

# Regulatory Investment Test for Distribution (RIT-D)

Response to AER Issues Paper

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## 1. Introduction and Summary

Grid Australia is pleased to make this submission to the AER in relation to its Issues Paper on the Regulatory Investment Test for Distribution (RIT-D).

As noted by the AER in its Issues Paper, the new RIT-D provisions in the Rules are closely modelled on the existing Regulatory Investment Test for Transmission (RIT-T) provisions. As a consequence, several of the AER's observations and comments in relation to the RIT-D are also relevant in the context of the RIT-T.

In addition, Grid Australia members' experience with the RIT-T has highlighted a number of practical issues, particularly in relation to the process to be followed, where it would be beneficial for the AER to provide further guidance.

This submission covers the following key points:

- Cost estimates for options considered under the RIT-T (and RIT-D) regulatory investment tests are in many cases high-level estimates primarily used to rank options. The AER should be mindful of the accuracy of the estimates upon which the regulatory investment test was conducted, when undertaking any *ex-post* assessment.
- Grid Australia supports the removal of the need to conduct the RIT-D analysis by comparison with a 'do nothing' base case for reliability-driven augmentations, on the basis that it avoids unnecessary analysis. A similar outcome could be achieved for the RIT-T through a revision in the AER's RIT-T Guidelines.
- There are a number of areas in relation to the process to be followed for both the RIT-D and RIT-T which would benefit from further guidance by the AER.
- The benefits associated with improved demand management not captured by the categories of market benefits explicitly included in the National Electricity Rules (NER) for the RIT-D are reductions in wholesale dispatch costs and ancillary services requirements. It would be preferable to retain the same terminology across the RIT-T and RIT-D, rather than introducing a new category of market benefit for the RIT-D.

Grid Australia also notes that TNSPs have built up a body of practical experience in relation to undertaking the RIT-T. Grid Australia's RIT-T Cost Benefit Handbook<sup>1</sup> was developed as a 'practitioners guide', and sets out approaches to calculating market benefits which do not require dispatch modelling, and which can be applied to demand management and other non - network options. Grid Australia would be happy to discuss further TNSPs' experience in relation to the RIT-T with the AER.

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<sup>1</sup> Grid Australia, RIT-T Cost Benefit Analysis, November 2011. Available at [http://gridaustralia.com.au/index.php?option=com\\_content&view=category&layout=blog&id=129&Itemid=246](http://gridaustralia.com.au/index.php?option=com_content&view=category&layout=blog&id=129&Itemid=246).

## 2. Use of the RIT-D in the revenue determination process

The AER comments in its Issues Paper that as part of its capex incentive scheme considerations, it may take into account RIT-D assessments during the revenue determination process.

‘For instance, we may, under the new ex-post review provisions of the rules, review RIT-Ds undertaken by the DNSP for network projects undertaken in the regulatory control period. The outcome of such review may have a bearing on the capital expenditure (capex) during the re-set process.’<sup>2</sup>

Grid Australia considers that the AER should clarify this statement in developing its RIT-D Guidelines. In particular, Grid Australia would have concerns if the AER’s intention was to routinely adopt the capital expenditure estimates used in the RIT-D or RIT-T assessments, as the starting point for any later *ex-post* review.

As recognised by the AER, the RIT-D (and RIT-T) takes place before investment decisions are made.<sup>3</sup> The capital expenditure estimates available at the time of the assessment are therefore necessarily still relatively high-level estimates, typically within a 30% tolerance band (although this differs between TNSPs and specific RIT-T applications). Subsequent to completion of the investment test, once a preferred option has been identified more detailed design and cost estimation is typically undertaken, and community consultation progressed in relation to the preferred option,<sup>4</sup> both of which may impact the earlier cost estimates.

At the investment test stage, the important thing is for the cost estimates to reflect the *relative* differences in costs expected between the different options. The RIT-D and the RIT-T are essentially rankings of alternative options, with the aim of identifying the option with the greatest net benefit. It is the relative rather than the absolute level of costs that is important for this assessment.

The AER’s current RIT-T Guideline explicitly notes that ‘[t]here may be a material degree of uncertainty regarding the costs of a credible option at the time a TNSP undertakes the RIT-T assessment’.<sup>5</sup> The RIT-T requires that where a TNSP establishes that there is uncertainty in relation to the cost of an option, the TNSP is to calculate a probability-weighted cost across a range of different cost assumptions.<sup>6</sup>

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<sup>2</sup> AER, *Regulatory investment test for distribution, Issues Paper*, January 2013, page 15.

<sup>3</sup> AER, *Regulatory investment test for distribution, Issues Paper*, January 2013, page 7.

<sup>4</sup> It would be both costly and unnecessary for community consultation to be undertaken prior to the finalization of the investment test, in relation to all of the credible options being examined, as ultimately only one credible option will be progressed (i.e. the preferred option identified by the investment test).

<sup>5</sup> AER, *Regulatory investment test for transmission application guidelines*, June 2010, page 12.

<sup>6</sup> AER, *Regulatory Investment Test for Transmission*, paragraph (3).

In practice, the range and accuracy of different cost assumptions considered will depend on the materiality of different cost assumptions to the relative costs of each option. Typically, a sensitivity of the cost assumptions used (such as +/- 30%) is sufficient to establish the robustness of the rankings of alternative options under the investment test.

Grid Australia suggests that the discussion of costs of each of the credible options in the AER's RIT-D Guidelines should explicitly recognise the inevitable high level nature of the cost estimates used in some cases, given the stage of the investment process.

Grid Australia considers that the relevance of the RIT-D (or RIT-T) to any later *ex-post* assessment of capex would primarily be in relation to whether or not the required investment test had been applied and whether the option with the greatest net market benefit was selected as the preferred option. Grid Australia would expect that in assessing the prudence of the capital expenditure occurred, it would be necessary for the TNSP to substantiate differences between the capital cost estimate used in the RIT-T, and outturn capex. Such substantiation may, for example, explain the impact of any later environmental assessment on the design and costing of the network option, and discuss the procurement process followed in relation to the preferred option. In the event that substantial differences in costs emerge, which could potentially have a material impact on the earlier RIT-T assessment, then the TNSP would also expect to explain how it had addressed this issue, including whether it had re-examined the earlier RIT-T assessment.

Grid Australia does not consider that it would be appropriate as part of a later revenue determination process for the AER to effectively 're-open' a previous RIT-D or RIT-T assessment, and consider whether the investment test had been appropriately applied. Such an approach would expose the NSP to additional risk, including that a later evaluation would inappropriately apply 'hindsight'. Indeed, in determining the prudence or efficiency of capital expenditure, the Rules require the AER to only take account of information and analysis the provider could reasonably be expected to have considered or undertaken at the time it undertook the relevant capital expenditure.<sup>7</sup> Under NER 5.16.6, TNSPs can apply to have the AER determine whether the preferred option satisfies the RIT-T. This provides an avenue for TNSPs to manage the risk of the AER later re-opening a RIT-T evaluation. However this provision only applies for investment which is not for reliability corrective action. There is no equivalent provision for TNSPs to seek confirmation from the AER of the regulatory investment test outcome in the case of reliability corrective action, or for DNSPs to seek similar confirmation in the case of the RIT-D.

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<sup>7</sup> NER, S6A.2.2 – Prudence and efficiency of capital expenditure.

### 3. Removal of the Base Case

The NER provisions relating to the RIT-D do not require RIT-D proponents to evaluate each credible option against a base case where no option is implemented. This is in contrast to the RIT-T, where the NER provisions do include reference to an assessment of each credible option compared to the situation where no option is implemented,<sup>8</sup> which is further reflected in the drafting of the RIT-T itself<sup>9</sup>, and the AER's RIT-T Guidelines.

A 'do nothing' option is not a realistic outcome where the identified need for an investment is reliability corrective action to meet statutory reliability requirements. Grid Australia agrees with the AER that removing the requirement to assess all credible options against a base case removes a level of unnecessary analysis for reliability driven projects. For these projects, the relative ranking of the options is more important than the absolute values of the net economic benefits for each option. The relative ranking of the options are in turn not affected by the values assumed for the base case.

Grid Australia considers that the rationale for the removal of the base case for the RIT-D applies equally to the RIT-T. In the absence of a formal Rule change to align the NER provisions for the RIT-T and RIT-D on this issue, Grid Australia considers that the AER could achieve the same outcome by amending the RIT-T Guidelines to make clear that in the case of reliability augmentations, the assessment of market benefit categories (including losses and unserved energy) in the base case need only be conducted on an indicative basis. This would remove any uncertainty as to the extent of analysis required to estimate the base case in these circumstances, in turn improving both the timeliness and reducing the costs associated with undertaking the RIT-T assessment.

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<sup>8</sup> NER, 5.16.1(c)(1).

<sup>9</sup> RIT-T, paragraph 4(a).

#### 4. RIT-D Guidelines: Scope for Further Guidance on Process to be Followed

Experience with the RIT-T to date has highlighted a number of practical issues with the consultation process. Grid Australia considers that the AER's RIT-D Guidelines should provide additional clarification in relation to these issues, which are common across both investment tests. Grid Australia further considers that the current RIT-T Guidelines should be updated to reflect these issues, and to ensure consistency on the guidance provided in relation to the two tests.

Specific areas where Grid Australia considers it would be worth the AER providing additional guidance are summarised below:

- Options proposed by stakeholders should be required to be sufficiently developed and supported by adequate information to enable an assessment of the technical feasibility of the proposed option and to estimate its potential costs.
  - Experience to date with the RIT-T is that potential proponents of non-network options, or stakeholders wishing to propose alternative network solutions, have in some cases submitted minimal details relating to their proposed option. The AER's Guideline should make clear whether the NSP is obligated to incur significant costs in further developing the proposed option, to enable its evaluation in the RIT-D/RIT-T.
- The Guidelines should make clear that the identification of additional options by stakeholders is envisaged to predominantly occur in response to the Non-network options report (in the case of the RIT-D) or the Project Specification Consultation Report (in the case of the RIT-T).
  - Grid Australia considers that the Project Assessment Draft Report (PADR) and the Project Assessment Conclusions Report (PACR) are appropriately considered as draft and final versions of the NPV analysis.
  - The submission by stakeholders of additional options following the PADR requires the entire NPV analysis to be re-run, particularly where these represent 'new' options, rather than variants of options included in the PADR analysis. This has the potential to lengthen the already substantial period necessary for undertaking the analysis, particularly where market modelling is required in order to calculate categories of market benefit. This is inconsistent with the NER requirement for the PACR to be

published 'as soon as practicable' after the end of the consultation period.<sup>10</sup>

- Grid Australia considers that additional options should only be considered at the PACR stage where the specific circumstances of the investment test application are such that the failure to consider these options would materially affect the outcome of the analysis.
- Requests by stakeholders for additional information, over and above that required to be provided under the Rules, should be substantiated with the reasons why the stakeholder considers that the additional information will be helpful.
  - Whilst no reasonable request for additional information would be refused, Grid Australia considers that it is important that stakeholders are not able to use requests for additional information as a means of imposing a delay on the process. The NER is already very comprehensive in terms of the information which NSPs are required to provide in the various RIT-T and RIT-D documents.
- Similarly, where stakeholders question particular assumptions in the analysis, they should also provide a view as to why they think that changes in those assumptions will affect the outcome of the RIT-D (or RIT-T) analysis. This would again help to ensure that the consultation process is not used as a vehicle by stakeholders to delay the process.

The comments above should not be interpreted as Grid Australia seeking to dismiss information and options from stakeholders that are provided in a timely way, with sufficient information to support the process. Grid Australia notes that a range of new consumer advocacy measures are being proposed as part of changes to national energy arrangements and these new measures may be used to support stakeholders participating in the RIT-T or RIT-D processes.

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<sup>10</sup> NER 5.17.4(o); NER 5.16.4(t).



## 5. Distribution level market benefits

The AER has commented in its Issues Paper that ‘broader types of market benefits may result from demand-side activities’, and makes explicit reference to savings in wholesale markets from reductions in energy demand.<sup>11</sup> The AER concludes that:

*‘We are likely to include an additional, broader class of market benefit to ensure that all the market benefits from improved demand management are accounted for.’*

A key difference between the NER provisions for the RIT-D and those for the RIT-T is a change in market benefits specifically listed in the Rules. In particular, as noted in the AER’s Issues Paper, ‘changes in fuel consumption arising through different patterns of generation dispatch’ (which would capture savings in wholesale markets from reductions in electricity demand) and changes in ancillary service costs are not explicitly listed as a benefit under the RIT-D.

Grid Australia considers that benefits associated with improved demand management are likely to be reflected in:

- reductions in wholesale dispatch costs,
- reductions in ancillary services requirements (and in particular reactive compensation which is required most at times of high demand),
- a deferral in the need for generator investment (captured under ‘other parties costs’ in the RIT-D), or
- a deferral in the need for network investment (directly reflected in the network investment timing in the credible options considered under the analysis).

Of these benefits, the wholesale dispatch costs and reductions in ancillary services costs are missing from the categories included in the RIT-D.

Grid Australia considers that it may be preferable to retain the same terminology across the RIT-T and RIT-D, rather than introducing a new category of market benefit for the RIT-D, which essentially reflects categories which are included in the RIT-T.

Grid Australia also notes that its RIT-T Cost Benefit Handbook<sup>12</sup> sets out ‘simplified’ approaches (i.e. which do not require market dispatch modelling) for calculating dispatch cost, generator investment and ancillary service benefits, which could be used for non-network options (including demand management).

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<sup>11</sup> AER, page 18.

<sup>12</sup> Grid Australia, RIT-T Cost Benefit Analysis, November 2011. Available at [http://gridaustralia.com.au/index.php?option=com\\_content&view=category&layout=blog&id=129&Itemid=246](http://gridaustralia.com.au/index.php?option=com_content&view=category&layout=blog&id=129&Itemid=246).

## 6. Conclusion

In this submission, Grid Australia has made the following key points based on its members' experience in practical application of the RIT-T:

- Cost estimates for options considered under the RIT-T (and RIT-D) regulatory investment tests are in many cases high-level estimates primarily used to rank options. The AER should be mindful of the accuracy of the estimates upon which the regulatory investment test was conducted, when undertaking any *ex-post* assessment.
- Grid Australia agrees that the removal of the 'do nothing' base case for reliability-driven augmentations from the RIT-D analysis will prevent unnecessary analysis, and supports a similar change being achieved for the RIT-T through revision of the AER's RIT-T guidelines.
- Grid Australia has listed a number of process areas which could benefit from further guidance from the AER, in both the proposed RIT-D and RIT-T guidelines.
- Grid Australia considers that it would be preferable to retain the same terminology across the RIT-T and RIT-D for market benefit categories.