



Draft determination

Cost thresholds review for the regulatory investment test

September 2015

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Executive Summary

The regulatory investment test for transmission (RIT-T) and regulatory investment test for distribution (RIT-D) are cost benefit tests that network businesses are required to apply prior to augmenting the network. The RIT-T and RIT-D only applies to investments which are above certain cost thresholds. The National Electricity Rules (NER) require us to review changes in input costs every three years and adjust the RIT-T and RIT-D cost thresholds to reflect these changes.

Consistent with the NER requirements, this document sets out the AER's draft determination of the 2015 cost threshold review for the RIT-T and RIT-D.

Our draft determination for the RIT-T cost thresholds is that:

- the \$5 million cost thresholds referred to in clauses 5.15.3(b)(1),(2),(3),(4) and (6) of the NER should be increased to \$6 million, and
- the \$35 million cost threshold referred to in clause 5.15.3(b)(5) of the NER, which was increased to \$38 million in the 2012 cost thresholds review be increased to \$41 million

Our draft determination for the RIT-D cost thresholds is that:

- the \$5 million cost thresholds referred to in clauses 5.15.3(d)(1) and (2) remain unchanged
- the \$10 million cost threshold referred to in clause 5.15.3(d)(3) remain unchanged
- the \$20 million cost threshold referred to in clause 5.15.3(d)(4) be increased to \$21 million, and
- the \$2 million cost thresholds referred to in clause 5.15.3(d)(5) remain unchanged

We propose that the revised cost thresholds take effect on 1 January 2016.

1 Introduction

We, the Australian Energy Regulator (AER), are responsible for the economic regulation of electricity transmission and distribution services in the National Electricity Market (NEM) as well as some gas transportation services. We also monitor compliance with, and are responsible for enforcement of the National Electricity Law and National Gas Law.

Every three years we are required to review the appropriateness of the cost thresholds set out in chapter five of the National Electricity Rules (NER). These cost thresholds primarily provide full or partial exemptions to network businesses from undertaking a cost benefit test known as the regulatory investment test (RIT) and the associated consultation procedures.

On 31 July 2015, in accordance with clause 5.15.3 of the NER, we initiated a review of the cost thresholds associated with the regulatory investment test for transmission (RIT-T) and regulatory investment test for distribution (RIT-D) (2015 cost thresholds review). This also includes cost thresholds used in the definition of replacement transmission network asset, the definition of a potential transmission project and distribution annual planning reporting requirements for committed investments to address a refurbishment or replacement need or an urgent and unforeseen network issue.

The RIT is a cost benefit test which network businesses may be required to undertake when they have to augment their network to address an identified need. The RIT is known as the RIT-T in transmission and the RIT-D in distribution. The purpose of the RIT is to identify the investment in the network which maximises the present value of the net economic benefit for all those who produce, consume and transport electricity in the NEM.

Consistent with the requirements of clause 5.15.3(g), this document sets out our draft determination on the 2015 cost thresholds review.

2 Background

2.1 Rules requirements

Clause 5.15.3 of the NER states:

Regulatory investment test for transmission thresholds

(a) Every 3 years the *AER* must undertake a review of the changes in the input costs used to calculate the estimated capital costs in relation to:

1. replacement transmission network assets; and
2. transmission investment as referred to in paragraphs (b)(2) to (6),

for the purposes of determining whether the cost thresholds specified in paragraph (b) 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:

3. July 2009 in respect of the first cost threshold review; and
4. the date of the previous review in respect of every subsequent cost threshold review.

(b) For the purposes of paragraph (a), the cost thresholds for review are the following amounts:

1. in excess of \$5 million in relation to replacement transmission network assets;
2. of less than \$5 million referred to in clause 5.16.3(a)(2);
3. of less than \$5 million referred to in clause 5.16.3(a)(4);
4. of less than \$5 million referred to in clause 5.16.3(a)(5);
5. of less than \$35 million referred to in clause 5.16.4(z1)(1); and
6. in excess of \$5 million in relation to investment in transmission assets of the type referred to in the definition of potential transmission project in clause 5.10.2.

Regulatory investment test for distribution costs thresholds

(c) Subject to paragraph (f)(2), every 3 years, and at the same time as it undertakes its review of the cost thresholds for *regulatory investment test for transmission* under paragraph (a), the *AER* must undertake a review of the changes in the input costs used to calculate the estimated capital costs in relation to:

1. projects subject to the *regulatory investment test for distribution*; and
2. the cost threshold for committed investments that are to address a refurbishment or replacement need, or an urgent and unforeseen *network* need subject to the *Distribution Annual Planning Report*,

for the purposes of determining whether the costs thresholds specified in paragraph (d) 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:

3. 1 January 2013 in respect of the first cost threshold review; and
4. the date of the previous review in respect of every subsequent cost threshold review.

(d) For the purposes of paragraph (c), the cost thresholds for review are the following amounts:

1. \$5 million referred to in clause 5.17.3(a)(2);
2. \$5 million referred to in clause 5.17.3(a)(6);
3. \$10 million referred to in clause 5.17.4(n)(2);
4. \$20 million referred to in clause 5.17.4(s);
5. \$2 million referred in S5.8(g).

Cost threshold reviews

(e) Each cost threshold review is to be commenced by the *AER* by 31 July of the relevant year.

(f) The first review of the cost thresholds for:

1. the *regulatory investment test for transmission* under paragraph (a) must be initiated in 2012; and
2. the *regulatory investment test for distribution* under paragraph (c) must be initiated in 2015.

(g) Within six 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.

(h) At the same time as it *publishes* the draft determination under paragraph (f), the *AER* must *publish* a notice seeking submissions on the draft determination. The notice must specify 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.

(i) 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 (g).

- (j) The final determination on cost thresholds must be made and *published* by the *AER* within 5 weeks following the end of the cost threshold consultation period
- (k) The *AER* may *publish* a draft determination under paragraph (g), a notice under paragraph (h), or a final determination under paragraph (j) for any cost threshold reviews under paragraphs (a) and (c) as a single document.

2.2 2012 cost thresholds review

In 2012 the AER undertook the first cost thresholds review for the RIT-T in accordance with the requirements set out in old clause 5.6.5E (now renumbered as clause 5.13.5) of the NER ([2012 cost thresholds review](#)). The cost thresholds review did not include a review of the thresholds associated with the RIT-D as those requirements had not yet been introduced in the NER.

In the 2012 cost thresholds review, we considered that rather than be precise, it was appropriate to use available indexes as an approximate guide to ascertain the range of cost variations and make a determination on the change in input costs. Thus, we examined a range of industry and broader economy wide indexes to determine whether any of the cost thresholds set out in old clause 5.6.5E(a) (now renumbered as clause 5.13.5(b)) needed to be amended to reflect increases or decreases in input costs since the introduction of the RIT-T in June 2009. We considered that it was appropriate to give greater weight to broader economy wide indexes as they are arguably good measures of overall price movements across the entire economy, are commonly used and understood, and in the absence of precise measures provide a reasonable proxy for changes in input costs over the period.

This approach was favoured over a more full scale review of precise changes in transmission network project costs given the regulatory burden it would impose on both network business and the regulator.

Following an examination of a range of broader economy wide indexes and some industry indexes, we considered that capital input costs had likely increased by approximately 10 per cent. Given this, we considered that the cost thresholds should be increased to account for the change in input costs. For administrative simplicity, we considered that changes should be rounded to the nearest million and that unless it was inappropriate, where the increase in input costs resulted in a pre-rounded variation figure of approximately halfway between two rounded figures (i.e. \$1.5 million), then the cost threshold should be rounded down rather than up.

We decided that the cost thresholds should be increased to reflect the 10 per cent change in input costs. On this basis:

- the \$5 million cost thresholds referred to in old clauses 5.6.5C(a)(2),(4) and (5) (now renumbered as clauses 5.16.3(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 (now known as investment in transmission assets of the type referred to in the definition of potential transmission project in clause 5.10.2) would move to \$5.5 million. However, given the approach taken to rounding these cost thresholds would be rounded down and remain unchanged at \$5 million.

- the \$35 million cost threshold referred to in old clause 5.6.6(y) (now renumbered as clause 5.16.4(z1)(1)) would move to \$38.5 million. Given the proposed approach to rounding, the cost threshold would be rounded down to \$38 million.

At the time, we noted that when the next cost thresholds review takes place we will consider changes to the cost thresholds using the un-rounded cost threshold figures of \$5.5 million and \$38.5 million as a starting point rather than the rounded cost thresholds.

3 Draft determination

Consistent with the requirements of clause 5.15.3(g), this section sets out our draft determination on the 2015 cost thresholds.

3.1 Changes in input costs

We have taken the same approach as in the 2012 cost thresholds review to assess whether there has been a change in input costs.

We note that the 2012 cost thresholds review only included a review of the RIT-T cost thresholds as the RIT-D had yet been introduced into the NER. We are of the view that a consistent approach should be taken for the RIT-T cost thresholds and RIT-D cost thresholds. Further, changes in capital input costs for transmission and distribution should be sufficiently similar such that the same indexes can be used for both RIT-T cost thresholds and RIT-D cost thresholds.

Thus, we have considered a broad range of possible indexes to obtain a range of values that represent a reasonable approximation of changes in capital costs since:

- the 2012 cost thresholds review for the RIT-T cost thresholds set out in clause 5.15.3(b), and
- 1 January 2013 for the RIT-D cost thresholds set out in clause 5.15.3(d).

Consistent with the 2012 cost thresholds review, greater weight will be given to economy-wide indexes. Table 1 below sets out the indexes we have considered and the percentage change of those indexes since the 2012 cost thresholds review of 31 July 2012 - Transmission) and 1 January 2013 - Distribution. The indexes considered are consistent with the indexes considered in the 2012 cost thresholds review. Some of the indexes have changed as they have been revised by the ABS since the 2012 cost thresholds review and are no longer available.

We note that the indexes used do not exactly align with the date range which we are considering to determine if there has been a change in input costs. However, we consider the date ranges provide a sufficient approximation of the movement in input costs since the 2012 cost thresholds review and 1 January 2013. For example, indexes sourced from the Australian Bureau of Statistics are updated quarterly, the June 2012 figures have been used as 31 July 2012 figures are not available.

Table 1 - Indexes considered in determining the change in input costs

Index	% change since 2012 cost thresholds review	% change since 1 January 2013
Consumer price index (CPI)	7.07	5.39
CPI - trimmed mean	7.49	6.18
CPI - weighted mean	7.86	6.37
Producer Price Index (PPI) - total domestic and import	4.59	3.76
PPI - primary metal and metal product manufacturing	-12.56	-12.65
PPI - fabricated metal product manufacturing	8.83	9.26
PPI - machinery and equipment manufacturing	3.35	4.27
Gross Domestic Product (GDP) - implicit price deflator*	0.40	1.21
GDP - chain price index*	1.30	1.61
GDP - implicit price deflator - fixed capital formation*	4.62	4.52
GDP - implicit price deflator - final consumption*	5.16	4.21
GDP - implicit price deflator - private fixed capital formation - new engineering construction	4.14	3.10

*At the time of this assessment, GDP data was only available up to the end of the first quarter of 2015 and so the table only measures the % change up to the first quarter of 2015.

Source: ABS¹

Based on inspection of the indexes set out in table 1, economy wide indexes have increased by approximately 5-7 per cent since the 2012 cost thresholds review and approximately 4-6 per cent since 1 January 2013. Consistent with the 2012 cost thresholds review, we consider that these broader indexes provide a good indicator of the likely movement in input costs and are preferred over industry indexes. The movements in these economy wide indexes are also in the range of movements of some the more specific indexes (i.e. PPI machinery and equipment manufacturing, PPI fabricated metal product manufacturing) over the same time.

¹ ABS Consumer Price Index Australia, June 2015, catalogue number 6401.0; Producer Price Index Australia, June 2015, catalogue number 6427.0; Australian National Income, Expenditure and Product, March 2015, catalogue number 5206.0.

Accordingly, we consider it is reasonable to infer that input costs have change by around 6 per cent since the 2012 cost thresholds review and 5 per cent since 1 January 2013.

3.2 Draft determination

Clause 5.15.3(g) of the NER requires us to outline in our draft determination whether we have formed a view that the cost thresholds need to be amended to reflect increases or decreases in input costs to ensure the appropriateness of the cost thresholds is maintained over time. If we consider there is a need to vary the cost thresholds, the draft determination must outline the amount of the new cost thresholds and the date the new cost thresholds.

3.2.1 Approach to rounding and variation of cost thresholds

We are taking the same approach to the variation of cost thresholds that was done in the 2012 cost thresholds review. That is, changes should be rounded to the nearest million and that unless it was inappropriate to do, where the increase in input costs resulted in a pre-rounded variation figure of approximately halfway between two rounded figures (i.e. \$1.5 million), then the cost threshold should be rounded down rather than up.

Further as stipulated in our final determination on the 2012 cost thresholds review, we will consider changes to the RIT-T cost thresholds using the un-rounded cost threshold figures of \$5.5 million and \$38.5 million from the 2012 cost thresholds review as a starting point rather than the rounded cost thresholds.

3.2.2 AER draft determination

As noted above, we consider that input costs have likely increased by around 6 per cent since the 2012 cost thresholds review and 5 per cent since the 1 January 2013.

On this basis, we consider that:

- the RIT-T cost thresholds set out in clause 5.15.3(b) should be increased by 6 per cent, and
- the RIT-D cost thresholds set out in clause 5.15.3(d) should be increased by 5 percent to maintain the appropriateness of those cost thresholds.

On this basis, for the RIT-T cost thresholds:

- the un-rounded \$5.5 million cost thresholds referred in clauses 5.15.3(b)(1), (2), (4) and (6) would move to \$5.83 million. Given the approach to rounding, this cost threshold will be rounded to \$6 million
- the un-rounded \$38.5 million cost threshold referred to in clause 5.15.3(b)(5) would move to \$40.81 million. Given the approach to rounding, the cost threshold will be rounded to \$41 million.

On this basis, for the RIT-D cost thresholds:

- the \$5 million cost thresholds referred to in clauses 5.15.3(d)(1) and (2) would move to \$5.25 million. Given the approach to rounding, the cost threshold will be rounded down and remain unchanged at \$5 million.

- the \$10 million cost threshold referred to in clause 5.15.3(d)(3) would move to \$10.5 million. Given the approach to rounding, the cost threshold will be rounded down and remain unchanged at \$10 million.
- the \$20 million cost threshold referred to in clause 5.15.3(d)(4) would move to \$21 million.
- the \$2 million cost thresholds referred to in clause 5.15.3(d)(5) would move to \$2.1 million. Given the proposed approach to round, the cost threshold will be rounded down and remain unchanged at \$2 million.

We propose that the revised cost thresholds take effect on 1 January 2016.

Consistent with our approach to date, in the next cost thresholds review we will use the un-rounded estimates as the base from which assess changes (i.e. the percentage change in inputs will be applied to the un-rounded \$5.83 million cost threshold RIT-T cost threshold rather than the \$6 million figure).

4 Notice seeking submissions

Clause 5.15.3 of the NER outlines the consultation process which we must follow when undertaking a cost thresholds. Consistent with those requirements, interested parties are invited to review the matters raised in this draft determination and provide written submissions by the close of business on 9 October 2015.

Submissions should be addressed to Mr Peter Adams, General Manager, Wholesale Markets Branch and can be sent electronically to AERinquiry@aer.gov.au with the following title in the email "*Submission to AER - 2015 cost thresholds review draft determination*".

Alternatively, submissions can be sent to:

Mr Peter Adams
General Manager — Wholesale Markets Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

The AER prefers that all submissions be sent in an electronic format in Microsoft Word or other text readable document form and publicly available, to facilitate an informed, transparent and robust consultation process.

Accordingly, submissions will be treated as public documents and posted on the AER's website, unless prior arrangements are made with the AER to treat the submission, or portions of it, as confidential. Those wishing to submit confidential information are requested to:

- clearly identify the information that is the subject of the confidentiality claim and
- provide a non-confidential version of the submission.

For further information regarding the AER's use and disclosure of information provided to it, see the *ACCC/AER Information Policy, 2014* available on the AER's website.

Any enquiries about this draft determination, or lodging submissions, should be directed to AERinquiry@aer.gov.au.