Draft determination

Cost thresholds review

September 2018

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1 Request for submissions

Clause 5.15.3 of the National Electricity Rules (NER) outlines the consultation process we must follow when reviewing certain cost thresholds that apply to the regulatory investment tests (RITs) and annual planning reports (APRs). Consistent with those requirements, we invite interested parties to review the matters raised in this draft determination and provide written submissions within no less than five weeks of when we publish this draft determination.

We are requesting written submissions by the close of business on **16 October 2018**. We prefer stakeholders send submissions electronically to: RIT@aer.gov.au

Alternatively, stakeholders can mail submissions to:

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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
- 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.

Please direct enquiries about this paper to RIT@aer.gov.au or to Lisa Beckmann on (02) 6243 1379.

2 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, the NER require us to adjust a specific set of cost thresholds, as set out in clause 5.15.3. This adjustment aims to reflect changes in input costs so the cost thresholds in the NER remain appropriate. On 31 July 2018, in accordance with clause 5.15.3 of the NER, we initiated a review of the cost thresholds associated with the RITs and APRs (2018 cost thresholds review). Consistent with the requirements of clause 5.15.3(g), this document sets out our draft determination on the 2018 cost thresholds review. We propose that the revised cost thresholds set out in this review take effect on 1 January 2019.

The majority of the cost thresholds under NER clause 5.15.3 relate to the regulatory investment test for transmission and distribution (the RIT–T and RIT–D, or collectively 'the RITs'). The RITs are cost benefit tests that network service providers (network businesses) must apply before making major investments in the network. 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. The RITs only apply to investments that are above certain cost thresholds. We are considering those cost thresholds as part of this review.

Other cost thresholds under NER clause 5.15.3 relate to the transmission and distribution annual planning reports (the TAPRs and DAPRs, or collectively 'the APRs'). An APR highlights opportunities and limitations in parts of a specific network for which the network business is responsible, as well as forecasting possible developments over the minimum planning period (five years for distribution and 10 years for transmission). APRs allow network businesses to aggregate the asset replacement costs they must report on for assets under a certain cost threshold. Moreover, distribution network service providers (distribution businesses) only need to report on committed investments to meet an urgent and unforeseen issue in their DAPRs if those investments are over a certain cost threshold.

3 Background

This section provides background on:

- the NER requirements underpinning this review; and
- the cost threshold review in 2015.

3.1 NER requirements

NER clause 5.15.3(a) requires we undertake a cost threshold review every three years. This clause specifies that we are to review changes in input costs for estimating capital costs, so that we can determine whether to adjust the cost thresholds to reflect any changes in input costs. The purpose of this is to ensure the cost thresholds specified in NER clauses 5.15.3(b) and (d) remain appropriate over time.

NER clauses 5.15(e) to (k) prescribe how we will run this cost threshold review. This entails:

- Commencing a review every three years by 31 July of the relevant year;
- Within six weeks of commencement, publishing a draft determination and a notice seeking submissions for a specified period of not less than five weeks. The draft determination must outline:
    - whether we consider any of the cost thresholds need to be amended to reflect changes in the input costs to ensure that the appropriateness of the cost thresholds is maintained over time;
    - our reasons for determining whether the cost thresholds need to be varied to reflect changes in the input costs;
    - 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
    - our reasons for determining the amount of the new cost threshold.
- Considering any written submissions received during the submission period in making a final determination within five weeks after the submission period.

3.2 Previous cost thresholds review

In 2012, we undertook our first cost thresholds review. This entailed reviewing cost thresholds that applied to the RIT–T exclusively, since the RIT–D and provisions to report on asset retirements in the APRs were yet to be introduced in the NER. In 2015, we undertook the first cost thresholds review for the RIT–D and the second cost thresholds review for the RIT–T.

For these reviews, our assessment approach entailed:

1. Examining changes in several indexes, including several:

- Measures of the consumer price index (CPI).
- Producer price indexes (PPIs). This included broader measures, such as the total PPI for imports and domestic production. This also included examining PPIs that would measure types of inputs that network businesses would use, such as the PPI for primary metal and metal product manufacturing, fabricated metal product manufacturing, and machinery and equipment manufacturing.
- Gross domestic product (GDP) implicit price deflators.

2. Using the changes in these indexes to ascertain the range of cost variations and use our regulatory judgement to make a determination on the change in input costs.
3. In applying our judgement, giving greater consideration to broader economy wide indexes as opposed to industry-specific indexes. This was on the basis that broader economy wide indexes:
    - are better 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.

We favoured this approach over a more full scale review of precise changes in transmission and distribution network project costs given the regulatory burden it would impose on both network businesses and us. For administrative simplicity, we rounded changes to the nearest million. We also rounded down where the increase in input costs resulted in a pre-rounded variation figure of approximately halfway between two rounded figures (for example, $1.5 million would be rounded down to $1 million).

Table 1 summarises how the different cost thresholds have changed over time with the cost threshold reviews in 2012 and 2015, leading to changes taking effect in 2013 and 2016 respectively.

Table 1: Cost threshold values over time ($ million)

Cost threshold	2010	2013	2016
The $5 million threshold under NER cl. 5.15.3(b)(2),(4),(6) for capital costs, over which a RIT–T applies.	5	5	6
The $35 million threshold under NER cl. 5.15.3(b)(5) for the proposed preferred option's capital costs, under which a RIT–T proponent can skip the 'project assessment draft report' consultation step.	35	38	41
The $5 million threshold for capital costs under NER cl. 5.15.3(d)(1), over which a RIT–D applies.	N/A*	5	5

The $10 million threshold under NER cl. 5.15.3(d)(3) for the proposed preferred option's capital costs, under which a RIT–D proponent can skip the 'draft project assessment report' consultation step.	N/A*	10	10
The $20 million threshold under NER cl. 5.15.3(d)(4) for the estimated preferred option's capital costs, over which a RIT–D proponent includes its 'final project assessment report' as part of its DAPR.	N/A*	20	21
The $2 million estimated capital cost threshold under NER cl. 5.15.3(d)(5), over which committed investments to address an urgent and unforeseen network issue must be included in the DAPR.	N/A*	2	2

* The predecessor of the RIT–D, the regulatory test, was in effect in 2010. The RIT–D came into effect in 2013.

Table 1 does not include the $200,000 threshold for an asset's replacement costs, under which network businesses can combine the information in its APRs for assets they expect to retire or de-rate.[1] This cost threshold was introduced following the repex rule change in 2017.

1 That is NER clauses 5.15.3(b)(1A) and 5.15.3(d)(4A).

4 Draft determination

We are taking the same approach to the variation of cost thresholds that was done in the 2015 cost thresholds review. That is, our approach involves reviewing the cost inputs and rounding any changes to the cost threshold to the nearest million, unless it was inappropriate to do (for example, we will round any changes to the $200,000 cost threshold to the nearest $100,000). Where the increase in input costs results in a pre-rounded variation figure approximately halfway between two rounded figures (for example, $1.5 million), then we would round the cost threshold down rather than up.

Consistent with the requirements of clause 5.15.3(g), this section sets out our draft determination on the 2018 cost thresholds. In making this draft determination, we have:

1. Measured changes in the range of indexes we considered previously in our 2015 cost threshold review from:
    - 17 July 2017 to June 2018, for the two $200,000 cost thresholds that were introduced with the repex rule change, which came into effect on 17 July 2017.
    - June 2015 to June 2018, for all other cost thresholds in this review, which were last reviewed in our 2015 cost threshold review (which measured changes in input costs up until 30 June 2015).[2]
2. Consistent with our approach in 2015, had regard to the range of changes, but placed a greater weight on economy-wide indexes in exercising out judgement. We have also applied a percentage change that is rounded to the nearest percentage point. This is:
    - 2.0% over the 17 July 2017 to June 2018 period; and
    - 6.0% over the June 2015 to June 2018 period.
3. Applied these percentage changes to:
    - In the case of the 2.0% change, the $200,000 cost threshold set out in the NER. We then round this to the nearest $100,000, and consistent with our 2015 cost threshold determination, would make the decision to round it down if the figure fell halfway.
    - In the case of the 6.0% change, the unrounded cost threshold figures from our 2015 determination.[3] We would then round these figures afterwards to

2 This is with exception to our use of GDP price deflators. Consistent with our previous reviews, we have measured changes in these indexes from the end of March quarter rather than the end of June quarter. We use the March measurement because this has always been the most up-to-date measurement we have available when performing this review.

3 This is consistent with the approach we said we would apply to this review when we made our cost threshold determination in 2015. For completeness, the unrounded figures we escalated by 6% in this draft determination include: $5.25m for NER cl 5.5.3(d)(1), $10.5m for NER cl. 5.15.3(d)(3), $21m for NER cl 5.15.3(d)(4), $2.1m for NER 5.15.3(d)(5), $5.83m for NER cl. 5.15.3(b)(2),(4),(6), and $40.81m for NER cl. 5.15.3(b)(1A).

the nearest million, and consistent with our 2015 cost threshold determination, would make the decision to round down any figure that fell halfway.

Table 2 sets out our draft determination on the cost thresholds for transmission network service providers (transmission businesses) as a result of this process.

Table 2: Draft determination — Transmission cost threshold amendments

Cost threshold in the NER	Current value ($m)	Escalator applied (%)	Proposed value ($m)
The $200,000 threshold under NER cl. 5.15.3(b)(1A) for an asset's replacement costs, under which a transmission business can combine the information in its TAPR for assets it expects to retire or de-rate.	0.2	2	0.2
The $5 million threshold NER cl. 5.15.3(b)(2),(4),(6) for capital costs, over which a RIT–T applies.	6	6	6
The $35 million threshold NER cl. 5.15.3(b)(5) for the proposed preferred option's capital costs, under which a RIT–T proponent can skip the 'project assessment draft report' consultation step.	41	6	43

Table 3 sets out our draft determination on the cost thresholds for distribution businesses.

Table 3: Draft determination — Distribution cost threshold amendments

Cost threshold	Current value ($m)	Escalator applied (%)	Proposed value ($m)
The $5 million threshold NER cl. 5.15.3(d)(1) for capital costs, over which a RIT–D applies	5	6	6
The $10 million threshold NER cl. 5.15.3(d)(3) for the proposed preferred option's capital costs, under which a RIT–D proponent can skip the 'draft project assessment report' consultation step	10	6	11
The $20 million threshold NER cl. 5.15.3(d)(4) for the estimated preferred option's capital costs, over which a RIT–D proponent includes its final project assessment report' as part of its DAPR.	21	6	22

The $200,000 threshold NER cl. 5.15.3(d)(4A for an asset's replacement costs, under which a distribution business can combine the information in its DAPR for assets it expects to retire or de-rate.	0.2	2	0.2
The $2 million estimated capital cost threshold NER cl. 5.15.3(d)(5), over which committed investments to address an urgent and unforeseen network issue must be included in the DAPR.	2	6	2

We propose that the revised cost thresholds take effect on 1 January 2019.

4.1 Changes in input costs

We have taken a consistent approach in line with the 2015 cost thresholds review to assess whether there has been a change in input costs for both the RIT and APR cost thresholds (see section 3.2 for a description of our previous approach). Further, changes in capital input costs for transmission and distribution should be sufficiently similar such that the same indexes can be used for both transmission and distribution 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:

- 17 July 2017, when the new cost thresholds under the repex rule change came into effect. Since the Australian Bureau of Statistics updates the majority of indexes we have considered quarterly, we have applied linear interpolation to approximate input cost changes since 17 July 2017.
- 30 June 2015, which was the period we measured input cost changes up to in our last cost threshold review.[4]

Consistent with the 2015 cost thresholds review, greater reliance will be given to economy-wide indexes. Table 4 below sets out the indexes we have considered and the percentage change of those indexes since the 2015 cost thresholds review and since the 2017 repex rule change. The indexes considered are consistent with the indexes considered in the 2015 cost thresholds review.

We have had limited regard to the industry-specific PPI indexes and GDP deflators in Table 4 on the basis that these indexes are more volatile and less widely used and

4 This is with exception to our use of GDP price deflators. Consistent with our previous reviews, we have measured changes in these indexes from the end of March quarter rather than the end of June quarter. We use the March measurement because this has always been the most up-to-date measurement we have available when performing this review.

understood, without necessarily better reflecting the input costs of the network businesses.[5] However, we have included these measures as a cross check on the reasonableness of the broader economy-wide indexes. These indexes indicate that more specific cost input price changes fall both above and below the average of the economy-wide indexes.

Further, we have more regard to economy-wide indexes over industry indexes because broader indexes:

- are better measures of overall price movements across the entire economy;
- are commonly used and understood, including in how we account for inflation in setting regulated revenues (which entails using CPI);
- in the absence of precise measures, provide a reasonable proxy for changes in input costs.

Table 4: Changes to indexes considered in draft determination (%, rounded)

Index	Change since June 2015	Change since 18 July 2017
Consumer price index (CPI)	5.1	1.7
CPI - trimmed mean	5.4	1.6
CPI - weighted mean	5.3	1.7
Producer Price Index (PPI) - total domestic and import	4.3	1.4
PPI - primary metal and metal product manufacturing	15.3	8.7
PPI - fabricated metal product manufacturing	11.9	6.6
PPI - machinery and equipment manufacturing	3.3	0.6
Gross Domestic Product (GDP) - implicit price deflator	6.1	1.7
GDP - chain price index	6.0	1.0
GDP - implicit price deflator - fixed capital formation	3.3	0.7

5 In general, there is not a direct relationship between costs of materials and input costs that network businesses incur. We consider that there is a great deal of uncertainty where movements in producer price indexes of raw materials do not necessarily imply a movement of the same magnitude in the costs of inputs that the network businesses incur such as cables and transformers.

GDP - implicit price deflator - final consumption	3.3	0.9
GDP - implicit price deflator - private fixed capital formation - new engineering construction	3.7	1.3
AER draft decision: Proposed cost escalator	**6.0**	**2.0**

Source: ABS.[6]

Overall, we consider 6.0% and 2.0% to be reasonable estimates of the change in input costs since June 2015 and July 2017, respectively. We formed this view having considered the following factors:

- The average of the different CPI measures (headline, trimmed mean and weighted mean) and the economy-wide GDP deflators (the implicit price deflator and chain price index) are 5.6% and 1.7% since June 2015 and July 2017, respectively. When rounded to the nearest percentage point, this supports escalating the cost thresholds by 6.0% and 2.0% since June 2015 and July 2017, respectively.
- The industry-specific PPI indexes and GDP deflators in Table 4 do not suggest the economy-wide measures are unreasonable for forming a view on input cost changes for the capital costs of network investment. These indicators are not clearly lower or greater than the economy wide measures, but rather fall on either side. This is not indicative of a material and systematic difference between input cost changes for network investment and price changes in the broader economy, suggesting that our use of economy-wide measures is reasonable.

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6 ABS Consumer Price Index Australia, March 2018, catalogue number 6401.0; Producer Price Index Australia, March 2018, catalogue number 6427.0; Australian National Income, Expenditure and Product, March 2018, catalogue number 5206.0.