Regulatory Test Thresholds

Submission on the Draft Determination

12 September 2008

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Overview of Submission

EnergyAustralia submits that the Commission should exercise its power under section 91A of the National Electricity Law and make a more preferable rule, as described in this submission, because it will better contribute to the achievement of the national electricity objective. Generally, the factors that the Commission has accepted as supporting a change to the regulatory test threshold for transmission apply equally to distribution and to have a different threshold for distribution will detract rather contribute to the achievement of the national electricity objective.

1. The threshold for distribution

The draft determination proposes that regulatory test thresholds for new large or new small distribution investments should not be changed. The reasons for this are:

> *While some of the issues of this Rule change proposal are applicable to distribution as well as transmission the Commission considers the assessment and applicability of these issues in relation to distribution to be a separate matter requiring separate analysis. The Commission therefore considers the applicability of the elements of this Rule change proposal to distribution to be out of scope of this Rule change proposal.*[1]

There are significant differences between transmission and distribution assets, and the services they provide. These differences include:

- Their position in the supply chain and role of providing reliability to end users;
- Distribution networks have a larger quantity of smaller assets.

In many circumstances the nature of these differences would mean that a separate review or approach would be required for distribution. However, the issues raised by this rule change are generic to both transmission and distribution investments.

Some of the considerations in the draft determination were:

- *Input cost information (see Appendix C Part 3.1.5);*
- *Information on the cost of undertaking the regulatory test compared to the capital costs of projects ;*
- *Examination of APRs and application notices to ascertain the number of projects that fall within relevant cost bands and to assist in understanding the level of information; and*
- *Historical information including the relevant ACCC decision that incorporated the thresholds in the National Electricity Code (now the Rules).*[2]

[1] AEMC draft determination, page 10.
[2] AEMC draft determination, page 11.

(a) Input costs

The similarity of a distribution investment to a transmission investment that is most relevant in this review is the comparable inputs and input costs.

Transmission and distribution have the same skilled labour. This labour force that design, build and operate transmission and distribution networks are readily transferable between the sectors. In some cases there are safety and other accreditations required to work on the higher voltage networks, but this is minimal.

Transmission and distribution have the same material inputs. They both rely on civil construction inputs, metals, and common electrical inputs such as transformers and circuit breakers.

The drivers of cost increases for transmission networks are the same as those of distribution networks. This is demonstrated by comparing the cost escalation factors advised by Competition Economics Group (CEG) for TransGrid, EnergyAustralia, Integral Energy and Country Energy for their recent regulatory proposals to the AER (copy attached).[3]

These cost escalators have shown the same cost increases for both transmission and distribution. As a result the regulatory test thresholds, in real terms, are becoming more burdensome. This means that investments that would have not previously been captured by the regulatory test, now will be. Further, some investments that were previously new small distribution investments are now being assessed as new large distribution investments. The effect in real terms is the thresholds are becoming lower with time and thus DNSPs are undertaking more regulatory tests. This is making it more costly for DNSPs to undertake.

As is the case for transmission, the increasing real cost of distribution investments, should result in the regulatory test thresholds being raised inline with those for transmission investments.

(b) Cost & benefit of undertaking the regulatory test

The cost of undertaking the regulatory test for a distribution network is the same that would be incurred by a transmission network. This is easily demonstrated using the following example.

EnergyAustralia has recently finalised it regulatory test report for the replacement and augmentation of feeders 908-909, which are a 132kV supply into Sydney. This was undertaken as a new large transmission network asset because the configuration of the network under the preferred solution resulted in an augmentation to the transmission network. If the alternative solution was more cost effective, then it would have been a new large distribution investment. In this case the regulatory test assessment would have been the same and the costs of undertaking the test would have been the same.

It is worth noting that the preferred project was worth $160m and, even with such a high value investment, no submissions were received by EnergyAustralia in relation to the application notice. In relation to other regulatory test assessments, EnergyAustralia rarely receives submissions. However when submissions are received they are

[3] CEG, Escalation factors affecting expenditure forecasts, July 2008.

normally not from proponents of non-network solutions, rather they are from residents requesting that the new power lines be under grounded for visual amenity. These concerns are valid, but are more appropriately addressed in the consultation that is required for planning approvals. In this regard, the regulatory test consultation provides little benefit.

It is also appropriate to increase the regulatory test thresholds for distribution because of the new ex ante capex framework in chapter 6 of the Rules. The ex ante framework requires the AER to set much more meaningful capex allowances and there is a higher burden on the DNSP to transparently justify its proposed expenditure. This new regulatory regime provides more powerful incentives for DNSPs to deliver efficient capex programs, which means that the publication and consultation on individual investments under a regulatory test is of less importance in the regime.

The draft determination notes that it attempts to strike an appropriate balance between regulatory scrutiny of augmentations and regulatory burden on TNSPs. The same rationale should result in the same increased thresholds for distribution investments.

(c) The potential gap between transmission and distribution thresholds

The draft determination has not addressed the issues affecting a DNSP that owns and operates a transmission network. Having two different thresholds will create uncertainty about how and when the regulatory test should be applied for certain investments.

When a DNSP is addressing its network limits, it must carry out an economic cost effectiveness analysis of the possible options to satisfy the regulatory test. Some of these options will result in the DNSP's transmission network being augmented and some of the options will result in its distribution network being augmented. This is not a problem while the regulatory thresholds for transmission and distribution investments are the same.

The draft determination has proposed not to change the new large & small distribution investment threshold from $10m and $1m, respectively. Instead it proposed to change the new large & small transmission investment thresholds to $20m and $5m. This mismatching of thresholds will be problematic for DNSPs that own transmission assets.

Under the proposed thresholds, EnergyAustralia could have investment options that include options to invest in either transmission or distribution. If both the transmission and the distribution options are valued between $10m and $20m, then the regulatory test must be applied. However consultation is generally determined by reference to the preferred option. So for example where the preferred option is a new small transmission asset, consultation on that option occurs when it is published in the Annual Planning Report (APR). A new small distribution asset may also be considered at that time but would not require separate consultation if it eventuated as the preferred option.

If there are different thresholds for distribution and transmission, a project valued at $15m could be regarded as either a new small transmission asset or a new large distribution asset. This would result in substantially different consultation requirements, for projects of similar value, purely on the basis of their classification. This is also a problem if a network service provider is assessing two alternative options both valued

at $15m, one being transmission and one being distribution. It is unclear what consultation is required.

Further, there could be issues of non-compliance if it becomes physically unable to undertake the new small transmission option close to the required date. The network service provider would presumably not have consulted (other than that required in the APR) because the new small transmission asset was the preferred option. It would then have to undertake the alternative new large distribution option, which would have required consultation.

In cases where transmission and distribution options were being considered, setting different thresholds for transmission as proposed by the draft determination, will likely result in such transmission investments being fully consulted upon. This will detract from the NEO by providing no additional benefit of regulatory scrutiny but increasing regulatory burden, compliance issues and potential confusion in the market.

A similar issue would result from different new small network thresholds. If there are there are two competing options valued at $3m, one distribution and one transmission, then there would be different requirements to publish a final report. The transmission option would not be a new small network asset and would require no final report. However the distribution option would be a new small network asset and would require a final report. This would result in uncertainty and would also detract from the NEO.

The problem caused by having different thresholds for distribution and transmission is that the preferred option does not always remain the same throughout the regulatory test assessment. Undertaking the correct regulatory test assessment process depends on the likely solution. After a regulatory test assessment process has been selected, it is possible for the preferred option to change. If this happens the Network Service Provider should not then be required to undertake more consultation because the preferred option has changed classification, say from transmission to distribution.

The distribution thresholds should be brought into line with the proposed transmission thresholds would redress this imbalance and ensure the Rule change would better contributes to the NEO.

2. Disclosure of replacement information

The proposed definition of “replacement transmission network assets” and the requirement regarding information publication gives rise to several issues that need to be clarified.

The requirement to publish transmission replacement capex information in the TNSP’s annual planning report will not capture any of EnergyAustralia’s transmission investments that replace a distribution asset. It is unclear whether it is intended that such information be published in its annual planning report. There are also emergency replacement works that a TNSP will not be planning at the time of publishing its annual report. In these cases it will not be possible to publish any information in the annual planning report. It would be worth clarifying this in the final Rule.

Further, the definition of replacement seems to exclude all investments that are captured by the definition of augmentation. This makes it unclear how a transmission

investment should be treated if it were to part replacement and part augmentation. The following lists some examples:

> **(a) Projects which initially augment the network but which are ultimately to replace assets.** It is possible that a single replacement project may result in a capacity increase at a specific location, but may form part of a longer term overall strategy to retire equipment of equivalent capacity. Generally, this will not be considered to be a network augmentation. For example, construction of one new substation of 10MVA capacity with the specific purpose of replacing two aged 5MVA substations in poor condition.
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> **(b) Replacement projects with an augmentation component.** It is possible that a project might be principally driven by a replacement need but will also have an augmentation component. For example, it can be cost efficient to design replacement projects to provide increased capacity compared to the assets being replaced, particularly when assets are being replaced due to age and given the changes in the characteristics of equipment and a continuing trend towards higher rated equipment.

In the AER's latest Final Decision on the regulatory test, it stated: "The AER clarifies that where a proposed investment is a mix of replacement and augmentation, a regulatory test should be conducted on the augmentation component if that augmentation component lies over the $1 million threshold". [4]

As a result of the AER's decision EnergyAustralia uses the following factors as a guide to determine where the regulatory test should be undertaken, where there is an incidental augmentation component to a replacement investment.

i **(Capacity increase of 5% or less: immaterial)** Assess the increase in capacity. Increases in capacity of 5% or less could generally be regarded as immaterial for the purpose of deciding if replacement expenditure includes an augmentation component.

ii **(Capacity increase of more than 5%: consider incremental cost)** Where replacement driven projects involve an increase in capacity of more than 5%, consideration should be given to the incremental cost of the increased capacity unless it can be demonstrated that best replacement for the aged asset delivers an increase in capacity and that none of the objectives of the project involve the delivering of additional capacity or the relieving of a constraint. If this is the case, the basis for this conclusion should be clearly documented.

iii **(Incremental cost $1m or less** If the incremental cost of the increased capacity is $1m or less then the "augmentation expenditure" is below the current lower limit of a new small network project and the project could still be treated as incidental because the incremental augmentation would not, if carried out independently, trigger the analysis, consultation and reporting obligations.

iv **(Incremental cost between $1m and $10m: new small network asset)** If the incremental cost of increased capacity is between $1 million and $10 million, then the augmentation component, if carried out independently, would currently be regarded as a new small network asset. Consequently unless there are unusual circumstances, such an augmentation component would be material and trigger the analysis, consultation and reporting obligations.

[4] AER, *Final Decision Regulatory Test version 3 & Application Guidelines*, November 2007, pg 10.

v **(Incremental cost above $10m: new large network asset)** If the incremental cost of the increased capacity is above $10 million, it is highly unlikely that there would be any basis for the augmentation project to be considered incidental. An expenditure of that scale would currently, if carried out independently, be treated as a new large network asset. Consequently such an augmentation component would be material and would trigger the analysis, consultation and reporting obligations.

These definitional issues will result in complicated compliance issues for EnergyAustralia that are unnecessary and would detract from the NEO. Therefore EnergyAustralia requests clarity in these instances.

3. Non-monetary thresholds/criteria

In the current Rules the AER may set monetary thresholds for the regulatory test different to those set in the Rules without consultation. It may also set non-monetary thresholds or criteria to distinguish between new small and new large network investments without consultation.

The draft determination proposes that the AER should undertake a three yearly review of the monetary thresholds but the AER's discretion to determine non-monetary criteria without any consultation has not been changed

Under the current Rules framework, it is not appropriate for the AER to be able to change the criteria for distinguishing between these assets just by an act of publication without industry consultation. It would be more appropriate and consistent with the current Rules framework that the consultation process be followed for any change to the either the monetary or non-monetary threshold.

The AER should be required to undertake public consultation if it decides to publish criteria to distinguish between new large and new small network assets.