

Review of the cost benefit analysis guidelines and RIT application guidelines

Consultation Paper

May 2023

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Contents

1	Introduction	4
2	Reasons and basis for updating guidelines	7
2.1	MCC rule change.....	7
2.2	AEMC Transmission Planning Investment Review.....	9
3	Proposed approach to the RIT guideline application amendments	10
3.1	Consultation Process	10
3.2	Timeline of consultation process.....	11
3.3	Summary of questions	12
3.4	Invitation for submissions.....	13
4	Proposed amendments to the RIT application guidelines	14
4.1	RIT reopening triggers	14
4.1.1	The issue.....	14
4.1.2	Preliminary view and proposed changes to the guidelines	15
4.2	Cost estimation in RITs.....	16
4.2.1	The issue.....	16
4.2.2	Preliminary view and proposed approach to guidance	16
4.3	Improved cost estimation transparency.....	19
4.3.1	The issue.....	19
4.3.2	Preliminary view and proposed approach to guidance	19
4.4	Early works	20
4.4.1	The issue.....	20
4.4.2	Preliminary view and proposed approach to guidance	21
5	Next steps	22
5.1	Indicative process	22
5.2	Invitation for submissions.....	22
	Appendix A: Abbreviations	23

1 Introduction

The Regulatory Investment Test (RIT) is a cost-benefit test that network businesses (RIT proponents) must undertake before building electricity network infrastructure. The purpose of this test is to assess a range of credible options that could address an identified need in the electricity network, and then identify the credible option that maximises the net economic benefits in the National Electricity Market.

In accordance with the National Electricity Rules (NER), we are responsible for establishing and maintaining guidelines on the application of the RIT. While the RIT instruments for transmission and distribution provide the framework for the cost-benefit test, the RIT application guidelines provide guidance on:¹

- The purpose of RITs and projects subject to assessment.
- The cost benefit assessment required to be undertaken in the RIT, including guidance on the selection of reasonable scenarios, selection of credible options and the preferred option, and treatment of uncertainty risks and externalities.
- The process to follow in applying the RITs by describing the stakeholder consultation steps prescribed in the NER, as well as the process for reapplying a RIT following a material change in circumstances.
- Calculating different classes of market benefits, using worked examples. This includes benefits associated with voluntary load curtailment, involuntary load shedding, costs to other parties, timing of expenditure, option value and energy losses.
- The dispute resolution process. This includes guidance on the requirements and procedure for making a RIT dispute, along with how we will make a determination on any dispute.

More broadly, our role in the transmission planning and distribution planning frameworks includes:

- providing guidance to Australian Energy Market Operator (AEMO), RIT-T (regulatory investment for transmission) and RIT-D (regulatory investment test for distribution) proponents, and other stakeholders on the application of the NER through the application of relevant guidelines
- monitoring compliance with the NER, including RITs and binding guidelines, and taking compliance action where necessary and appropriate
- identifying best practice cost benefit analysis to promote investment efficiency, consistent with our role in the current RIT processes
- making determinations to settle RIT disputes; and
- assessing efficient proposed expenditure associated with transmission and distribution projects within the contingent project application framework.

¹ AER, *RIT-T application guidelines*, September 2017; AER, *RIT-D application guidelines*, September 2017

Scope of this review

In this consultation paper, we discuss proposed amendments and seek stakeholder views on these amendments to the RIT application guidelines resulting from the Australian Energy Market Commission's (AEMC's) final rule on the *Material change in network infrastructure costs* and the AEMC's Transmission Planning Investment (TPI) Review.

The final rule requires, amongst other things, RIT proponents to consider whether there has been a material change in circumstances that requires the re-application of the RIT. This requires amendment to the RIT guidelines. The AEMC's TPI Review stage 2 report recommends that greater certainty be provided regarding early works activities undertaken by transmission businesses in advance of constructing a project. We will cover these early works issues as part of this review.

The AEMC's TPI Review stage 2 report also made recommendations around providing guidance on matters related to building and maintaining community acceptance of a project (referred to as transmission business gaining a social licence for a project). These recommendations include:

- engagement with local communities and other stakeholders
- the treatment of costs associated with building and maintaining social licence in the RIT-T, including providing worked examples of social licence activities; and
- the definition of a credible option in terms of being delivered in sufficient time to meet a network need.

The AEMC's report also recommended guidance to provide clarity around the operation and application of the NER that enable TNSPs to recover the efficient costs incurred in undertaking activities to build and maintain social licence.²

The AER agrees that these social licence issues need to be addressed but considers that these issues extend beyond a consideration of amendments to RIT guidelines. We therefore consider that it is more appropriate that these matters be included in a broader and more comprehensive process across both the planning and cost recovery regulatory frameworks. This approach is consistent with the AEMC's view that the AER could choose to provide guidance in a standalone document dedicated to the assessment of social licence activities and costs in the regulatory framework.¹ A broader review will ensure that all aspects of the regulatory framework will be assessed in a consistent manner and will promote more effective stakeholder engagement.

We intent to engage with stakeholders on our proposed approach to these matters to inform our process and approach.

This consultation paper forms an important part of our guideline review process. To help encourage input, we have included relevant background, our initial views on some matters and targeted questions. This consultation paper is structured as follows in 1.

² AEMC, TPI Review, stage 2 report, October 2022, p.23

Table 1: Structure of the consultation paper

Description	Section of issues paper
Reasons and basis for updating the guidelines	Section 2
Proposed approach to the RIT application guideline amendments	Section 3
Proposed amendments to the RIT application guidelines	Section 4
Next steps	Section 5
Abbreviations	Appendix A

2 Reasons and basis for updating guidelines

2.1 MCC rule change

We are required to update the RIT application guidelines and RIT instruments as result of the AEMC's *Material change in network infrastructure costs* (MCC) rule change. This rule change requires us to update:

- the RIT for transmission (RIT-T) guidelines for actionable Integrated System Plan (ISP) projects (which are housed within the Cost Benefit Analysis (CBA) Guidelines);³ and
- the application guidelines for RITs for transmission (i.e., non-actionable ISP projects)⁴ and distribution.⁵

In this paper we refer to all three documents together as the **Guidelines**.

As part of this review process, we may also identify that its appropriate to update the RIT-T⁶ and RIT-D instruments⁷ (together, the **RIT instruments**).

The MCC rule provides, amongst other things, a positive requirement that regulatory investment test (RIT) proponents must consider whether there has been a material change in circumstances that requires the re-application of the RIT. In particular, the MCC final rule determination requires that RIT proponents for projects over a \$100 million threshold develop re-opening triggers. If this threshold is met, the RIT proponent is required to consider if and how to reconsider the extent to which the previously identified preferred option is likely to remain the most net beneficial option in view of changed circumstances.

The final rule also allows the AER to consider guidance to improve the cost estimate accuracy of credible options in the RIT and if any aspects of the RIT-T and RIT-D application guidelines should be binding on RIT proponents.

The key features of the final rule are that it⁸:

- requires RIT proponents (other than the Australian Energy Market Operator where it is the sole RIT proponent) of projects with an estimated cost of greater than \$100 million to develop reopening triggers, which would clearly indicate whether the RIT-T proponent must consider if there is a material change in circumstances⁹
- requires RIT proponents, if they consider there has been a material change in circumstances (which would include the activating of a reopening trigger), to notify the AER and propose a course of action (backed by supporting analysis) to identify if

³ NER, cl. 5.22.5(a)

⁴ NER, cl. 5.16.2(e)

⁵ NER, cl. 5.17.2(e)

⁶ NER, cl. 5.16.2(e)

⁷ NER, cl. 5.17.2(e)

⁸ AEMC, Final Rule determination, Material change in network infrastructure project costs, 27 October 2022

⁹ Regardless of whether the \$100 million threshold is met, the NER requires all RIT proponents to consider if there has been a material change in circumstances.

the preferred option previously identified through the RIT remains the most net beneficial option in light of the changed circumstances¹⁰

- requires the AER to approve or reject and modify the RIT proponent's proposed course of action
- requires proponents of contingent projects, at the time of submitting the contingent project application, to provide a separate statement to the AER confirming, whether or not, there has been a material change in circumstances, including supporting analysis, and (if relevant) confirming that the AER was notified of any material change in circumstances and outlining the course of action that was undertaken
- clarifies the rules governing the AER guidelines for RITs to support strengthened guidelines for cost estimate development.

The transitional rules of the MCC rule change specifically **require** that the AER update the Guidelines to include:

- guidance on the purpose and appropriate approach to developing RIT reopening triggers, as well as examples of potential RIT reopening triggers; and
- actions that may be taken in response to a reopening trigger being triggered.¹¹

The MCC rule also clarifies that the AER can amend the Guidelines to elaborate on its guidance on any acceptable cost methodologies to also include *any* acceptable cost estimate classification systems¹², as well as consider any appropriate role for contingency allowances.¹³ This potential for the AER to include greater guidance is aimed at encouraging RIT applicants to develop more robust cost estimates, which would reduce the likelihood that reapplication of the RIT is needed as a result of a material change in circumstances.

The MCC rule change also acknowledges that the AER may specify the relevant parts of the RIT-T and RIT-D application guidelines that are binding on RIT proponents¹⁴ (as it is already permitted to do so for the CBA guidelines)¹⁵. Making relevant aspects of the Guidelines binding is aimed at promoting stakeholder confidence in the RIT process.

Any amendments to the Guidelines to accommodate the MCC rule change must be made before the rule commencement date of 9 October 2023.

¹⁰ The credible option that maximises the present value of net economic benefit to all those who produce, consume and transport electricity in the market.

¹¹ AEMC, Material change in network infrastructure project costs - Final Determination, section 2.5, October 2022. NER, cl 11.154.3 These amendments are required made under clause 11.154.3 (a)(1) of the NER for amending the CBA guidelines, clause 11.154.3 (a)(2) of the NER for amending the RIT application guidelines and clause 11.54.3 (3) of the NER for amending the distribution application guidelines., relating to the amendments made to clauses 5.16A.2(c)(4); 5.16.2(c)(10) and 5.17.2(c)(10).

¹² NER, clause 11.154.3 and the amendments made by MCC rule change to clauses 5.16A.2(c)(2); 5.16.2(c)(6) and 5.17.2(c)(6).

¹³ NER, clause 11.154.3 and the amendments made by MCC rule change to clauses 5.16.2(c)(8) and 5.17.2.(c)(8).

¹⁴ NER, clauses 5.16.2(h) and 5.17.2(h) inserted by the MCC rule change.

¹⁵ NER, clause 5.22.5(c).

2.2 AEMC Transmission Planning Investment Review

Separate to the MCC related amendments, we have a general discretion to amend the CBA guidelines and the RIT application guidelines in accordance with the relevant NER consultation procedures referred to above.¹⁶ The process for amending the RIT Instruments is also the same.

The AEMC's Transmission Planning Investment (TPI) Review stage 2 final report¹⁷ made several recommendations that are relevant to our consideration to include other matters in our update of the CBA Guideline. We will consult in this Guideline Review, in accordance with the rules consultation procedures, on the recommendation to provide greater certainty regarding early works activities undertaken by transmission businesses in advance of constructing a project.

As discussed in section 1, we have decided not to consult on the AEMC's TPI recommendations on social licence related matters as part of this Guideline Review. While these social licence considerations are important, the AER considers that they involve wider issues than a consideration of amendments to RIT guidelines. We consider therefore that it is more appropriate that these matters be included in a broader and more comprehensive process across both the planning and cost recovery regulatory frameworks.

We intend to engage with stakeholders on our proposed approach to these matters to inform our process and approach.

¹⁶ NER, clauses 5.22.5(a); 5.16.2(e) and 5.17.2(e).

¹⁷ AEMC, Transmission Planning and Investment Review – Stage 2, Summary, October 2022

3 Proposed approach to the RIT guideline application amendments

3.1 Consultation Process

The consultation paper aims to engage stakeholders on key issues ahead of any guideline amendments. Stakeholder feedback and views gathered from submissions will be used to inform draft amendments to the relevant Guidelines.

The consultation requirements for amending the RIT-T (for non-actionable ISP projects) and RIT-D applications guidelines differ to those consultation requirements applying to the CBA guidelines (including RIT-T guidelines for actionable ISP projects).

The transmission and distribution consultation procedures set out a two-stage guideline review process:

- Stage 1: Publish proposed guideline amendments accompanied with an:
 - explanatory statement that sets out provision of the rules under which amendment is proposed and reasons for amendment; and
 - invitation for written submissions, allowing no less than 30 business days for making of submissions by stakeholders.
- Stage 2: Publish final decision on guideline amendment within 80 business days of publishing the proposed guideline amendment.

The consultation requirements for the CBA guidelines are prescribed by the rules consultation procedures. The standard rules consultation procedures (applicable for the purposes of this review) set out a three- stage guideline review process:

- Stage 1: Publish a consultation paper accompanied with:
 - an explanatory statement that sets out particulars of the proposal, the issues involved and options to address them, if applicable
 - the provision of the NER under which the consulting party is making the proposal; and
 - an invitation to make written submissions; and due date for written submission, no earlier than 20 business days after date of publication of consultation paper.
- Stage 2: Publish draft decision/guidelines no later than 50 business days after the due date for submissions on consultation paper accompanied with an invitation for written submissions, allowing no less than 20 business days for submissions by stakeholders.
- Stage 3: Publish final decision/amended guidelines no later than 50 business days after the due date for submissions on the draft decision.

The key practical difference under the transmission and distribution consultation procedures is that, unlike the rules consultation procedure, there is no requirement for a consultation

paper to be published ahead of the draft proposal. That said, the AER still has discretion to publish consultation papers as it considers appropriate.¹⁸

All consultation procedures allow, under specific circumstances, to extend the time on the final decisions. Further details on these procedures are set out in the NER.¹⁹

We intend to run the consultation processes for each of the guidelines together so that we can ensure consistency between the guidelines and reduce the burden on stakeholders having to make separate submissions. We also intend to run a three-stage consultation process thereby satisfying the minimum requirements of the NER consultation procedures applicable for amending the Guidelines in this review.

3.2 Timeline of consultation process

This consultation paper is the first step of our consultation process.

As noted above, the AEMC’s MCC rule determination specifies the rules commencement date of 9 October 2023 which requires that the AER amend relevant guidelines by the commencement date. However, we also intend to consult on the early works recommendation to provide guidance in early works (identified in Section 3.2) of the AEMC’s TPI Review stage 2 final report to capture stakeholder feedback in the same process.

As set out below, we intend to complete the Guideline Review process in a manner which accommodates the different NER consultation procedures as discussed in section 3.1 within a single, streamlined process.

Table 2 summarises the main project steps and proposed dates for this consultation process.

Table 2: Indicative project timeline

Project step	Expected date
Consultation Paper published (Stage 1 of the Rules Consultation Procedure, and voluntary step for the Transmission/Distribution Consultation procedures)	18 May 2023
Submissions close	19 June 2023
Draft Guidelines published (Stage 2 of the Rules Consultation Procedure and Stage 1 of the Transmission/Distribution Consultation Procedures)	24 July 2023
Public Forum	August 2023
Submissions close	4 September 2023
Final Guidelines published (Stage 3 of the Rules Consultation Procedure and Stage 2 of the Transmission/Distribution Consultation Procedures)	9 October 2023

¹⁸ NER, clauses 6.16(d) and 6A.20(d).

¹⁹ NER cl. 8.9.2 for Rules Consultation Procedures, NER Part H of Chapter 6A for Transmission consultation procedures and NER Part G of Chapter 6 for distribution consultation procedures

3.3 Summary of questions

This consultation paper forms an important part of our guideline development process. To help encourage input, we have included questions, along with some of our initial views, throughout this paper. For convenience, we have also included these questions below.

Question	Section reference
Do stakeholders agree with our proposed non-prescriptive approach to guidance on re-opening triggers (including worked examples, where required)?	4.1
Are there any other factors/principles other than those identified that RIT proponents should consider in setting out reopening triggers?	4.1
Do stakeholders agree that it is desirable to adopt a consistent cost estimate classification system in the RIT-T and RIT-D application guidelines?	4.2
Do stakeholders have views on whether the application of an acceptable cost estimate classification should be a binding obligation on RIT proponents in applying the RIT?	4.2
Should a binding obligation be imposed on RIT-T (non-actionable ISP projects) and RIT-D proponents to conduct sensitivity analysis on the estimated costs of credible options in the RIT application guidelines?	4.2
Is there a need for transparency in the RIT regarding the relationship between contingencies to account for cost uncertainty and the level of cost accuracy of credible options?	4.2
Do stakeholders agree with our proposed approach to guidance to increase the transparency of the cost estimates of credible options? For example, by requiring RIT proponents to set out their cost estimation methodology, including key inputs and assumptions that are material in the cost estimation of credible options.	4.3
Do stakeholders agree with our proposed approach to guidance that balances prescription of the activities included in the scope of early works with the flexibility for RIT-T proponents to include activities consistent with the AEMC's definition of early works?	5.1
Are there activities that should be included in the scope of the early works that are consistent with the AEMC's definition of early works?	5.1

3.4 Invitation for submissions

We invite submissions by the close of business **19 June 2023**. We prefer stakeholders send submissions electronically to: AERpolicy@aer.gov.au.

Alternatively, stakeholders can mail submissions to:

Mr Gavin Fox
(A/g) General Manager, Market Performance
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

We prefer all submissions be publicly available to facilitate an informed and transparent consultation process. We will therefore treat submissions as public documents unless otherwise requested.

We request parties wishing to submit confidential information to:

- clearly identify the information that is subject of the confidentiality claim, and reasons for the confidentiality claim
- provide a non-confidential version of the submission, in addition to a confidential one.

We will place all non-confidential submissions on our website at www.aer.gov.au. For further information regarding our use and disclosure of information provided to us, see the *ACCC/AER Information Policy*, June 2014 available on our website.

Please direct enquiries about this paper to AERpolicy@aer.gov.au.

4 Proposed amendments to the RIT application guidelines

We are required to amend the RIT-T application guidelines for actionable ISP projects, the RIT-T application guidelines and the RIT-D application guidelines. These amendments are required under rules 11.154.3 (a)(1), (a)(2) and (a)(3) of the NER, respectively.

4.1 RIT reopening triggers

4.1.1 The issue

The AEMC determined that RIT proponents (for both transmission and distribution projects) with estimated costs of a credible option above \$100 million, are required to incorporate reopening triggers in their RIT assessments to identify whether there has been a material change in circumstance, including a change to the identified investment need. Specifically, the AEMC's final determination on the *Material change in network infrastructure costs* rule change states that the objective of the reopening triggers is to help the RIT proponent determine whether there has been a material change in circumstances between the final RIT report and the contingent project application.²⁰ It notes that:²¹

There is currently no consultation process for the final RIT report, and adding such an additional step risks adding time to the RIT process with the benefit of additional consultation unclear. The objective of the reopening triggers is to help the RIT proponent determine whether there has been an MCC [material change in circumstances] between the final RIT report and the CPA [contingent project application]. This implies that the reopening triggers should be fixed by the final RIT report stage and should account for any change in the preferred options between the draft and final RIT report.

In addition, the AEMC states that current the material change in circumstances provisions in the NER are unlikely to be fit-for-purpose mainly because:²²

- a 'material change in circumstances' is not clearly defined in the NER; and
- these provisions confer discretion on the RIT proponent to form a view as to any material change in circumstances without any guidance.

The final rule does not require AEMO to develop reopening triggers where it is the sole RIT-T proponent. However, for any interconnector projects where AEMO and another transmission network service provider (TNSP) are joint proponents, reopening triggers must be included in the RIT. This means that, for any interconnector projects where AEMO and another TNSP are joint proponents, reopening triggers must be developed.²³

In particular, the *Material change in network infrastructure costs* rule requires:

- RIT proponents to develop reopening triggers to help them determine whether the preferred option may no longer be the most net beneficial option

²⁰ AEMC, *Material change in network infrastructure project costs - Final Determination*, section 4.2, October 2022

²¹ *Ibid*, section 2.4.2

²² *Ibid*, section 2.4.1

²³ *Ibid*, section 4.4.3

- RIT proponents to outline these reopening triggers in the Project Assessment Draft Reports for RIT-Ts/Draft Project Assessment Report for RIT-Ds (as is applicable) for consultation
- RIT proponents to consider whether any re-opening triggers have been triggered; and
- the AER to update the RIT application and CBA guidelines to provide guidance to RIT proponents in relation to developing reopening triggers.²⁴

4.1.2 Preliminary view and proposed changes to the guidelines

We propose to provide non-prescriptive guidance (including worked examples) around the requirement for RIT proponents to set out reopening triggers in their RIT reports. We consider that our proposed approach:

- meets the intent of the *Material change in network infrastructure costs* rule
- recognises the dynamic nature of the market in which proponents are conducting cost benefit analysis; and
- places an appropriate and high onus on the transparency of proponent assumptions and decision rules.

We also consider this guidance would encourage RIT proponents to:

- be transparent regarding the changes in circumstances related to key variables in their cost benefit analysis in RITs assessments
- undertake robust scenario and sensitivity analyses where they should be identifying 'boundary values' for important input assumptions at which the preferred option changes; and
- effectively engage with stakeholders at the draft RIT stages by clearly identifying circumstances under which the preferred option may change following RIT assessments.

We consider that changes in circumstances that may change the preferred option may in some cases depend on the interaction of specific market developments that affect the conclusions in a RIT-T. Consequently, in developing reopening triggers, RIT proponents should identify and test the boundary values of related key variables taken together that:

- affect the sign of the net economic benefits; and
- ranking of credible options.

This means that our proposed approach to guidance is not likely to be prescriptive given changes in circumstances that may change the preferred option will vary significantly in RITs.

²⁴ This affects both the RIT-T application guidelines for actionable ISP projects and non-actionable ISP projects and the RIT-D application guidelines.

Questions:

Do stakeholders agree with our proposed non-prescriptive approach to guidance of reopening triggers (including worked examples, where required)?

Are there any other factors/principles other than those identified above that RIT proponents should consider in setting out re-opening triggers?

4.2 Cost estimation in RITs

The *Material change in network infrastructure costs* rule has clarified that the AER can provide guidance in relation to any acceptable cost estimate classification systems that should be used for the RIT, and any role for contingency allowances.

We may also amend the RIT-T application guidelines (for non-actionable projects) and the RIT-D application guidelines to make relevant aspects of these guidelines a binding requirement on RIT proponents, in the same ways the rules provide for the CBA guidelines. This addresses any concern that the guidelines are not binding on RIT proponents.

4.2.1 The issue

The AEMC in its *Material change in network infrastructure costs* rule change determined that:²⁵

- the AER can provide guidance on any acceptable cost estimate classification systems that should be used for the RIT and any role for contingency allowances; and
- the AER can specify which parts of the RIT-T and RIT-D guidelines are binding on RIT-T proponents.

The AEMC also recommended that the AER generally consider how the guidelines governing RITs could be strengthened to promote the development of more robust cost estimates.

4.2.2 Preliminary view and proposed approach to guidance

Cost estimate classification systems

The AEMC's final determination clarified that the AER may consider whether to amend the Guidelines to:

- provide guidance on any acceptable cost estimate classification systems for the purposes of cost accuracy levels to be used in the RIT-T; and
- to consider whether any guidance should be binding on RIT proponents in applying the RIT-T.²⁶

²⁵ AEMC, *Material change in network infrastructure project costs - Final Determination*, section 5.5, October 2022

²⁶ *Ibid*, section 5.1

The AEMC refers to the Association for the Advancement of Cost Engineering (AACE) international cost estimate classification system that applies general principles to classify cost estimates.²⁷ This system has been used by AEMO in its Transmission Cost Database for the purposes of classifying the cost accuracy of future ISP projects and to cross check the level of accuracy of TNSP project cost estimates for the purposes of the ISP.²⁸ The use of the AACE to inform the level of the accuracy of cost estimates has also been applied by some RIT-T proponents in the application of the RIT-T²⁹. We consider the AACE provides a useful and consistent approach to informing stakeholders on the expected accuracy of project cost estimates.³⁰

The AACE cost estimate classification system states that the 'estimate class' is based upon the maturity level of the project based on the status of specific key planning and design deliverables.³¹ We understand that at the project planning stage, the level of expected cost accuracy may differ depending on the nature of the project (e.g., a greenfield network augmentation project may be subject to greater cost uncertainty than a 'business as usual' project). As such we do not propose to include guidance on a specific accuracy class within the AACE to be used in a RIT.

We are interested in stakeholder views as to whether a consistent cost estimate classification system should be adopted in the CBA (specifically RIT-T for actionable projects), RIT-T (non-actionable projects) and RIT-D application guidelines to inform stakeholders of the expected level of accuracy of cost estimates. We would also welcome views on whether there are any other widely accepted cost estimate classification systems that could be used in the RIT.

Role of sensitivity analysis in the RIT-T

The role of sensitivity testing is also important to understand to identify the impact of cost uncertainty on the robustness of the RIT outcomes. The RIT application guidelines currently encourage RIT proponents to conduct sensitivity analysis and illustrate the boundary values for input assumptions at which the preferred option would change. For actionable RIT-Ts, however, RIT-T proponents *must consider* performing sensitivity testing by varying one or multiple inputs/assumptions.³² To ensure a more consistent approach between the CBA Guidelines and the RIT-T and RIT-D application guidelines, we are interested on stakeholder views as to whether a binding obligation on RIT-T and RIT-D proponents to conduct sensitivity analysis on the estimated costs of credible options, should be included in the RIT application guidelines.

²⁷ AEMC, Material change in network infrastructure project costs - Final Determination, section 5.1, October 2022

²⁸ <https://aemo.com.au/en/consultations/current-and-closed-consultations/transmission-costs-for-the-2022-integrated-system-plan>

²⁹ For example, Transgrid used AACE based cost estimates in its Humelink RIT-T completed in July 2021.

³⁰ AER, Guidance Note for the regulation of actionable ISP projects, 2021

³¹ AACE, 56R-08: Cost Estimate Classification System, Determination of the cost estimate class, August 2020, p.5

³² AER, CBA guidelines, August 2020, p. 68

Role of contingency allowances

In its final rule determination, the AEMC clarified the rules to enable the AER to consider whether to provide guidance on the role of contingency allowances in the estimation of RIT project costs.³³

In general, contingency allowances in cost estimates have been used to account for project cost uncertainties. In March 2021, we developed and published a guidance note to improve the predictability and transparency of how we will assess the costs of large transmission projects, identified as 'actionable' in AEMO's Integrated System Plans (ISPs).³⁴ This note provided guidance on how we expect transmission businesses to include and test contingency allowances as part of the contingent project process.

Although our guidance note mainly related to how we will assess costs in contingent project processes for large transmission projects, we consider that some of the guidance may also be useful for all RIT proponents when undertaking RITs, where an explicit contingency allowance is included in the estimated costs of a credible option. This guidance, amongst other things, expects Network Service Providers (transmission and distribution) to transparently identify and assess different project risks, for which the Network Service Provider is seeking a cost allowance.

We are interested in stakeholder views on the use of contingency allowances in RIT processes and the need for guidance to encourage transparency on the relationship between cost contingencies to account for cost uncertainty and the level of cost accuracy of credible options.

Questions

Is it desirable to adopt a consistent cost estimate classification system in the RIT-T and RIT-D application guidelines?

Do stakeholders have views on whether the application of an acceptable cost estimate classification should be a binding obligation on RIT proponents in applying the RIT?

Should a binding obligation be imposed on RIT-T (non-actionable ISP projects) and RIT-D proponents to conduct sensitivity analysis on the estimated costs of credible options in the RIT application guidelines?

Is there a need for transparency in the RIT regarding the relationship between contingencies to account for cost uncertainty and the level of cost accuracy of credible options?

³³ AEMC, Material change in network infrastructure project costs - Final Determination, section 5.2.1, October 2022

³⁴ In the RIT context, costs refer to the present value of the direct costs of constructing and providing a credible option.

4.3 Improved cost estimation transparency

4.3.1 The issue

The AEMC's final determination also recommended that the AER consider how the guidelines governing RITs could be strengthened to promote the development of more robust cost estimates.³⁵ In considering whether the RIT application guidelines could be further strengthened, we recognise that the RITs provide limited transparency regarding the basis for the derivation of estimated costs of credible options. In particular, the RIT-T and RIT-D application guidelines, and CBA guidelines (which apply to actionable ISP projects) provide limited guidance on how cost estimates should be developed and applied in the RIT.

The RIT application guidelines set out the NER requirements on RIT proponents to quantify the estimated cost for each credible option. In relation to the RIT-D and the RIT-T, the following classes of costs are used within the NER and the instruments:³⁶

- (direct) costs in constructing and providing the credible option
- operating and maintenance costs over the operating life of the credible option
- cost of complying with laws, regulations and applicable administrative requirements in relation to the construction and operation of the credible option
- any other costs determined to be relevant by the AER.

However, there is limited transparency in the RIT's regarding the material cost inputs and assumptions used to derive the estimated costs for each class of costs for each credible option (e.g., the inputs and assumptions used to determine land related costs included in cost estimates). Improved transparency regarding the derivation of the estimated costs of credible options should enable stakeholders to better scrutinise these estimates and better engage with the RIT proponent on the robustness of estimated costs.

4.3.2 Preliminary view and proposed approach to guidance

We are interested in stakeholder views on the usefulness of providing additional guidance to encourage RIT proponents to be transparent in the RIT regarding material cost inputs and assumptions within each class of estimated project costs.

Questions

Do stakeholders agree with our proposed approach to guidance to increase the transparency of the cost estimates of credible options? For example, by requiring RIT proponents to set out their cost estimation methodology, including key inputs and assumptions that are material in the cost estimation of credible options.

³⁵ AEMC, Material change in network infrastructure project costs - Final Determination, section 1.1, October 2022

³⁶ NER, cl. 5.17(c)(6) and RIT-T instrument, paragraph 5

4.4 Early works

We have decided to consult on the AEMC's TPI stage 2 report recommendations in relation to 'early works' that involve activities in advance of a transmission business constructing a project.

The AEMC's recommendations for guidance on early works are relevant to the RIT-T applications guidelines for actionable ISP projects housed in the CBA guidelines only.

4.4.1 The issue

In its stage 2 report, the AEMC recommended that the AER provide additional guidance to stakeholders in the CBA guidelines for actionable ISP projects regarding the term 'early works' and the activities it encompasses.

The term 'early works' is not currently defined or explicitly referred to in the NER. The AEMC defined the term early works as:³⁷

...activities that are completed prior to the construction of the preferred option, to improve the accuracy of cost estimates, and/or to ensure that a project can be delivered within the time frames specified by the most recent ISP.

This definition of early works used by the AEMC does not prescribe the suite of relevant activities which would be considered within scope of early works. While this provides discretion to RIT-T proponents of actionable projects to determine these activities, this also introduces some uncertainty as to the relevant activities covered by early works, prior to project construction.

Further, the AEMC's TPI stage 3 report proposes that early works be defined in the NER to reflect the objectives of early works. The AEMC recommends amending the regulatory framework to encourage more extensive planning activities by TNSPs earlier in the economic assessment process to mitigate the risks of later cost project increases and project delay due to later consideration of the relevant planning activities.³⁸ This Guideline Review will not consult on the AEMC's stage 3 report recommendation that the rules be amended to:³⁹

- enable TNSPs to submit an early works contingent project application without the need to complete a RIT-T and pass the ISP feedback loop to provide TNSPs with cost recovery certainty and an incentive to undertake early works activities concurrently with the RIT-T process
- introduce a NER definition of early works to underpin the AER's assessment of an early works contingent project application to protect consumers against inefficient expenditure.

In the event that early works can be conducted concurrently with the RIT-T process, this should strengthen the robustness of project costs estimates for credible options. As stated in our Guidance Note on the regulation of large transmission projects, the objective of early

³⁷ AER, Guidance Note, Regulation of large transmission projects, March 2021, p.26.

³⁸ AEMC, TPI Review, stage 3 report, May 2023, p.7

³⁹ AEMC, TPI Review, stage 3 report, May 2023, pp.7-8

works activities is to help manage cost uncertainty in the delivery of major transmission investments.⁴⁰ In particular, our Guidance Note stated:⁴¹

There is evidence of the benefits of good planning and design work for large infrastructure projects. Investing time in the planning and design phase can help identify and quantify project risks, and enable innovative and cost effective design. This leads to more reliable cost estimates and expenditure forecasts...

The AEMC in its stage 3 report also recommends that the AER provide further guidance on the cost recovery of these costs in terms of activities to be included in a separate guidance on contingent project application for early works.

4.4.2 Preliminary view and proposed approach to guidance

We are interested in stakeholder views on the scope of early works activities that should be included in guidance consistent with the AEMC's definition of early works. We consider that guidance on this may need to balance the prescription of early works activities to provide clarity with the flexibility for RIT proponents to determine which activities are consistent with the definition of early works on a project basis.

Questions

Do stakeholders agree with our proposed approach to guidance that balances prescription of the activities included in the scope of early works with the flexibility for RIT-T proponents to include activities consistent with the AEMC's definition of early works?

Are there specific activities that should be included in the scope of early works activities that are consistent with the AEMC's definition of early works?

⁴⁰ AER, Guidance Note - Regulation of actionable ISP projects, March 2021

⁴¹ *ibid*, p. 26

5 Next steps

5.1 Indicative process

This consultation paper is the first step of our consultation process to update the Guidelines. As discussed in this paper, the AEMC's *Material change in network infrastructure costs* rule specifies the commencement date of 9 October 2023 for completing amendments to the RIT application guidelines. However, we also intend to consult on guidance to improve clarity regarding early works activities in advance of project construction arising from the recommendations of AEMC's TPI stage 2 final report in this process.

Table 3 summarises the main project steps and indicative dates for this consultation process.

Table 3: Indicative project timeline

Project step	Expected date
Consultation Paper published	18 May 2023
Submissions close	19 June 2023
Draft Guidelines published	24 July 2023
Public Forum	August 2023
Submissions close	4 September 2023
Final Guidelines published	9 October 2023

5.2 Invitation for submissions

We are seeking submissions on the amendments to the Guidelines under review, including those that arise from the *Material change in network infrastructure costs* rule change and the AEMC's recommendations. This is the first formal step in the process for amending the CBA Guidelines which house the RIT-T application guidelines for actionable ISP projects in accordance with the rules consultation procedure, and an extra step we have incorporated as part of amending the other Guidelines.

We are seeking submissions by 19 June 2023. Submissions received will inform our draft RIT application guideline amendments, including where relevant, any amendments to the RIT-T and the RIT-D instruments.

Appendix A: Abbreviations

This appendix provides the extended form of key abbreviations used in this issues paper.

Abbreviations

Shortened Form	Extended Form
AACE	Association for the Advancement of Cost Engineering
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
CBA	cost benefit analysis
ISP	Integrated System Plan
MCC	Material change in network infrastructure project costs
NER	National Electricity Rules
RIT-D	regulatory investment test for distribution
RIT-T	regulatory investment test for transmission
TNSP	transmission network service provider
TPI	Transmission Planning Investment