

21 June 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A244
Sydney South NSW 1235

Via website: www.aemc.gov.au

Dear John,

Cost Pass Through Arrangements for Network Service Providers

Grid Australia is making this submission in response to the AEMC's Draft Rule Determination on the National Electricity Amendment (Cost pass through arrangements for network service providers) Rule 2012 ('Draft Rule Determination').

Grid Australia considers that the AEMC's Draft Rule Determination substantially addresses the key issues which Grid Australia's earlier Rule Change Proposal sought to deal with. Although the AEMC's Preferred Rule does not result in the same degree of regulatory certainty as would have been provided under Grid Australia's Rule Change Proposal, in practice Grid Australia considers it likely that the outcomes under the two Rules will be essentially the same. In particular Grid Australia:

- Is pleased that the AEMC has acknowledged the importance of the ability of network service providers to recover the costs of unexpected events, and the legitimate role of the cost pass-through provisions in the National Electricity Rules (the Rules) in achieving this;
- Supports the ability of Transmission Network Service Providers (TNSPs) to propose nominated cost pass through events as part of their regulatory submission. This provides TNSPs with the flexibility to propose cost pass through events where this represents the most efficient means of dealing with the risk of uncertain, high cost events beyond the TNSPs' reasonable control and brings the regulatory framework in this area for TNSPs in line with that for Distribution Network Service Providers (DNSPs);
- Supports the proposed inclusion of 'nominated pass through considerations' in the Rules, in order to provide clear guidance to Network Service Providers (NSPs), the AER and customers in relation to the criteria which need to be considered in approving an NSP's nominated cost pass through event. Grid Australia considers that codification of these factors in the Rules is appropriate in order to improve regulatory certainty. This is particularly important given the AEMC's Draft Rule Determination not to include additional

prescribed cost pass through categories in the Rules, which means that there will be increased reliance on the nominated cost pass through provisions; and

- Supports the proposed amendments to the Rules to address the 'dead zone' issue.

Grid Australia would welcome the opportunity to review the drafting of the Final Rule change developed by the AEMC, prior to the AEMC's Final Rule Determination.

Should you wish to discuss any aspect of this submission, please contact me on (08) 8404 7983.

Yours sincerely,



Rainer Korte
Chairman
Grid Australia Regulatory Managers Group

Cost Pass Through Arrangements for Network Service Providers

Response to AEMC Draft Rule Determination

21 June 2012

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1. Introduction

Grid Australia is making this submission in response to the AEMC's Draft Rule Determination on the National Electricity Amendment (Cost pass through arrangements for network service providers) Rule 2012 ('Draft Rule Determination').

Grid Australia considers that the AEMC's Draft Rule Determination substantially addresses the key issues which Grid Australia's earlier Rule Change Proposal sought to deal with. Although the AEMC's Preferred Rule does not result in the same degree of regulatory certainty as would have been provided under Grid Australia's Rule Change Proposal, in practice Grid Australia considers it likely that the outcomes under the two Rules will be essentially the same. Therefore Grid Australia considers that the critical elements of its earlier Rule Change Proposal are addressed by the Draft Rule Determination. In particular Grid Australia:

- Is pleased that the AEMC has acknowledged the importance of the ability of network service providers to recover the costs of unexpected events, and the legitimate role of the cost pass-through provisions in the National Electricity Rules (the Rules) in achieving this;
- Supports the ability of Transmission Network Service Providers (TNSPs) to propose nominated cost pass through events as part of their regulatory submission. This provides TNSPs with the flexibility to propose cost pass through events where this represents the most efficient means of dealing with the risk of uncertain, high cost events beyond the TNSPs' reasonable control and brings the regulatory framework in this area for TNSPs in line with that for Distribution Network Service Providers (DNSPs);
- Supports the proposed inclusion of 'nominated pass through considerations' in the Rules, in order to provide clear guidance to Network Service Providers (NSPs), the AER and customers in relation to the criteria which need to be considered in approving an NSP's nominated cost pass through event. Grid Australia considers that codification of these factors in the Rules is appropriate in order to improve regulatory certainty. This is particularly important given the AEMC's Draft Rule Determination not to include additional prescribed cost pass through categories in the Rules, which means that there will be increased reliance on the nominated cost pass through provisions; and
- Supports the proposed amendments to the Rules to address the 'dead zone' issue.

The remainder of this submission discusses each of these points in turn. Detailed comments on the AEMC's Draft Rules are provided in Appendix A. These comments mainly reflect minor suggested drafting changes.

2. Cost pass through is an appropriate means of addressing the risk of uncertain, external events

Grid Australia's Rule Change Proposal was focused on making a number of changes to the current Rules in order to allow TNSPs to better utilise the cost pass through provisions in clause 6A.7.3 of the Rules. The Rule Change Proposal highlighted that the use of the cost pass through provisions can represent a cost efficient approach to the management of the risks associated with uncertain, external events beyond the reasonable control of the TNSP. This is particularly the case where commercial insurance for such risks is either not available, or only available at an excessive cost, and where a self-insurance allowance is either difficult to calculate (due to the uncertain nature of the event) or not credible (due to the catastrophic nature of the risks involved).

The AEMC has recognised in its Draft Rule Determination the importance of the cost pass through provisions in the Rules in ensuring that network businesses are able to recover the efficient costs associated with unexpected events.¹ The AEMC states that 'not allowing network businesses the opportunity to recover their efficient costs in those limited circumstances where insurance and self-insurance cover is limited or not available is likely, over the long term, to affect the efficient investment in, and efficient operation of, those networks.'²

Grid Australia does not agree with the AEMC that the cost pass through provisions should be the 'last option' (with the exception of the capex re-opening provisions) available to network businesses with regard to risk management.³ Rather, as noted in both its initial Rule Change Proposal and its subsequent submission to the AEMC's Consultation Paper, Grid Australia considers that it is appropriate to use the cost pass-through provisions whenever these represent a more cost effective means of addressing the risk of uncertain, external events, compared with the inclusion of the costs of direct insurance or self-insurance in the NSP's operating cost allowance.⁴

Notwithstanding this point, Grid Australia considers that the proposed amendments to the Rules will enable the AER to determine the efficiency of alternative approaches to managing the risks of external events. Since the AER will be making its determination in relation to an NSP's nominated cost pass through events at the same time that it is making its determination in relation to the reasonableness of the operating expenditure

¹ AEMC Draft Rule Determination, p. 9.

² AEMC Draft Rule Determination, p. 14.

³ AEMC Draft Rule Determination, p.17.

⁴ Grid Australia Rule Change Proposal, October 2011, p. 27 and p. 29; Grid Australia Submission in response to AEMC Consultation Paper, March 2011, section 2.

forecast for the forthcoming regulatory period, it will be able to weigh up the efficiency of the inclusion of a direct insurance or a self-insurance allowance in operating expenditure, against the alternative of including a nominated cost pass through event. The proposed amendments to the Rules also address the current risk for TNSPs that the AER may reject the costs of very high premiums for direct insurance or self-insurance in relation to an external event as being inefficient, without the TNSP having recourse to the cost pass through provisions.

3. The ability for TNSPs to nominate additional pass-through categories

Grid Australia strongly supports the AEMC's Draft Rule Determination to amend the Rules to provide TNSPs with the ability to nominate additional pass through events as part of their regulatory submission. This amendment, which is in line with Grid Australia's Rule Change Proposal, provides flexibility for NSPs to propose additional cost pass through events as relevant to their particular circumstances. It also allows the AER to consider these proposed pass through events at the same time as it is considering the efficiency of the proposed operating expenditure forecasts submitted by the businesses. As discussed above, this allows the AER to explicitly consider the trade-off between cost pass through events and forecast insurance costs (both direct insurance and self-insurance) at the same time.

The proposed amendments also provide greater alignment between the Rules for TNSPs and DNSPs in relation to this issue.

Grid Australia notes that the AEMC has decided in its Draft Rule Determination not to include as prescribed pass through events in the Rules the two additional pass through events proposed by Grid Australia in its Rule Change Proposal, namely the 'natural disaster event' and the 'insurance cap event'. The AEMC's Draft Rule Determination has also removed the 'terrorism event' from the list of prescribed pass through events.

Grid Australia would have preferred for these prescribed pass through events to be included in the Rules, in order to provide regulatory certainty in relation to the eligibility of these events for consideration under the cost pass through mechanism in the Rules. However, Grid Australia notes that NSPs are able to propose these events as nominated pass through events, under the AEMC's proposed amendments to the Rules. Moreover, the AEMC has highlighted that its conclusion does not imply that these types of event should not be accepted as pass through events, but only that the decision should be made by the AER as part of the determination process, 'considering the circumstances of each business' rather than being prescribed in the Rules.⁵ As noted in Grid Australia's Rule Change Proposal, the AER has approved equivalent pass through events for DNSPs. Grid Australia therefore considers that

⁵ AEMC Draft Rule Determination, p.22.

the amendments proposed by the AEMC to enable TNSPs to propose nominated cost pass through events at the time of their regulatory submission is likely in practice to result in the approval of ‘natural disaster’ and ‘insurance cap’ events by the AER, whilst allowing for consideration of the applicable circumstances at the time of each NSP’s regulatory submission.

In accepting that the ability for NSP’s to nominate pass through events is likely to provide a substitute for these pass through events being defined in the Rules, Grid Australia considers that it is important that guidance is provided in the Rules on the factors which the AER should consider in deciding on whether to approve nominated pass through events. This is discussed further below.

4. Guidance to be included in the Rules in relation to the AER’s assessment of nominated pass-through events

The AEMC has included a set of ‘nominated cost pass through considerations’ in its proposed amendments to the Rules. Under the proposed amendments, NSPs must ‘have regard to’ these considerations in proposing nominated cost pass through events and the AER ‘must take into account’ these considerations in determining whether to accept an NSP’s proposed nominated pass through events.

Grid Australia notes that the nominated pass through considerations largely reflect the assessment framework previously adopted by the AER for the Victorian DNSPs. As such, the proposed amendments to the Rules largely codify the AER’s current practice.

Grid Australia strongly supports the inclusion of the nominated pass through considerations in the Rules. Grid Australia agrees with the AEMC⁶ that the codification of these factors in the Rules will provide additional certainty to NSPs, the AER and consumers in terms of the criteria that nominated pass through events need to satisfy in order to be approved. Grid Australia considers that this is particularly important in the light of the AEMC’s draft determination not to include additional prescribed pass through events in the Rules, and to remove the ‘terrorism event’ from the list of defined pass through events. A consequence of the AEMC’s draft determination is that there will be greater reliance on the NSPs’ ability to propose nominated pass through events. It is therefore important that there is increased certainty and transparency in relation to the basis on which such proposals will be assessed by the AER. The codification of guidance in the Rules is preferable to the inclusion of factors in an AER-determined Guideline.

The AEMC has posed the following specific question in relation to the proposed nominated pass through considerations:

⁶ AEMC Draft Rule Determination, p.15.

Question 1.

- a. Are there any other considerations important for nominated pass through events that should be included?
- b. Do the nominated pass through event considerations strike a good balance between prescription and flexibility?

Grid Australia considers that the AEMC's proposed nominated pass through considerations do capture the key factors that should be taken into account in deciding on whether a particular nominated pass through event should be approved. Grid Australia does not therefore propose that any additional considerations should be included in the Rules.

However, in terms of the AEMC's proposed wording of the nominated pass through event considerations, Grid Australia suggests the following under-lined changes to paragraphs (c) and (d) of the AEMC's proposed definition:

- c. a prudent service provider in the same circumstances could reasonably prevent an event of that nature or type from occurring or could substantially mitigate the cost impact of such an event;
- d. it would be reasonable for a service provider in the same circumstances to ~~could~~ insure against the event, having regard to:
 1. the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; and
 2. whether the event can reasonably be self-insured on the basis that:
 - i. it is reasonably possible to calculate the self-insurance premium; and
 - ii. the potential loss to the relevant service provider would not have a significant impact on the service provider's ability to provide *network services*.

Grid Australia considers that the suggested amendments further clarify the circumstances in which commercial insurance and self-insurance would be considered to be 'not available on a reasonable basis', and where cost pass through becomes 'the least inefficient option'.⁷

⁷ AEMC Draft Rule Determination, p. 17.

Grid Australia considers that the nominated pass through event considerations proposed by the AEMC do strike a good balance between prescription and flexibility.

5. Amendments to address the ‘dead-zone’

The AEMC’s Draft Rule Determination incorporates amendments to the Rules to allow for pass through applications to be made for events which occur in a previous regulatory period, in circumstances where it is too late to include the costs associated with those events in an NSP’s revenue control for the subsequent regulatory control period. This addresses the so-called ‘dead-zone’ issue.

The AEMC agreed in its Draft Rule Determination that the amendments to the Rules will provide network businesses with the reasonable opportunity to recover their efficient costs should a pass through event occur within this period. Moreover, the AEMC notes that the amendments remove a known anomaly from the Rules and create consistency for all time periods.

Grid Australia supports the amendments proposed by the AEMC in its Draft Rule Determination, which largely reflect those included in Grid Australia’s Rule Change Proposal.

Appendix A – Comments on the Draft Rules

Grid Australia has the following comments in relation to the detailed Draft Rules included in the AEMC's Draft Rule Determination. Grid Australia would be happy to discuss these comments with the AEMC in more detail, as required.

1. Clause 6.5.10(a) – Grid Australia suggests that the words “a proposed pass through clause with a” be deleted, as the actual pass through provisions are contained in clause 6.6.1 and so it is difficult to see what additional pass through clauses would be required. It should be sufficient that the building block proposal sets out the events that are to be pass through events.
2. Clause 6.5.10(a) and (b) - Grid Australia suggests that the word "additional" be inserted before "events" (cl.6.5.10(a)) and "pass through events" (cl.6.5.10(b)). This would be consistent with clause 6.12.1(14). In addition, it would be worth including a note to clause 6.5.10(a) which states "Note: See clause 6.6.1(a1)(5)" so as to make it clear that the relevant events are events in addition to those specified in clause 6.6.1(a1)(1)-(4).
3. Clause 6.6.1(a1), Note - substitute "Amendment" for "Amendments".
4. Clause 6.6.1(a1)(5)) and the definitions of "eligible pass through amount" (second paragraph (b)) and "required pass through amount" (second paragraph (b)) - "distribution determination" is not defined in the Rules and so should not be italicised.
5. Clause 6.6.1(j)(2)(i) - "occurred" should not be italicised.
6. Clause 6.6.1(j)(2A) - the reference to "standard" control services should be replaced by a reference to "direct" control services.
7. Clauses 6.6.1(j)(2A) and (4) - insert "and" at the end of each clause.
8. Clause 6.6.1(j)(7) - substitute "annual revenue requirements" for "annual revenue requirement".
9. Clause 6A.6.9(a) – Grid Australia suggests that the words "a proposed pass through clause with a" be deleted, as the actual pass through provisions are contained in clause 6A.7.3 and so it is difficult to see what additional pass through clauses would be required. It should be sufficient that the Revenue Proposal sets out the events that are to be pass through events.
10. Clause 6A.6.9(a) and (b) - Grid Australia suggests that the word "additional" be inserted before "events" (cl.6A.6.9(a)) and "pass through events" (cl.6A.6.9(b)). This would be consistent with new clause 6A.14.1(9). In addition, it would be worth including a note to clause 6A.6.9(a) which states "Note: See clause 6A.7.3(a1)(5)" so as to make it clear that the relevant events are events in addition to those specified in clause 6A.7.3(a1)(1)-(4).

11. Clause 6A.7.3(j)(4) – delete ‘and’ at the end of this clause
12. Clause 6A.7.3(j)(6A) - "maximum allowed revenue" is referable to a regulatory year rather than a regulatory control period (see cl.6A.3.1) and so the two references to "maximum allowed revenue" should be references to "maximum allowed revenues".
13. Definition of ‘pass through event’ – the cross reference to clause 6.6.6(1)(a1) should instead be a cross reference to 6.6.1(a1).
14. Definition of ‘nominated pass through event considerations’, par.(c) and (d) – Grid Australia suggests that this be reworded as follows:
 - d. a prudent service provider in the same circumstances could reasonably prevent an event of that nature or type from occurring or could substantially mitigate the cost impact of such an event;
 - e. it would be reasonable for a service provider in the same circumstances to ~~could~~ insure against the event, having regard to:
 1. the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; and
 2. whether the event can reasonably be self-insured on the basis that:
 - iii. it is reasonably possible to calculate the self-insurance premium; and
 - iv. the potential loss to the relevant service provider would not have a significant impact on the service provider’s ability to provide *network services*.
15. The Grid Australia Rule Change Proposal suggested that the definition of ‘approved pass through amount’ should be amended by changing the cross references to clauses 6A.7.3(d)(2) and 6.6.1(d)(2) to clauses 6A.7.3(d) and 6.6.1(d) respectively. As the current cross references are incorrect, Grid Australia continues to propose these changes.
16. The Grid Australia Rule Change Proposal suggested that the definition of ‘materially’ should refer to “a” (rather than “the”) regulatory control period. This is necessary because of the ‘dead zone’ issues where the pass through event can have a cost impact in a subsequent regulatory control period. Grid Australia therefore continues to propose this change.
17. Clause 11.(xx).1, definition of “current regulatory control period” – insert “at” before ‘the commencement date’.