Cost Thresholds Review for the Regulatory Investment Test for Transmission

Final determination

November 2012

Inquiries about this review should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Tel: (03) 9290 1444
Fax: (03) 9290 1457
Email: AERInquiry@aer.gov.au

AER reference: 49538 – D12/167458

Contents

Shortened forms

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
APR	annual planning report
DNSP	distribution network service provider
Electricity Rules	National Electricity Rules
MCE	Ministerial Council on Energy
NEM	National Electricity Market
NSP	network service provider
NTNDP	National Transmission Network Development Plan
NTPA	National Transmission Planning Arrangement
RIT-D	regulatory investment test for distribution
RIT-T	regulatory investment test for transmission
TNSP	transmission network service provider

1 Summary

The regulatory investment test for transmission (RIT-T) is a cost-benefit test that transmission companies must apply before building electricity transmission infrastructure. The test applies for only transmission investments above certain cost thresholds. The National Electricity Rules (Electricity Rules) require the Australian Energy Regulator (AER) to review changes in input costs every three years and adjust the cost thresholds to reflect these changes.

The AER published a draft determination on the review of the cost thresholds on 11 September. The AER received one submission.

After considering the submission, the AER's final determination upholds the AER's draft determination that:

- the $5 million cost thresholds in clause 5.6.5C, in relation to the definition of replacement transmission network asset and transmission investment, as referred to in the definition of new network investment, be maintained at $5 million; and
- the $35 million cost threshold in clause 5.6.6(y) be increased to $38 million. The revised cost threshold will take effect on 1 January 2013.

2 Introduction

The AER is responsible for the economic regulation of electricity transmission and distribution services in the national electricity market (NEM) as well as some gas transportation services. The AER also monitors compliance in the wholesale electricity and gas markets and is responsible for enforcement of the National Electricity Law and National Gas Law.

The RIT-T is a cost-benefit analysis used to identify the transmission investment option (the preferred option) that maximises the net economic benefits and, where applicable, meets the relevant jurisdictional reliability standards.[1]

All transmission investment is subject to both the RIT-T and RIT-T consultation procedures unless exempted by clause 5.6.5C of the Electricity Rules. Several of the categories of exemption exclude a class of transmission investment where the estimated capital cost does not exceed a cost threshold of $5 million.

1 The existing regulatory test applies to projects which address a need on the network. The Ministerial Council on Energy, now referred to as the Standing Council on Energy and Resources (SCER), in March 2011 proposed a new project assessment process for distribution, the regulatory investment test for distribution (RIT-D). This rule change proposal is currently was considered by the AEMC and the Final Rule Determination was made on 11 October 2011. From 31 August 2013, the RIT-D will replace the regulatory test for distribution network service providers.

Similarly, the definition of replacement transmission network asset and transmission investment as referred to in the definition of new network investment include cost thresholds of $5 million as part of their definition.

Further, where transmission investment is subject to the RIT-T and the preferred option does not exceed a cost threshold of $35 million, the network service provider preparing the RIT-T may be exempted from parts of the RIT-T consultation procedures.[2]

The AER must review the appropriateness of these cost thresholds every three years by assessing changes in input costs. On 11 September 2012, the AER published its draft determination on the cost thresholds review. The AER received one submission. Consistent with the requirements of clause 5.6.6E, this document represents the AER's final determination on the cost thresholds review.

3 Rule requirements

Clause 5.6.5E of the Electricity Rules states:

(a) Every 3 years the AER must undertake a review (the cost threshold review) of the changes in the input costs used to calculate the estimated capital costs in relation to replacement transmission network assets and in relation to transmission investment as referred to in the definition of new network investment and referred to in clauses 5.6.2A(b)(6), 5.6.5C(a)(2), (4) and (5) and 5.6.6(y)(1) for the purposes of determining whether the amounts:

(1) in relation to replacement transmission network assets;

(2) of less than $5 million referred to in clause 5.6.5C(a)(2);

(3) of less than $5 million referred to in clause 5.6.5C(a)(4);

(4) of less than $5 million referred to in clause 5.6.5C(a)(5);

(5) of less than $35 million referred to in clause 5.6.6(y)(1); and

(6) in excess of $5 million in relation to transmission investment as referred to in the definition of new network investment,

(each a cost threshold) need to be changed to maintain the appropriateness of the cost thresholds over time by adjusting those cost thresholds to reflect any increase or decrease in the input costs since 1 July 2009 in respect of the first cost threshold review and since the date of the previous review in respect of every subsequent cost threshold review.

(b) Each cost threshold review is to be commenced by the AER on 31 July of the relevant year, with the first such review to be initiated in 2012.

---

[2] cl. 5.6.6(y) National Electricity Rules.

(c) Within 6 weeks following the commencement of a cost threshold review, the AER must publish a draft determination outlining:

(1) whether the AER has formed the view that any of the cost thresholds need to be amended to reflect increases or decreases in the input costs to ensure that the appropriateness of the cost thresholds is maintained over time;

(2) its reasons for determining whether the cost thresholds need to be varied to reflect increases or decreases in the input costs;

(3) if there is to be a variation in a cost threshold, the amount of the new cost threshold and the date the new cost threshold will take effect; and

(4) its reasons for determining the amount of the new cost threshold.

(d) At the same time as it publishes the draft determination under paragraph (c), the AER must publish a notice seeking submissions on the draft determination and which specifies the period within which written submissions can be made (the cost threshold consultation period) which must be no less than 5 weeks from the date of the notice.

(e) The AER must consider any written submissions received during the cost threshold consultation period in making its final determination in respect of the matters outlined in paragraph (c).

(f) The final determination must be made and published by the AER within 5 weeks following the end of the cost threshold consultation period (the cost threshold determination).

4 Cost threshold determination

Clause 5.6.5E requires the AER to review the change in the inputs costs used to calculate estimated capital costs in relation to transmission investment since 1 July 2009 to determine whether the cost thresholds should be changed to maintain their appropriateness. This section of the document outlines the AER's final determination on whether the cost thresholds should be amended to reflect changes in input costs.

4.1 Draft determination

In the draft determination, the AER proposed not to undertake a full scale review of the precise changes in capital input costs for TNSP network projects as such a process would involve unnecessary regulatory burden on both TNSPs and the AER. The AER proposed instead to examine a board range of possible indexes to obtain a range of values that represent a reasonable approximation of changes in capital input costs since 1 July 2009.

Potentially relevant indexes are listed in the **Appendix A**. The AER considered it was most appropriate to use the available indexes as a rough guide to the range of cost increases and to give greater weight to broader economy-wide indexes. The use of broader economy-wide indexes was preferred as they are arguably a good measure of overall cost movements across the entire economy, are commonly used and understood, and in the absence of a precise measure provide a reasonable proxy for changes in input capital costs over the period.

On this basis, the AER considered that capital input costs have likely increased by approximately 10 per cent.

The AER also considered that for the purposes of administrative simplicity, any change in the cost thresholds to reflect changes in capital input costs should be rounded to the nearest million. Where the approximate change results in a pre-rounded variation figure of approximately $500 000, or $1.5m, $2.5m etc (i.e. half way between two rounded figures), then it should be rounded down rather than up. This reflects the importance of the RIT-T in ensuring transparency and competitive neutrality vis-a-vis non-network options.

As capital costs have increased by approximately 10 per cent, the AER considered the cost thresholds should be amended to reflect this increase. On this basis, the draft determination concluded that:

- the $5 million cost threshold would move to approximately $5.5 million. Given the AER's proposed approach to rounding, the AER considered that the $5 million threshold remain at $5 million.

- the $35 million cost threshold would move to approximately $38.5 million. Given the proposed approach to rounding, the AER considered that the $35 million threshold be changed to $38 million. The AER proposed that the revised cost threshold for clause 5.6.6(y) take effect on 1 January 2013.

As noted in the draft determination, when the next cost thresholds review takes places, the AER will consider changes to the cost thresholds using the un-rounded cost thresholds figures of $5.5 million and $38.5 million as the starting point, rather than the rounded cost thresholds.

4.2 Final determination

The AER received one submission on the draft determination from Grid Australia. Grid Australia is the organisation which represents the owners of Australia's electricity transmission networks in the National Electricity Market (NEM), and Western Australia.

Grid Australia supported the AER's proposed methodology of determining the changes in capital input costs and agreed with the AER's revised cost thresholds.

Given the submission raised no concerns with the AER's draft determination, the AER's final determination maintains the AER's draft decision that:

- The $5 million threshold referred to in clauses 5.6.5C(a)(2), (4) and (5), in relation to replacement transmission network assets and in relation to transmission investment as referred to in the definition of new network investment not be changed

- The $35 million threshold in clause 5.6.6(y) be changed to $38 million. The revised cost threshold for clause 5.6.6(y) will take effect on 1 January 2013.

Appendix A – indexes considered by the AER

Table A – Change in potentially relevant indexes June 2009 to June 2012

Index	Percentage change June 2009 to June 2012
CPI	8.0 per cent
Core inflation[3]	8.0 per cent
GDP chain price index	9.8 per cent
GDP deflator	10.4 per cent
GDP deflator – final consumption	7.9 per cent
GDP deflator – new engineering construction capital formation	5.6 per cent
GDP deflator – all capital formation	–0.7 per cent
PPI stage of production – final goods	5.6 per cent
PPI stage of production – final capital goods	2.3 per cent
Communication equipment manufacturing	2.9 per cent
Electric cable and wire manufacturing	17.9 per cent
Other electrical equipment manufacturing	–1.6 per cent
Copper materials in distribution transformers	13.6 per cent
Copper materials in power transformers	31.6 per cent
Road and Bridge Construction	12.3 per cent
Non-residential building construction	3.2 per cent
Building construction in Australia	4.2 per cent
Iron and steel	–13.5 per cent
Aluminium	12.9 per cent
Copper and brass	12.6 per cent
Electricity, gas, water, and waste services labour	12.8 per cent

Source: ABS Australian and New Zealand Standard Industrial Classification (ANZSIC), 2006; catalogue number 1292.0; Producer Price Indexes, Australia, June 2012, catalogue number 6427.0, and Consumer Price Index, Australia, June 2012, catalogue number 6401.0.

3 Calculated as the average of the weighted median and trimmed mean measures of consumer price inflation.