

Australian Energy Regulator

Better Regulation Program

MEU Response to

Draft Guideline on

Regulatory Investment Test – Distribution (RIT-D)

Submission by

The Major Energy Users Inc

July 2013

Assistance in preparing this submission by the Major Energy Users Inc (MEU) was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

This project was part funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy and research projects for the benefit of consumers of electricity and natural gas.

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1. Introduction and overview

The Major Energy Users Inc (MEU) welcomes the opportunity to provide comments on the AER draft guideline on the Regulatory Investment Test – Distribution (RIT-D).

1.1 Overview

The Better Regulation program undertaken by the AER is to develop guidelines essential for the implementation of the Network Rule changes introduced in 2012, many of which allow the AER to exercise discretion in the development of the costs that network service providers (NSPs) are allowed when charging customers for the use of the services provided. These rule changes resulted from a recognition that the earlier rules allowed NSPs to garner greater cost recovery than was efficient for the cost in actually providing the service. It has been this over-recovery from consumers that has been a driver of burgeoning electricity prices seen across the nation and which has eroded Australia's competitive position in the price of energy needed by all consumers, especially the manufacturing sector which has seen higher input costs coupled to a high \$A making them less competitive internationally. As a result, the manufacturing sector has been substantially harmed with investment and employment in the sector falling dramatically causing considerable economic damage.

The MEU sees that the introduction of the RIT-D is a key element in the process for ensuring that investment in the electricity distribution networks will be limited to only essential augmentations. There has been considerable criticism of network investment over the past 7-8 years, with many, including the MEU, observing that unnecessary investment has been made in the electricity networks, often driven by the rules themselves, which have overtly incentivised investment, making network investment an avenue for providing networks with greater opportunities to make bogus cost claims and reward their shareholders, most of which are governments.

The RIT-D provides a mechanism for limiting investment in electricity networks to the minimum necessary to continue to provide a service that meets the reliability required by consumers and to augment the networks to the minimum to reflect increases in demand.

The development of a RIT-D to substantiate an investment in a network, in addition to justifying the need, also is an avenue whereby NSPs are required to provide additional information. It is well recognised that there is a substantial information asymmetry favouring the NSPs and the MEU sees that in developing the RIT-D, some of this asymmetry can be reduced. An example concerns the additional relevant information that ElectraNet and

AEMO have released in the development of the RIT-T to substantiate the augmentation of the Heywood interconnector between SA and Victoria. The MEU has been pleased at the effort that the TNSPs devoted to developing the best solution for the needed increase in interconnection. The MEU considers that this RIT sets a model example for all RITs (both for transmission and distribution) as a standard that demonstrates good business practice.

1.2 The RIT process is not unique

The MEU notes that its members all implement investment (capex) proposals. The RIT-T and RIT-D are merely processes that should be undertaken by any competent firm. A sound business practice requires the proponent of an investment to identify a need, prove that the need must be fulfilled, identify the best option to fulfil the need, and to then demonstrate that the cost of the best option will be less than the benefits that will result from the investment.

Unless this process is implemented, there can be no certainty that the investment is sound. The process ensures that each investment proposed is sensible and justifiable.

Essentially, the capex process put in place by firms must provide the discipline to provide adequate proof that the investment is needed and the costs identified will provide a net benefit to the firm.

NSPs are monopolies and therefore regulation is needed to ensure that the monopoly does not cause consumers more than the efficient costs. The MEU considers that the RIT process must ensure that there is a surrogate of competition being applied to investment proposals made by NSPs so that only efficient costs are paid by consumers. This imposes considerable responsibility on the AER and therefore the RIT process must be comprehensive to enable rigorous evaluation.

1.3 The capex process is more than just a cost/benefit analysis

An associated aspect of any investment is that after the investment has been made, sound business practice requires a process for assessing whether the cost of implementing the preferred option was matched by the assumptions made in the development of the proposal and whether the benefits that justified the investment have been realised. The MEU considers that the RIT process must also include a retrospective assessment of whether the costs reflect actuality and benefits are achieved. Unless both of these are satisfied, the investment cannot be assumed to be efficient.

This additional step can be carried out within the current rules that allow all (even inefficient) investment to be added to the regulatory asset base (RAB) if the amount of actual capex does not exceed the allowed capex. The purpose of the requirement is for the proponent to carry out its own ex post review of

the investment project and to compare the outcomes with the assumptions made to justify the project. Such a review would not necessarily result in any adjustment being made by the AER to the amount to be rolled into the RAB, but would provide all stakeholders and the AER with a good understanding of the success and validity of the process used to substantiate the investment.

The MEU considers that under a regulatory mechanism which allows the retention of inefficient investment (as distinct from a firm operating in a competitive environment where the market will force a firm to write down an inefficient investment), the AER has a greater responsibility of oversight of the justification of investments proposed.

1.4 Conclusion

The MEU considers that these views must be the focus of the assessment of the adequacy of the draft guideline.

Generally, the MEU sees that the draft guideline has a number of features that will improve the overall performance of NSPs in substantiating their proposals for investment. Despite this general support, the MEU does see that the draft guideline could be significantly improved to ensure that the basics of soundly based investment are implemented and reflect the processes used by well run firms. Where the MEU differs from the AER in its views, the MEU commentary provides details of those aspects where the MEU considers the RIT-D process could and should be improved.

This submission follows the structure of the AER draft guideline.

2. RIT-D and application guidelines

In the explanatory statement, the AER notes the development of the RIT-D is prescriptive but that there are elements where its discretion can be exercised

2.1 Market benefits

We propose that RIT-D proponents include all classes of market benefits in its analysis that it considers to be material when applying a RIT-D. However, the quantification of market benefits is optional for reliability driven projects.

The MEU supports that the RIT-D must include all market benefits. However the MEU is concerned that the AER curiously considers that the calculation of market benefits is optional when assessing reliability projects. The MEU considers that this option should not be provided to DNSPs

For example:

- Congestion in a DNSP network can impact capacities in other elements of a network because in an AC network parallel circuits can have a massive impact on the flows through other circuits, especially including those of TNSPs.
- The assumption seems to imply that the impacts by individual consumers will be negligible but this overlooks that there are many quite high demand users embedded in the DBs (some using many 10s of MWs) and that actions by such large users could have a significant impact on the reliability of supply to other users, such as by load shedding at critical times.

The MEU does not agree that the DB has the option to exclude market benefits for reliability projects. However, the MEU accepts that if a high level assessment shows there are no market benefits, then this should be sufficient to exclude a more detailed assessment of the market benefits.

2.2 Customer initiated projects

Our proposed approach is to maintain the requirements set out in the NER. In accordance with cl. 5.17.4 of the NER, a RIT-D assessment is required under the NER, even if the conduct of the RITD would adversely affect the overall timing of a customer-initiated project.

The MEU considers that the RIT-D should include the effects of committed customer projects even if they have not physically commenced. Once a

project has commenced (regardless of whether initiated by a customer or a DB) the RIT-D should include for its impact.

The MEU is of the view that the RIT-D is a process – it is not an end in itself.

2.3 Removal of the base case

We propose that RIT-D proponents be allowed to select one credible option to serve as the base case against which other credible options are compared. This may involve comparing credible options against a 'do nothing' base case.

The MEU disagrees. The base case should always be the “business as usual” position. That is, the base case presents what the outcome will be without the investment being made. This must always be the default position and the proposed investment benefits measured against this.

In the case of reliability investments, reliability should be determined on the basis of a value assigned to the value customers place on reliability. This means the base case is an essential starting point. It could be that the base case might well be the best option where reliability suffers marginally because the cost of addressing it exceeds the value placed on it by consumers.

2.4 Additional distribution level market benefits

We propose that it is appropriate to give RIT-D proponents the option to consider wholesale market impacts, where such impacts could reasonably be considered material.

The MEU is concerned that providing this discretion to DBs could lead to exclusion of demand side responsiveness and therefore providing the DB the option to consider wholesale market benefits is not appropriate or acceptable.

The DB must be required to demonstrate that they have sought demand side responses and have not received them or they have been discounted because of the price offered. It is simply not enough that the DB should decide whether there is potential for DSR – the DBs must demonstrate they have attempted to seek DSR and that the outcome has not resulted in the most credible option.

It is also possible that DSR could have a market benefit if the demand reduction offered is high enough. In this regard, the MEU notes that consumers are load shedding when spot prices are high (either because they operate in the spot market or because they have a contract arrangement with

their retailer). This then demonstrates that there could well be market benefits from DSR even though the consumer is embedded within a DB.

The other concern the MEU has is that network reliability is very high and that many DSR options are marginally less reliable. For example, DNSPs operate with SAIDI levels of 97-98% reliability yet generation units operate with reliability levels of 93-95%. This means that the DB has the ability to discount a DSR option due to low reliability.

Giving the DB option to assess whether options provide wholesale market impacts could result in a more expensive outcome for consumers.

2.5 STPIS

We propose not to revise STPIS targets as a result of a RIT-D.

The MEU disagrees. Consumers pay the benefits from the STPIS to the DB as a reward for providing a better level of service. At the same time consumers pay a return to the DB for the costs of any reliability augmentation of the network through the capex program.

The proposal of the AER results in double counting. Not only do consumers pay for the costs incurred in funding the capex for the reliability investment but the DB will get a bonus from the outcomes from the improved reliability resulting from the investment.

2.6 Interested parties

The draft application guidelines set out that material and adverse market impacts for the purposes of defining interested parties should include:

- An impact on a network operator or other stakeholders such as aggregators or energy service companies in the NEM that:
- Constrains the network operator's ability to fulfil functions mandated under the NER; or
- Undermines the stakeholder's ability to perform its operations to the extent that it can no longer operate or perform a particular function. This may result from physical obstruction or a substantial reduction in profitability; or
- An impact on an electricity consumer, in their role as a consumer of electricity that reduces the quality or reliability of their electricity supply below what is required under the NER or reduces the sum of consumer and producer surplus.

The MEU is concerned that the definitions are somewhat obscure and could result in some parties affected by the investment not being able to be involved in the RIT process.

The term “interested parties” should overtly include any end user of the network services and consumer advocates who have a standing in the electricity regional markets impacted and who represent the interests of consumers of electricity.

An adverse market impact should include a cost increase in the supply of the services incurred by any end user of the network service, and its nominated representative.

It is important that the consumer stakeholder definition be set as widely as possible to ensure there is consumer involvement in the process. This is important because unless consumers are made aware of the RIT-D process it will be difficult for consumers to offer DSR options for full investigation or even be identified.

2.7 Determining discount rates

For regulatory consistency, we propose having the same method for determining the discount rate across both regulatory investment tests. The methodology under the RIT-T specifies that the present value calculations must use a commercial discount rate appropriate for the analysis of a private enterprise investment in the electricity sector. The discount rate used must be consistent with the cash flows being discounted and proponents should use the regulatory weighted average cost of capital (WACC) as the lower bound.

The MEU is extremely concerned with the proposed approach and considers that, as a standard, the discount rate should be the WACC used in the latest regulatory reset. The DB should not have the option unless there are extremely strong reasons to vary from the prevailing value for that DB’s WACC.

The RIT is all about investment and as investments are automatically rolled into the RAB (except under unusual circumstances), the value of the investment will be subject to the WACC used at the next reset. The AER will set the WACC at what it considers to be the efficient level based on market conditions.

If the option is permitted to increase the discount rate above the prevailing rate allowed for the DB, then this must be accompanied by a detailed explanation as to why a higher value is to be used and why that this higher

value is considered to be more efficient than the WACC already being used for investments.

As a basic premise that MEU considers that the prevailing WACC should be used and any changes from this must be carefully and fully explained.

2.8 Deemed values

Our proposed approach is not to prescribe ranges for sensitivity, because these are likely to change between RIT-D assessments. However, the RIT-D will prescribe that RIT-D proponents use the VCR in the RIT-D calculations, as prescribed in their respective jurisdiction.

The MEU notes that some regions do not use a value of Customer Reliability (VCR) but use determinative standards for setting reliability. This means that some regions do not have an “approved” valuation for VCR. Further the AEMC has identified that these determinative standards are not efficient (eg the AEMC identified that in NSW the determinative standards had resulted in excessive costs).

The MEU therefore considers that the guideline needs to address this inconsistency, although the MEU supports the use of VCR in preference to the approach of using determinative standards.

The MEU also notes that VCR can only be applied in the case of reliability projects and therefore market benefits (not VCR) should apply for all other augmentations.

2.9 Guidance for stakeholder consultation

We do not propose to include specific guidance on stakeholder consultation because we note that the NER provides detailed guidance on this issue. Clause 5.17.4(a) of the NER, specifies:

- If a RIT-D project is subject to the regulatory investment test for distribution under clause 5.17.3, then the RIT-D proponent must consult with the following persons on the RIT-D project in accordance with this clause 5.17.4:
- (1) all Registered Participants, AEMO, interested parties and non-network providers; and
 - (2) if the RIT-D proponent is a Distribution Network Service Provider, persons registered on its demand side engagement register.

The MEU considers that unless the demand side register is wide reaching, it will be easy for DBs to overlook potential DSR options on the basis that the register was insufficient for the purpose. The AER needs to ensure that the register is comprehensive

When developing the RIT the DBs should be required to identify all end users impacted and to identify those with sufficient demand to be able to provide adequate DSR. In this regard, the MEU has noted that even if there are no single end users with sufficient demand to be able to provide adequate DSR, the DBs should look to see if a number of end users acting in concert might be able to provide the enough DSR to obviate the problem identified.

2.10 Illustrating the RIT-D process

We have included a flowchart under section 3 of the application guidelines. This illustrates how projects flow through the RIT-D process.

The MEU considers the flow chart provides a sound basis for the process but is of the view that a formal high level assessment is needed before making the decision not to proceed with non-network options.

2.11 Screening for non-network options

We have formalised guidance on how to screen for non-network options under part 7 of the draft application guidelines. We are of the view that a Notice as required under cl. 5.17.4(d) of the NER and the Draft Project Assessment Report (DPAR) as required under cl. 5.17.4(i) of the NER are separate documents. They should not be used interchangeably.

The MEU has a real and deep concern that non-network options will be "pushed under the carpet" as it has been recognised that NSPs have an incentive to implement network solutions for addressing network needs.

This means that this screening must be a fundamental part of the process, even though it is recognised a great deal of work will be needed to ensure there is every opportunity to identify non-network options.

2.12 Lead party in joint planning

The draft application guidelines do not specify who should be the lead party in joint planning RIT-D projects.

The MEU does not disagree with this approach and considers that in most cases who should be the lead party will become obvious.

2.13 Reapplication of RIT-D

A number of submissions requested that the AER provide guidance on the reapplication of the RIT-D. Our proposed approach is to not add anything further to the requirements set out under cl. 5.17.4(t) of the NER.

The MEU appreciates the reasons for the AER making its proposed approach, but it considers that the AER should be more aware of the reasons for needing to make a reapplication.

For example, the clause makes reference to there being a material change in circumstances. As has been recently seen in the NEM, consumer demand has been falling. A RIT might have been developed where the forecast demand was much higher. It would be inappropriate for the RIT proponent to persist in implementing an augmentation that, before the augmentation is commenced, is no longer appropriate because the forecast increase in demand is no longer occurring.

By the AER not providing guidance that such a reapplication must be made (under the rules only the RIT proponent is charged with seeking a reapplication) because circumstances have changed, could result in an unnecessary augmentation being implemented because there was no requirement to make a reapplication.

The MEU considers that a RIT proponent must be required to make a reapplication if the circumstances underpinning the initial RIT application have changed.

2.14 General guidance on market benefits

Clause 5.17.1(c)(4)(iii) of the NER requires RIT-D proponents to consider whether each credible option could deliver changes in costs for parties, other than the RIT-D proponent. We propose to define other parties as: all those, other than the RIT-D proponent, who produce, consume or transport electricity in the NEM that own plant and/or incur capital, operating and maintenance costs in the NEM.

Our draft RIT-D application guidelines also clarify that, if a RIT-D augmentation changes the connection costs of a third party, RIT-D proponents should count this as a benefit under the RIT-D.

The MEU supports the above..

2.15 Transition from RT

Our proposed approach is to specify that, a NSP has commenced assessing a project under the Regulatory Test if, before 1 January 2014, it has:

- Published a project evaluation under the former regulations
- identified the project in a published DAPR released a request for information, and/or
- commenced an option analysis for the project under the Regulatory Test.

The MEU supports this approach with regard to the first dot point. However, the MEU also considers that care needs to be taken to ensure that DBs have not "rushed" projects through just to avoid the RIT process.

The MEU does not consider the second and third dot points are appropriate as the MEU considers that work undertaken to this stage could be readily incorporated into a RIT with little additional effort and cost or any loss of time.

2.16 Estimating option value

We do not consider that RIT-D proponents should treat option value differently under the RIT-D. If performed properly, a cost-benefit analysis should capture option value in the identification of credible options and scenario analysis.

The MEU agrees with the AER.

2.17 Estimating costs under uncertainty

Where there is material uncertainty regarding project costs, we consider that RIT-D proponents should assign probabilities to each reasonable sensitivities and weight them accordingly to derive an expected cost for each credible option.

The MEU supports this approach

2.18 Estimating costs generally

Costs incurred before the RIT-D process is finalised would typically be treated as sunk costs and therefore excluded from the cost-benefit analysis.

However, we will monitor the issue of easements under the RIT-T, because this may have an impact on the RIT-D.

Other costs, such as the administration of tenders and contracts should be included in the RIT-D when they are material and relate to a credible option.

The MEU generally supports this approach.

In the case of easements which have been acquired at an earlier time, should be considered to be sunk costs too has they will have been already included in the RAB from the earlier time. If they have not, then the cost of an easement will be a cost under the RIT

The RIT process needs to differentiate between costs that are incurred as part of the normal process of network management (ie were included in opex at a reset) and costs that are specifically dedicated to the RIT process. This would particularly apply to administration and other similar costs which are part of the “normal” operations of an NSP. It is essential that the RIT process is not used as an avenue for double counting.

2.19 Dispute resolution

We consider that cl. 5.17.5 of the NER is sufficiently explicit on the dispute resolution process under the RIT-D. Therefore, we propose to base our dispute resolution guidance, as required under cl. 5.17.2(b)(2)(iv) and cl. 5.17.5 of the NER.

The MEU recognises the constraints imposed on the AER and therefore supports this approach.