25 February 2013

Mr Chris Pattas
General Manager
Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Pattas

The NSW DNSP's Response to the *AER Issues Paper - Regulatory Investment Test for Distribution (RIT-D).*

The NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) welcome the opportunity to provide this joint submission in response to the *AER Issues Paper - Regulatory Investment Test for Distribution (RIT-D).*

Introduction

The NSW DNSPs have been actively involved in the development of a national framework for distribution network planning and expansion and have participated in the AEMC rule change process, which formalised the RIT-D into the National Electricity Rules (the Rules).

While broadly supportive of the final Rule determination, several of the key decisions regarding implementation of the RIT-D were delegated to the AER as part of its application guidelines development. It is for this reason that the NSW DNSPs feel that it is important to provide our input into the development of the guidelines at this early stage to ensure that the intent of the Rule determination is preserved. Accordingly, this submission addresses each of the questions in the Issues Paper (attachment A) as well providing broader comments on the RIT-D.

We have also been working closely with the Energy Networks Association (ENA) on the development of its response to the Issues Paper, which we fully endorse.

Comments on the RIT-D

We acknowledge that the Issues Paper is the first stage of the consultation process on the RIT-D application guidelines. While we are appreciative of the opportunity to respond to the Issues Paper, more substantive comments will be able to be provided once the AER has developed the draft guidelines. Nevertheless, we offer the following initial comments:

- It is important to recognise that there are several components of the Regulatory Investment Test for Transmission (RIT-T) that do not apply to the RIT-D. As a result, the complexity of considerations under the RIT-D should be commensurate with the value and electricity market impact of distribution projects in order to ensure that the regulatory and administrative burden is proportionate.

- We would expect that the AER will provide guidance on *how* to consider market benefits, the magnitude of credible option analyses to undertake and will impose sensible limitations on who should be considered an 'interested party' for the purposes of the guidelines;

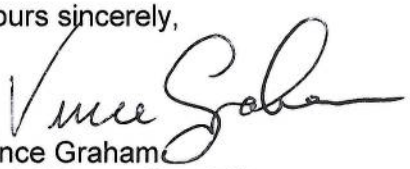
- As a general rule, the guidelines should provide simple methodologies for the quantification of market benefits and deemed values where appropriate. However, the guidelines should also provide sufficient flexibility for a DNSP to use more complex methodologies where appropriate and justifiable; and
- Service Target Performance Incentive Scheme (STPIS) payments and penalties are a transfer payment between participants in the market and should therefore not be included in any economic analysis under the RIT-D.

Conclusion

The NSW DNSPs are committed to the overall aim of a national framework for distribution network planning and expansion so long as the focus remains firmly on the long term interests of customers. This submission raises a number of issues which we consider need to be addressed and clarified in the RIT-D guidelines to provide a workable framework going forward.

If you would like to discuss this matter further, please contact Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9853-4375 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely,



Vince Graham
Chief Executive Officer
Ausgrid, Endeavour Energy and Essential Energy

Attachments

1. Responses to the Issues Paper Questions

Attachment 1 - Responses to the Issues Paper Questions

Similarities and differences between the RIT-T and RIT-D

Question 1

Stakeholders should have regard to the regulatory test, RIT-T and RIT-T guidelines when considering their response to this Issues Paper. We are interested in what provisions of the RIT-T should be included in the RIT-D, modified or excluded altogether.

It is important to recognise that there are several components of the RIT-T that do not apply to the RIT-D. These include: the requirement to consider wholesale market competition benefits, changes in fuel consumption costs arising through different patterns of dispatch, the impact on generator bidding behaviour and the requirement to undertake market dispatch modelling. These issues are not a component of the RIT-D as distribution projects generally do not influence these classes of market benefits. It is therefore not prudent for a DNSP to develop the critical competencies, systems and models to undertake this sort of analysis. As the RIT-T and RIT-D are different in these important ways, it is appropriate that they are treated separately.

In terms of joint projects, where a joint TNSP and DNSP project is determined to be a RIT-T project, the AER should provide guidance as to how it would deal with situations where there is no agreement between the DNSP and TNSP as to who should be the lead party. While not specified in the Rules, we believe that the TNSP is best placed to be the lead party responsible for carrying out the RIT-T. This is appropriate as DNSPs generally do not have the competencies or systems to undertake the level of analysis required under the RIT-T.

Question 2

We are interested in how the differences in electricity distribution and transmission may require us to adjust our approach to the way RIT-T and RIT-D should be considered.

We note that there are some major differences between the RIT-T and RIT-D in the assessment of market benefits. The RIT-T requires an assessment of a base case (no credible option implemented) and the quantification of additional market benefits associated with large generator competition benefits, fuel costs and inter-regional benefits. The market benefits required to be quantified under a RIT-T are likely to be much more significant than those that have to be considered and optionally quantified under the RIT-D. For example, the approach to considering the market benefits of customer load curtailment, involuntary load curtailment and distribution network losses for the RIT-D would be significantly different because typically a RIT-D project would affect a smaller proportion of the National Electricity Market (NEM) and it would be unlikely to have any impact on inter-regional benefits.

As a result of these differences, the complexity of considerations under the RIT-D should be commensurate with the value and electricity market impact of distribution projects in order to ensure that the regulatory and administrative burden is proportionate.

Removal of the base case

Question 3

We are interested in how stakeholders believe this will change the analysis for RIT-D proponents.

The RIT-D is a process for the ranking of potential credible options in order to identify the option with the highest economic benefit. Removal of the base case (the case where no credible option is implemented) makes for a more efficient and cost effective RIT-D assessment process as it does not alter the RIT-D ranking of possible credible options. We therefore support this approach.

Distribution level market benefits

Question 4

We are seeking stakeholder views on how any of the factors which should deliver market benefits listed above should be clarified.

The AER should provide advice on how to *consider* market benefits. For example, it might be prudent to specify in the guidelines that a market benefit is considered immaterial (and therefore no RIT-D quantification is required) if a 'back of envelope' calculation determines that it is less than a certain percentage of project cost or based on a lower burden of proof where in a class of projects particular benefits have proved immaterial in previous RIT-D assessments. We would also submit that it is equally important that the guidelines provide examples of items not to be included, for example unpriced externalities.

In relation to 'any other class of market benefit determined to be relevant by us', we are uncertain as to how this process would work in practice, particularly within the time constraints of the RIT-D process. We note that the RIT-T provides the opportunity for proponents to identify other relevant market benefits and costs and to seek written confirmation from the AER that they are accepted. We would expect the RIT-D would operate in a similar manner.

Question 5

We are also interested in whether we should look at any additional distribution level market benefits, other than those specified under clause 5.17.1(c)(4). In particular, we are interested in whether broader types of demand side participation are likely to result in distribution level market benefits. In addressing this, we recommend that stakeholders have regard to the AEMC's Power of Choice Review.

Additional Market Benefits

At this stage, we are unable to consider any additional market benefits that should be included beyond those specified in clause 5.17.1(c)(4). However, we note that clause 5.17.1(c)(4)(viii) allows any other class of market benefit determined to be relevant by the AER to be included.

Demand Side Participation

We note that the RIT-D process makes explicit and transparent the existing obligations to 'consider' demand side participation (DSP) when evaluating investment options. Additionally, the new requirement for a demand side engagement strategy will assist in increasing the profile of DSP options. The RIT-D would therefore operate in a similar manner to the current regulatory investment test, but would allow distributors to include market benefits in the analysis of business cases for demand management.

The RIT-D is not without issue. This is because simply being able to consider the benefits does not enable proponents to access additional funds to cover costs of such projects within the regulatory period.

The costs of the demand management project still must be paid for through the difference between the value of deferred network capital (return on and return of capital) included in the revenue allowance during the period, and the additional operating costs required (in addition to the allowance) to facilitate and operate the project. The business case for a network proposing a demand management option is therefore effectively the same under the RIT-D as it is under the current investment test – savings within the framework must be sufficient to pay for the project, otherwise it cannot proceed. At no point can a network access a separate funding stream to help pay for the project even though the benefits that may arise from the project may be spread through the market and more than outweigh the costs.

The inability of DNSPs to access a share of market benefits in financial terms means that investment in demand management projects will occur in fewer circumstances than might otherwise be the case (i.e. viable cases will not be pursued).

We would contend therefore that the inclusion of market benefits in the analysis of the business case does little to actually facilitate (i.e. fund) project implementation, unless market benefits are identified and incorporated in the determination of the allowed revenue for a regulatory period or as an addition to allowed revenues. There is an opportunity to change this within the current regulatory framework through the AER's incentive arrangements and the RIT-D guidelines.

Question 6

Specifically, noting the recently released Power of Choice report, does the RIT-D consideration of market benefits need to be amended to support demand side participation?

As projects are reviewed under the RIT-D, opportunities will emerge for DSP as the most efficient solution from a whole value chain viewpoint. To ensure efficient DSP is delivered in-line with the NEL objectives, the guidelines could specify the values or methodologies for evaluating the full chain market value of demand reductions. This would allow networks a share of the transmission and generation benefits that a network DSP option delivers. The DSP market benefits would be predetermined deemed values for generation and transmission set to equal the long run marginal cost of augmentation.

Question 7

The RIT-D process is designed to capture significant new projects and programs. It is feasible that the scale of these new projects and programs could be large enough to have a material impact on overall network reliability. In these cases, it is most likely that the reliability impact will be a positive one and this would then result in the DNSP receiving an incentive payment under the Service Target Performance Incentive Scheme (STPIS). It is also technically feasible that the STPIS outcomes could be negatively impacted by a RIT-D project or program. In both of these cases, it would be reasonable to assess the STPIS impact and potentially adjust the STPIS targets to account for the forecast reliability change. How should the consideration of market benefits under the RIT-D recognise the impact the proposed works would have on the STPIS?

STPIS payments and penalties are a transfer payment between participants in the market and should therefore not be included in any economic analysis under the RIT-D. The RIT-D process is designed to capture significant new projects and programs and as such the NSW DNSPs consider that there is only a tenuous link to the STPIS (which is a wide reaching incentive scheme) within a defined regulatory control period. Therefore, we consider that it is more appropriate for any impacts that may potentially arise from a RIT-D process to be assessed at the subsequent determination.

Question 8

A portion of electricity is naturally lost in its transmission and distribution. RIT-D proponents pass through these costs on the network, although proponents are obligated to comply with certain efficiency standards. How should the economic cost of electricity loss be treated within the market benefits assessment?

The NSW DNSPs consider that the market benefit value of reduced electricity losses in a RIT-D should be considered, but the guidelines should define a simplified default methodology that may be used. However, DNSPs should also be free to use an alternative methodology if its validity can be demonstrated. Like all categories of benefit, the decision to quantify and the depth of analysis required should be proportionate to the level of the value initially assessed under the simple methodology.

Material and adverse NEM impacts for the purpose of interested parties

Question 9

We are seeking stakeholder views on who should be considered an interested party under this definition.

We note that in its submission to the consultation paper on the draft Rules, the AER expressed concern that the draft definition of 'interested party' was ambiguous. The AEMC amended the Rules to recognise that without further clarification, the definition of 'interested party' may unintentionally expand the scope of parties eligible to raise a dispute beyond national electricity market impacts. The final Rules therefore clarified that the material and adverse market impact experienced by the interested party must arise in the national electricity market (NEM).

In addition to the above, the AER also has the discretion to determine what it considers to be a material and adverse NEM impact for the purposes of interested parties. We would therefore recommend that the AER give careful consideration to this matter to avoid the potential for vexatious disputes. As an example, it would be inappropriate for a party to be deemed an 'interested party' if their interest in the project related to the potential future use of a new investment rather than the investment itself. This could arise if a party is concerned that the NEM investment may be a forbearer to the development of a new mine or industrial complex.

Question 10

We are interested in what guidance stakeholders would find useful in interpreting the definition of interested parties.

Please refer to response to question 9.

Question 11

We are of the view that the change in terminology from material and adverse 'market impacts' to 'NEM impacts' improves clarity. We are seeking stakeholders' views on this.

Please refer to response to question 9.

Estimating costs

Question 12

We are interested in stakeholder views regarding what other financial costs are likely to be relevant.

We would encourage the AER to adopt a flexible approach to the consideration of costs to incorporate risk and managing uncertainty.

Question 13

The RIT-T specifies that transmission network service providers could determine additional classes of costs if we agreed that they were relevant. We are seeking stakeholders' views on whether it should make a similar specification for RIT-D proponents under the RIT-D.

Provisions available to RIT-T proponents for the quantification of any other relevant classes of costs not identified in the Rules, or in the RIT-T, should also be available for RIT-D projects. RIT-D proponents, rather than just the AER, should be able to determine additional relevant classes of costs and to obtain agreement in writing from the AER during the RIT-D project assessment stage in a process similar to the RIT-T.

Question 14

The RIT-T specifies that if the costs were materially uncertain, the cost should reflect the probability weighted present value of the direct costs of the credible option under a range of different cost assumptions. We are seeking stakeholders' views on whether we should make a similar specification under the RIT-D.

This should be limited to situations where there is material uncertainty about input costs and where the choice of preferred option is shown to be sensitive to those variations.

Question 15

We seek stakeholder views on whether the RIT-D should specify the same methodology for determining the discount rate as the RIT-T and current regulatory test.

It would be a useful simplification to specify the use of the current regulatory WACC (i.e. the WACC in the prevailing Distribution Determination) as the discount rate. If the AER chooses to specify a different process, then the guidelines should set out the reasoning behind such a choice and provide a clear and simple means of determining the appropriate rate, including worked examples.

Question 16

We seek stakeholder views on the methodology that the RIT-D should specify for estimating costs.

It is suggested that any methodology should not be overly prescriptive, but that it should specify that cost estimates should be risk based estimates that take into account the level of uncertainty associated with the particular investment.

Question 17

We are interested in whether stakeholders think the methodology should be adopted from those specified under the RIT-T and regulatory test.

The methodology could be adopted from those specified under the RIT-T and the regulatory test, but the methodology should recognise that the scale and nature of some distribution investments may not require the same level of analysis and accuracy as that for a major transmission investment.

More generally, we seek guidance and clarification on the extent of possible credible option analysis required for each RIT-D project. The AER RIT-T Guidelines state that a credible option may not be economically feasible if it has an estimated cost that is substantially larger in magnitude than that of other options to address the *identified need*, and is not expected to have significantly higher market benefits.

RIT-D Guideline Issues

Question 18

We seek stakeholder views on what guidance and examples for distribution would be useful in the RIT-D guidelines.

We recommend that a number of specific distribution network examples (as listed in clause 5.17.1 (c)(4)) be developed. These examples should be sufficiently broad to recognise the fact that network management is increasingly an integrated approach rather than being conducted exclusively on a project by project basis. Specifically, guidance is required on the process and justification required when determining the case that market benefits would not be material in the evaluation and therefore not required to be quantified for the RIT-D evaluation.

The ENA submission details the types of network examples that the AER should provide guidance and worked examples on. These include:

- New distribution feeder;
- New sub-transmission feeder/line, including a replacement and augmentation component for both radial and meshed sub-transmission lines;
- Additional transformer at a Zone Substation;
- New Zone Substation (augmentation);
- New Dual Function Asset;
- Incidental augmentation associated with an asset replacement project; and
- Augmentation of a Zone Substation due to a customer initiated project (i.e. customer connection).

Question 19

The RIT-T guidelines provide guidance and worked examples on these topics. Having regard to the RIT-T guidelines, we are interested in whether the RIT-T guidelines provide useful information which should be adopted in the RIT-D guidelines.

The RIT-T guidelines provide many useful worked examples that are applicable to the analysis of potential credible options on the transmission network and cover the complexities involving the evaluation of broader electricity market benefits such as competition benefits, generator fuel cost, benefits to other regions etc. However, many of the worked examples do not apply to the evaluation of projects on the distribution network. This is because the RIT-D contains fewer classes of market benefits and does not concern itself with the broader RIT-T specified market benefits and the analysis of "states of the world" that include the wholesale market.

The NSW DNSPs would find it more beneficial to be given guidance on a range of worked examples focusing on the assessment of common types of RIT-D projects, and the consideration and decision of whether to quantify the relevant RIT-D specified market benefits.

Question 20

Additionally, we are interested in whether stakeholders consider the guidelines should provide guidance and worked examples on any additional areas that have not been specified under clauses 5.17.2(c) or 5.17.2(b)(2) of the NER.

At a minimum, we consider that guidance and worked examples for the RIT-D process and the valuation of market benefits and option costs under of clauses 5.17.1(b)(2) and 5.17.2(c) should be included.

6.2 Application of guidelines

Question 21

We seek views on what guidance we should give on when a regulatory test assessment will be considered to have commenced for the purposes of 11.50.5(c).

DNSPs should be free to elect which RIT applies to all investments that have commenced, but not yet finalised at the time of commencement of the RIT-D. A regulatory test assessment should be considered as commenced where a clear network need has been identified, documented and consideration of options has been undertaken.

Process to be followed

Question 22

We seek stakeholders' views on whether there are any particular areas where further guidance on the RIT-T assessment process would be useful.

As indicated in our response to Question 1, where a joint TNSP and DNSP project is determined to be a RIT-T project, the AER should provide guidance as to how it would deal with situations where there is no agreement between the DNSP and TNSP as to who should be the lead party. While not specified in the Rules, we believe that the TNSP is best placed to be the lead party

responsible for carrying out the RIT-T. This is appropriate as DNSPs generally do not have the competencies or systems to undertake the level of analysis required under the RIT-T.

Question 23

We seek stakeholder views on what methodologies the RIT-D application guidelines should adopt for valuing market benefits.

We would expect that the AER will provide guidance on *how* to consider market benefits, the magnitude of credible option analyses to undertake, and will impose sensible limitations on who should be considered an 'interested party' for the purposes of the guidelines.

Given the more numerous and lower value of distribution projects, there is a need for simplified methods of quantification. Deemed values where possible should be established (which may vary by DNSP and be subsequently updated in determinations). Simplified methods should be developed where case by case evaluation is required. DNSPs should be free to apply more complex methods where they deem it appropriate, subject to demonstrating their validity.

Dispute Resolution

Question 24

We seek stakeholder views on what dispute resolution guidance would be of assistance. The RIT-T guidelines provide guidance on dispute resolution. Having regard to the RIT-T guidelines, we are interested in whether this content should be adopted into the RIT-D guidelines.

We agree that the dispute resolution process described in the RIT-T guidelines could generally be adopted into the RIT-D process. However, we note that clauses 5.16.5 (g) (2) & (3) are not applicable to the RIT-D.