing repex project to address an identified need, then we consider a RIT-D may be required if such a change leads to incremental, aggregate costs that exceed the cost threshold.

As an example, a DNSP might seek to improve the safety or reliability of the network. This is the identified need. It may determine that the best way to achieve this network need is to change a procurement or design standard or alter the engineering criteria under an existing ongoing repex project that determines when assets within an asset class are to be replaced. In this example, the project change may result in a greater number of asset replacements, or the replacement of assets with a different, more expensive type of asset. This network investment is a RIT-D project if the incremental, aggregate costs of all asset replacements after the project change—compared with the costs if the change had not occurred—exceed the RIT-D cost threshold.

To determine whether a project is likely to exceed the RIT-D cost threshold, the DNSP should assess the incremental costs associated with the RIT-D project compared with the counterfactual (i.e. the expected costs if the project remains unchanged). The modelling period for this assessment should provide a reasonable indication of the market benefits and costs of the credible option. In accordance with clause 5.17.2(c)(3) of the NER, we discuss suitable modelling periods in the Guidelines.[17]

It may be the case that for such network investments, the regulatory burden of undertaking the RIT-D may not be significant because there may be only one viable option for these replacements. In any case, the RIT-D process allows for a DNSP to undertake a screening for alternative options—including non-network options—and transparently set out its analysis for coming to such a conclusion.[18] Such a process should align with a DNSP's normal planning practices for large capital investments.

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16 We note that the Guidelines refer to "asset replacement program". We do not consider that any distinction should be drawn between the use of "program" versus "project" in the Guidelines and in this compliance bulletin. They may be used interchangeably when describing multiple asset replacements relating to the one identified need.

17 AER, *Application guidelines – Regulatory investment test for distribution*, December 2018, pp. 56–57.

18 NER, cl. 5.17.4(d).

3.3 Clarifying the identified need

The NER broadly defines an 'identified need' as, relevantly, 'the objective that [the DNSP] seeks to achieve by investing in the network in accordance with the Rules…'.[19] In simple terms, the identified need is the reason why the DNSP is making a capital investment. DNSPs should frame the identified need as an objective, rather than a means to achieve an objective. This should prevent biasing the development of credible options towards a particular solution.[20]

When determining if an investment to address an identified need exceeds the RIT-D cost threshold, DNSPs must consider all capital costs across the whole scope of the investment. As an example, a project might involve assessing a particular asset at multiple discrete sites (such as a substation) that has been identified as unsafe. At each site a decision is made about whether the asset is safe or must be replaced. In this example, the identified need is to maintain system safety and applies to all of the identified assets at all of the relevant sites and not to each asset individually. The implication of this is that all possible replacements must be considered together for the question of whether the RIT-D cost threshold is met.[21]

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19 NER, Chapter 10.

20 AER, *Application guidelines – Regulatory investment test for distribution*, December 2018, p. 15.

21 AEMC, *Replacement expenditure planning arrangements, Rule determination*, 18 July 2017, p. 68.

4 Future compliance monitoring

The AER will continue to monitor compliance with clause 5.17 of the NER. This will ensure that capital investment decision-making is transparent and that those options that maximise benefit to consumers are undertaken. Specifically, we will focus on ensuring that a RIT-D is undertaken for replacement capital expenditure investments in accordance with the NER.