RULE CHANGE

AEMC

Australian Energy Market Commission

DRAFT RULE DETERMINATION

National Electricity Amendment (Cost pass through arrangements for network service providers) Rule 2012

Rule Proponent(s)

Grid Australia

Commissioners

Henderson
Spalding

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. The AEMC has two principal functions. We make and amend the national electricity and gas rules, and we conduct independent reviews of the energy markets for the MCE.

Summary of draft rule determination

The Australian Energy Market Commission (AEMC or Commission) has determined to make a draft rule and this associated draft rule determination, in response to Grid Australia's rule change request, regarding the cost pass through provisions under the National Electricity Rules (NER) that apply to network service providers. The draft rule is a more preferable rule, containing some elements of the rule proposed by Grid Australia and other elements that the Commission considers will, or is likely to, better contribute to achievement of the National Electricity Objective.

Grid Australia rule change request

On 14 October 2011, Grid Australia made a request to the Commission regarding the cost pass through provisions for network service providers. The rule change request consisted of four components:

- a new definition for a prescribed 'natural disaster event';
- a new definition for a prescribed 'insurance cap event';
- the ability for transmission network service providers to nominate additional pass through events; and
- draft rules to address the 'dead zone' issue for events that occur in a previous regulatory control period, but which have not been incorporated in the network businesses forecasts for the subsequent regulatory control period.

The Commission's draft rule determination

The Commission carefully considered submissions received from stakeholders in response to the consultation paper, and has responded to those submissions in this draft rule determination.

With the exception of the capital expenditure re-opening provisions, the Commission considers that cost pass throughs should be the last option available to network businesses with respect to risk management. This is to protect the incentive mechanisms that operate under the building block approach to revenue determination, which help ensure that prices for consumers are no more than necessary to provide an appropriate level of service.

However, the Commission recognises that in order to provide network businesses with a reasonable opportunity to recover their efficient costs for providing direct control network services, network businesses should be able to recover the costs associated with events that are outside of their reasonable control.

Therefore, the Commission has determined:

- to provide transmission businesses with the ability to nominate additional pass through events as part of their revenue proposal;

- to include a set of 'nominated cost pass through considerations' in the NER that the Australian Energy Regulator must consider when deciding whether to accept the network businesses proposed pass through events;
- not to include Grid Australia's definition for a prescribed natural disaster event;
- not to include Grid Australia's definition for a prescribed insurance cap event;
- transitional arrangements to enable Powerlink (whose regulatory control period commences 1 July 2012) to nominate pass through events within three months of commencement of the rule; and
- to remove the terrorism event from the prescribed pass through events under the NER.[1]

In addition, the Commission has also agreed to the inclusion of amendments to address the predominately administrative 'dead zone' issue in its draft rule.

The Commission remains of the view that the capital expenditure re-opening provisions should be retained for 'large, shipwreck-type events' and should continue to be subordinate to cost pass throughs.

Consultation on the draft rule determination

The Commission invites submissions on this draft rule determination, including the draft rule, by 21 June 2012.

Any person or body may request that the Commission hold a hearing in relation to the draft rule determination. Any request for a hearing must be made in writing and must be received by the Commission no later than 17 May 2012.

Submissions and requests for a hearing should quote project number “ERC0137” and may be lodged online on the Commission's homepage.

1 Other than in respect of network service providers current regulatory control periods.

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1 Grid Australia's rule change request

1.1 The rule change request

On 14 October 2011, Grid Australia made a request to the Australian Energy Market Commission (Commission) to make a rule regarding the cost pass through provisions under the National Electricity Rules (NER) for network service providers (rule change request).

1.2 Rationale for rule change request

Grid Australia submitted that under the NER, transmission and distribution network service providers are exposed to the risk of significant cost impacts arising from natural disasters that are outside of their reasonable control.[2]

In its rule change request, Grid Australia considered the availability of some types of cover in the commercial insurance market is thin. For some events, particularly in the case of extreme forms of natural disaster, past claims experience is very limited and subject to wide variations depending on the severity of the event. In these circumstances it is difficult to estimate the probability of occurrence, and/or the costs that may result. As a consequence, insurance may only be available at a reasonable cost up to a cap, leaving network businesses with residual exposure to losses above the cover limit.[3] Grid Australia also noted that the available premiums to increase the cover limit may be prohibitively priced.

In the 'dead zone' for cost pass throughs, defined as the time between when a network service provider lodges its revenue/regulatory proposal for the next regulatory control period and the start of that period, there is a risk that network service providers are unable to recover their costs if an unforeseen, exogenous event occurs. For example, Grid Australia noted that where a cost pass through event occurs during the 'dead zone', there is a risk under the current rules that a network service provider is unable to amend its regulatory proposal. It is also not possible for the network service provider to apply for a cost pass through in the following regulatory control period.[4]

1.3 Solution proposed in the rule change request

Grid Australia proposes to resolve the issues discussed above by making a rule that seeks to:

- incorporate a prescribed 'natural disaster event' within the definition of 'pass through event' under chapter 10 of the NER, to apply to distribution and transmission businesses;

2 Grid Australia rule change request, October 2011, p. 3.

3 Id., p. 4

4 Id,. p. 3.

- include a prescribed 'insurance cap event' within the definition of 'pass through event' under chapter 10 of the NER, to apply to distribution and transmission businesses;

- enable transmission network service providers the ability to propose additional pass through events as part of their revenue proposals; and

- provide rules that would address the so-called 'dead-zone', to apply to distribution and transmission businesses.

1.4 Relevant background

A cost pass through may occur within a regulatory control period when a pre-defined exogenous event occurs which materially increases or decreases a network businesses costs (capital and/or operating expenditure). In these circumstances, the Australian Energy Regulator (AER) may approve a positive (or negative) pass through amount under the cost pass through provisions in clauses 6.6.1 and 6A.7.3 of the NER that apply to distribution and transmission businesses.

Positive cost pass throughs exist in the rules as a mechanism to allow network businesses to recover their efficient costs incurred as a result of events that could not be forecast as part of their regulatory or revenue proposal that otherwise would have a significant financial effect on the ability of networks to invest in and operate their networks.

The currently prescribed pass through events are defined in Chapter 10 of the NER and include any of the following:

(a) a regulatory change event;

(b) a service standard event;

(c) a tax change event;

(d) a terrorism event.

Transmission businesses are also eligible for a prescribed insurance event, defined under Chapter 10 of the NER, which is in addition to those above.

Distribution businesses are not eligible for the insurance event, but are able to nominate events (in addition to those listed above) as a pass through event for its distribution determination when applying to the Australian Energy Regulator (AER) as part of its regulatory proposal.

In addition, under the National Electricity (Retail Support) Amendment Rule that has been approved by the Ministerial Council on Energy (MCE) as part of the National Energy Customer Framework, distribution businesses are also eligible for a 'retailer insolvency event'.

For transmission network service providers, the NER requires that a pass through event must 'materially' impact its maximum allowed revenue for that regulatory year.[5] This materiality threshold currently does not apply to distribution businesses under the NER. Cost pass throughs operate by network businesses applying to the AER for a cost pass through amount. If the AER approves the cost pass through amount then the network businesses can recover the costs approved through their network revenue/prices in future regulatory years.

The natural incentive properties of cost pass throughs are very weak. There is no direct financial benefit to the business from out performing in relation to those events that are covered by cost pass throughs, unlike the incentive arrangements for operating expenditure captured in the building blocks.

Clauses 6.6.1(j)(3) and 6A.7.3(j)(3) of the NER allow the AER to take into account the efficiency of the provider's decisions and actions in relation to the risk, as an attempt to impose some incentives to not overspend in relation to cost pass throughs. However, the efficiency incentives on matters that remain cost pass throughs are very poor.

1.5 Commencement of rule making process

On 2 February 2012, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence the rule making process and the first round of consultation in respect of the rule change request. A consultation paper prepared by AEMC staff identifying specific issues or questions for consultation was also published with the rule change request. Submissions closed on 1 March 2012.

The Commission received seven submissions on the rule change request as part of the first round of consultation. They are available on the AEMC website.[6] A summary of the issues raised in submissions and the Commission’s response to each issue is contained in Appendix A.

1.6 Consultation on draft rule determination

In accordance with the notice published under section 99 of the NEL, the Commission invites submissions on this draft rule determination, including a draft rule, by 21 June 2012.

In accordance with section 101(1a) of the NEL, any person or body may request that the Commission hold a hearing in relation to the draft rule determination. Any request for a hearing must be made in writing and must be received by the Commission no later than 17 May 2012.

5 Materially is defined as more than one per cent of the transmission network service providers maximum allowed revenue for that regulatory year.

6 www.aemc.gov.au

Submissions and requests for a hearing should quote project number "ERC0137" and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

2 Draft rule determination

2.1 Commission's draft determination

In accordance with section 99 of the NEL the Commission has made this draft rule determination in relation to the rule proposed by Grid Australia.

The Commission has determined it should not make the rule proposed by the Grid Australia and to make a more preferable rule.[7]

The Commission's reasons for making this draft rule determination are set out in section 3.1.

A draft of the rule that the Commission proposes to make (draft rule) is attached to, and published with this draft rule determination. Its key features are described in section 3.2.

2.2 Commission's considerations

In assessing the rule change request the Commission considered:

- the Commission's powers under the NEL to make the rule;
- the rule change request;
- the consultant's report commissioned by Grid Australia from Marsh Risk Consulting on the quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance;
- the fact that there is no relevant MCE statement of policy principles;[8]
- submissions received during first round consultation;
- the Commission's analysis as to the ways in which the proposed rule and the draft rule will or is likely to, contribute to the National Electricity Objective (NEO);
- the revenue and pricing principles under section 7A of the NEL;
- the Commission's final report to the MCE on its request for advice on cost recovery for mandated smart metering infrastructure; and

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7 Under section 91A of the NEL the AEMC may make a rule that is different (including materially different) from a market initiated proposed rule (a more preferable rule) if the AEMC is satisfied that having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates), the more preferable rule will or is likely to better contribute to the achievement of the National Electricity Objective.

8 Under section 33 of the NEL the AEMC must have regard to any relevant MCE statement of policy principles in making a rule.

- transmission and distribution determinations for network businesses published by the AER.

2.3 Commission's power to make the rule

The Commission is satisfied that the draft rule falls within the subject matter about which the Commission may make rules. The draft rule falls within section 34 of the NEL as it relates to sections 34(1)(a)(i), the operation of the national electricity market and 34(1)(a)(iii), the activities of persons (including Registered Participants) participating in the national electricity market or involved in the operation of the national electricity system.

Further, the draft rule falls within the matters set out in schedule 1 to the NEL as it relates to items 24/17 and 26A/26H, because it relates to the principles to be applied, and procedures to be followed, by the AER in exercising or performing an AER economic regulatory function or power relating to the making of a transmission or distribution determination.

2.4 Rule making test

Under section 88(1) of the NEL the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

For the rule change request, the Commission considers that the relevant aspect of the NEO is the impact to price, quality, reliability and security of supply of electricity that may arise as a result of any change in the efficient operation of, and ability and incentive of, network service providers to invest in their network assets.[9]

The Commission is satisfied that the draft rule will, or is likely to, contribute to the achievement of the NEO because:

9 Under section 88(2), for the purposes of section 88(1) the AEMC may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE Statement of Policy Principles.

- allowing transmission businesses the ability to nominate pass through events when submitting their revenue proposals would balance the allocation of risks between transmission businesses to recover their efficient costs (to attract sufficient investment in their networks) and end consumers (to ensure that prices are no more than necessary to provide an appropriate level of service). It would also contribute to alignment of the incentives for transmission and distribution network providers;

- providing the AER with the 'nominated pass through event considerations' would provide an appropriate hierarchy for the management of risk for the AER to consider when approving nominated pass through events, and would enable network businesses the opportunity to recover their efficient costs;

- addressing the 'dead zone' would provide regulatory certainty to network businesses by allowing them a reasonable opportunity to recover their efficient costs, should a pass through event occur during this period. This would promote the effective operation of, and efficient investment in, network businesses in the long-term interests of consumers; and

- providing transitional arrangements would provide regulatory certainty and transparency for network businesses in applying the cost pass through provisions, and thereby promote efficient operation and use of network services for the long term interests of consumers of electricity.

However, the Commission is not satisfied that all aspects of Grid Australia's proposed rule will, or are likely to, contribute to the achievement of the NEO because:

- the proposed definition for a natural disaster event adds unnecessary prescription to the NER and does not allow for differences between network businesses or for the definition to be refined over time, which is likely to result in higher than necessary prices for consumers in the long term;

- the insurance cap event could erode the incentives on network businesses to seek the prudent and efficient level of insurance cover for its circumstances, which is likely to result in higher than necessary prices for consumers in the long term; and

- removal of the subordination of the capex re-opening provisions to cost pass throughs would erode regulatory certainty for network businesses and consumers.

2.5 More preferable rule

Under section 91A of the NEL, the AEMC may make a rule that is different (including materially different) from a market initiated proposed rule (a more preferable rule) if the AEMC is satisfied that, having regard to the issues or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates), the more preferable rule will or is likely to better contribute to the achievement of the NEO.

In addition to the reasons outlined in section 2.4 and having regard to the issues raised by the rule proposed in the rule change request, the Commission is satisfied that the draft rule will, or is likely to, better contribute to the NEO for the following reasons:

- providing factors for consideration by the AER when approving nominated pass through events would help ensure that pass through events are only used in situations where commercial insurance and self-insurance are not available on a reasonable basis, or the network business is unable to mitigate or avoid the event without creating unacceptable risks. This would protect the incentive regime under the NER and better promote the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers of electricity with respect to price; and
- because removal of the terrorism event from the defined pass through events, as noted in Chapter 1.4, cost pass throughs erode the incentives on network businesses to undertake, where available, market-based mechanisms to mitigate the cost impacts that could arise, which is not in the long term interests of consumers of electricity with respect to price.

2.6 Other requirements under the NEL

In applying the rule making test in section 88 of the NEL, the Commission has taken into account the revenue and pricing principles as required under section 88B of the NEL as the rule change request relates to matters specified in items 17, 24, 26A and 26H in schedule 1 to the NEL.

The Commission has taken into account the revenue and pricing principles in making this draft rule determination, as the rule relates to item 26 of Schedule 1 of the NEL. Some aspects of the revenue and pricing principles relate to providing a reasonable opportunity to service providers to recover efficient costs.[10] Other aspects of the revenue and pricing principles relate to providing network services providers with effective incentives in order to promote economic efficiency with respect to direct control network services the network operator provides.[11]

The Commission considers that the draft rule is consistent with the revenue and pricing principles as it provides an efficient and transparent mechanism for the recovery of unforeseen costs that network businesses incur in their capacity as network operators. While at the same time, the inclusion of the nominated pass through considerations in the draft rule provides network businesses with effective incentives to promote economic efficiency in managing the risks associated with these unforeseen events.

10 NEL section 7A(2)

11 NEL section 7A(3).

3 Commission’s reasons

The Commission has analysed the rule change request and assessed the issues arising out of it. For the reasons set out below, the Commission has determined to make a more preferable draft rule.

3.1 Assessment

Cost pass throughs are an important mechanism under the NER in respect of network regulation. They are needed because of the inability of network businesses, and the AER, to forecast all possible events that could affect the ability of the network businesses to provide network services at the time of setting the revenue or regulatory determinations. Network businesses should be provided the reasonable opportunity to recover, in future regulatory years, the efficient costs they incur as a result of unexpected events. The inability to recover these costs would otherwise have a significant financial effect on the ability of networks to invest in and operate their networks.

However, the natural incentive properties of cost pass throughs are very weak. Network businesses should have effective incentives in order to promote economic efficiency with respect to the network services they provide. Therefore, cost pass throughs should, where appropriate, provide:

- flexibility for changing circumstances;
- direct application to the individual circumstances of each network business; and
- encouragement for network businesses to utilise market-based mechanisms.

On that basis a rule is required to allow network businesses the ability to nominate pass through events specific to their circumstances, but subject to a set of nominated pass through considerations.

3.2 Draft rule

The Commission has agreed to the making of a draft rule. The draft rule that has the following key features:

- transmission network service providers have been given the ability to nominate pass through events as part of their revenue proposals;
- the terrorism event has been removed from the prescribed pass through events for both distribution and transmission businesses;
- a new definition 'nominated pass through event considerations' has been included in chapter 10 that outlines the factors the AER must consider when

approving nominated pass through events for both distribution and transmission businesses;

- drafting to address the 'dead zone' has been incorporated in chapters 6 and 6A for both distribution and transmission businesses;
- the defined pass through events have been moved from chapter 10 to clause 6.6.1(a1) for distribution, and clause 6A.7.3(a1) for transmission; and
- transitional arrangements have been included to:
  - retain the 'terrorism event' as a prescribed pass through event for network service providers current regulatory control periods; and
  - enable Powerlink (whose regulatory control period commences 1 July 2012) to nominate pass through events within three months of commencement of the rule.

The key differences between the draft rule and that proposed by Grid Australia are:

- a natural disaster event has not been included;
- an insurance event has not been included;
- the terrorism event has been removed (except in respect of network service provider's current regulatory control periods);
- the proposed amendment to clause 6A.7.1(a)(7) to remove the current subordination of the capex re-opening provisions has not been included; and
- the AER is required to have regard to certain specified matters (nominated pass through considerations) when determining whether to accept nominated pass through events.

The draft rule has been drafted as if the National Electricity (Retail Support) Amendment Rules, approved by the MCE, have commenced.

3.3 Civil penalties

The draft rule does not amend any rules that are currently classified as civil penalty provisions under the NEL or Regulations. The Commission does not propose to recommend to the MCE that any of the amendments in the draft rule be classified as civil penalty provisions.

4 Assessment framework

This Chapter briefly outlines the AEMC's approach to assessing the rule change request in accordance with the requirements set out in the NEL. This framework is the same as that used in the consultation paper and the same assessment framework has been used to assess the more preferable rule that has been developed.

In assessing any rule change request, the Commission must have regard to the extent to which the rule will, or is likely to, contribute to the achievement of the NEO. In making this assessment, weight may be given to any specific aspect of the NEO as appropriate.

Grid Australia's rule change request may potentially affect the ability, and the efficient operation, of the incentives on network service providers to invest in their network assets. Generally, any change in the level of investment in networks is likely to impact the price, quality, reliability and security of supply of electricity. Therefore, the most relevant aspect of the NEO is whether the draft rule will better balance the need to attract sufficient investment in the networks with the need to ensure that prices for consumers are no more than is necessary to provide an appropriate level of service.

In assessing the rule change request and the draft rule, the following issues have been considered:

- Allocation of risks between business and end consumers - to what degree is the efficient trade-off between the network business mitigating its risk through commercial, and/or self, insurance and end consumers bearing the risk? How should the risk be allocated between the business and end consumers?

- To what extent are the changes unexpected and outside of the networks' control, and are they consistent with standard force majeure provisions in commercial contracts? Is it appropriate to remove any incentive on network service providers to protect their equipment against natural disasters?

- Recovery of efficient costs – does the proposed rule ensure that network service providers would be able to recover appropriate costs and encourage efficient investment in, and operation of, electricity networks?

- Regulatory certainty and transparency – does the proposed rule provide an appropriate amount of regulatory certainty and transparency to reduce ambiguity and costs in defining and applying the cost pass through provisions in the rules for electricity networks?

- Alignment of incentives for transmission and distribution network providers - consistency with the rules for DNSPs is only relevant to the extent that there are benefits from that consistency, therefore, does the rule change request better contribute to achievement of the NEO compared with the current rules for TNSPs? Are there reduced compliance costs and greater administrative efficiency for a company that owns both distribution and transmission assets and increased transparency of the regulatory framework for investors?

- Any other aspects relevant in the rules - for example, to what extent does/should the regulated weighted average cost of capital (WACC) include a provision for the risk of unforeseen exogenous events occurring?.

The proposed rule will also be compared with the current arrangements to ascertain whether it would better meet the objectives and principles of the regulatory framework under chapters 6 and 6A of the rules, including:

- achieving a balance between the interests of transmission network businesses and end consumers; and
- providing transparent and timely regulatory processes.

5 Ability for TNSP's to nominate additional cost pass through events

5.1 Grid Australia's view

Grid Australia noted in its rule change request that currently TNSPs are only allowed to apply to the AER to pass through the costs of the prescribed events defined in Chapter 10 of the NER. Grid Australia suggested that there are a number of additional risks faced by TNSPs, associated with uncertain events outside of their reasonable control that may include, but not be limited to, events such as cyber-attacks and aviation mishaps, unrelated to terrorism.[12]

Grid Australia also noted that DNSPs are allowed to include nominated pass through events in their regulatory proposals. Once accepted by the AER, the nominated pass through event acts as a pass through event for that DNSP for the forthcoming regulatory control period.

Therefore, Grid Australia proposed that the NER be amended to provide TNSPs with the same flexibility to propose specific pass through events at the time of submitting their revenue proposals. Grid Australia submitted that this would provide TNSPs with the same flexibility to manage risks by using the pass through provisions as currently afforded under the rules to DNSPs.[13]

5.2 Stakeholder views

There was general agreement among stakeholders to allow transmission network businesses to nominate additional pass through events at the time of submitting their revenue proposals to the AER. For example, Ergon Energy and the AER supported Grid Australia's rule change request as it would provide TNSPs with the same flexibility as afforded DNSPs in managing risks and bring chapters 6 and 6A more into greater alignment.[14]

On the other hand, while TRUenergy supported Grid Australia's proposal for greater consistency in the NER, it considered that the AER should "decide on whether to approve a pass through based on the criteria that is currently applied to distributors".[15] TRUenergy suggested that this would "ensure that [the AER] did not undermine the incentive arrangements in approving a pass through as part of its assessment process".[16]

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12 Grid Australia rule change request, October 2011, p. 19.

13 Id., p. 20.

14 Ergon Energy submission on the consultation paper, p2 and AER submission on the consultation paper, p. 3.

15 TRUenergy submission on the consultation paper, p. 4.

16 Ibid.

In its submission the AER outlined the criteria that it utilised in approving the nominated pass through events for the Victorian distribution determinations. In particular the AER emphasised the importance of the potential loss to the DNSP being catastrophic and that in these circumstances a pass through event may be more appropriate, subject to it satisfying the other pass through criteria.[17] However, the AER did not "support the codification of these criteria in the NER on the basis that it would be more appropriate to include these criteria, which reflect high level principles, in an AER guideline".[18]

5.3 Analysis and conclusions

5.3.1 Conclusion

Transmission businesses should have the ability to nominate pass through events when submitting their revenue proposals, which would provide an appropriate balance in the allocation of risks between businesses (to recover costs to attract sufficient investment in their networks) with end consumers (to ensure that prices are no more than necessary to provide an appropriate level of service). However, in order to provide network businesses, the AER and consumers with additional certainty the draft rule will introduce a set of factors that the AER must consider when deciding whether to accept the network businesses' proposals.

The ability for transmission businesses to nominate additional pass through events is also consistent with the assessment framework to align the incentive arrangements for transmission and distribution businesses.

5.3.2 Analysis

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. Businesses that cannot recover their efficient costs are reluctant to continue to invest in that industry.

Allowing transmission businesses the ability to nominate pass through events would thereby provide transmission businesses with the same opportunity afforded to distribution businesses to recover their efficient costs.

This should, however, be limited to instances where efficient costs are incurred because unforeseen costs arise as a result of events outside a network business' reasonable control.

In respect of cost pass through events, there should be greater consistency between the rules governing transmission and distribution businesses under chapters 6 and 6A of

17 AER submission on the consultation paper, p. 4.

18 Ibid.

the NER. The Commission's initial preference is for "a single framework across electricity distribution, electricity transmission and gas".[19] Therefore, providing transmission businesses with the opportunity to propose additional pass through events to the AER would further strengthen the consistency between electricity distribution and transmission.

This approach will result in an increase in administration in approving pass through events. However, this administrative increase is likely to be lower than the benefits obtained from greater flexibility to account for the individual circumstances of each business.

Factors for consideration

As noted by TRUenergy, it is necessary to maintain the incentive regime under the NER. This would be best achieved by providing the AER with factors for it to consider when approving additional pass through events. In the consultation paper the Commission queried whether it would be better to codify these factors for consideration under the NER, or provide an obligation on the AER to produce a guideline that outlined the factors it would consider in approving additional pass through events.[20]

These factors should be included in the NER, as opposed to being set out in a guideline determined by the AER in accordance with its consultation procedures. While it is understood that a degree of flexibility is lost, the nominated pass through considerations in the draft rule are representative of the factors crucial in defining those events that may be nominated as a pass through event.

Specification of these factors in the NER also provides more certainty to both network businesses and consumers. The network businesses have certainty as to the relevant factors that must be considered when nominating additional pass through events. Similarly, consumers have certainty that they will bear the risk of a pass through of costs only when it is necessary they do so.

For reference, the relevant factors that the AER used to consider nominated pass through events for the Victorian distribution businesses are provided below.[21]

Box 5.1: Factors the AER considered for the Victorian distribution businesses

1. The event is not already provided for:

   (a) in the defined event definitions in the NER (and does not conflict or

19 AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Directions Paper*, 2 March 2012, Sydney, p. 66.

20 AEMC 2012, *Cost pass through arrangements for network service providers, consultation paper*, 2 February 2012, Sydney, p. 19.

21 Id., pp. 10-11.

undermine the events defined in the NER)

(b) through the opex allowance (e.g. the insurance or self-insurance components)

(c) through the WACC (events which affect the market generally and not just the provider are systematic risk and already compensated through the WACC), or

(d) through any other mechanism or allowance.

2. the event is foreseeable — in that the nature or type of event can be clearly identified

3. the event is uncontrollable — in that a prudent service provider through its actions could not have reasonably prevented the event from occurring or substantially mitigated the cost impact of the event

4. the event cannot be self-insured because a self-insurance premium cannot be calculated or the potential loss to the relevant DNSP is catastrophic

5. the party who is in the best position to manage the risk is bearing the risk

6. the passing through of the costs associated with the event would not undermine the incentive arrangements within the regulatory regime.

While this outlines the major factors for consideration when determining a cost pass through, the factors outlined in item one are already covered under clauses 6.6.1(j) and 6A.7.3(j) of the NER. However, items two to six may be distilled down to the following important elements, which are important considerations to maintain the incentive regime. To the extent that these factors apply to both distribution and transmission businesses, a new definition under Chapter 10 of the NER is proposed, namely:

Box 5.2: Nominated pass through considerations

The *nominated pass through event considerations* are whether:

(a) the event proposed is an event covered by a category of pass through event specified in clause 6.6.1(a1) (in the case of a distribution determination) or clause 6A.7.3(a1) (in the case of a *transmission determination*);

(b) the nature or type of event can be clearly identified at the time the determination is made for the service provider;

(c) a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;

(d) a service provider could insure against the event, including:

(1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or

(2) whether the event can be self-insured on the basis that:

(i) it is 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*.

These factors mean that, for the incentive regime to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are unavailable, or the cost pass through is the least inefficient option.

The nominated pass through considerations are an additional aspect of the draft rule. The intention of the nominated pass through considerations is to incorporate the essential components of a cost pass through regime. Stakeholders are encouraged to comment on the following aspects of the nominated pass through considerations.

Question 1 Nominated pass through considerations

(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?

Capex re-opener

Cost pass throughs should be the last option available with respect to risk management, with the only exception being the capex re-opener.[22]

The consultation paper noted that when introducing chapter 6A the AEMC had indicated that the capex re-opener was intended for 'large, shipwreck-type events', and that cost pass throughs should be a preferable means of redress of these sorts of risks.[23] Grid Australia's rule change request suggested amendments to the wording of clause 6A.7.1(a)(7) to remove the current subordination of the capex re-opening provisions.[24]

22 NER clause 6A.7.1.

23 AEMC 2012, *Cost pass through arrangements for network service providers, consultation paper*, 2 February 2012, Sydney, p. 14.

24 Grid Australia submission on the consultation paper, March 2012, p. 8.

It considered that this would allow transmission businesses the flexibility to seek "cost recovery via the most appropriate route (cost pass through under clause 6A.7.3 or re-opening under clause 6A.7.1) for events which satisfy the conditions for both mechanisms".[25]

However, the means for addressing risk have a logical hierarchy and are not a 'smorgasbord' in which network businesses should be able to select their preferred option.

Capex re-openers should only be used for 'large, shipwreck-type events', where all available alternatives have been exhausted, and therefore should remain subordinate to cost pass throughs.

25 Grid Australia rule change request, October 2011, P. 26.

6 Defined natural disaster event under the NER

6.1 Grid Australia's view

In its rule change request, Grid Australia proposed that the chapter 10 definition of a pass through event be amended to incorporate a new 'natural disaster event'. A 'natural disaster event' was proposed as follows:[26]

> "Any flood, fire, earthquake or other natural disaster beyond the reasonable control of a *Transmission Network Service Provider* or *Distribution Network Service Provider*, which *materially* increases the costs to the *Transmission Network Service Provider* of providing *prescribed transmission services* or the costs to the *Distribution Network Service Provider* of providing *direct control services*."

Grid Australia submitted that this additional pass through event would capture a key category of uncertain events outside of a network service provider's reasonable control in which they typically incur substantial costs, including those arising from property damage to towers and lines and third party liability claims.

Grid Australia stated that the Victorian distribution determinations included a natural disaster event as a nominated pass through event. The AER has also allowed natural disasters to fall within the general nominated pass through events for distribution businesses in earlier distribution determinations. Grid Australia also noted that the AER has stated that it may be appropriate to codify additional pass through events once positions have been settled.[27]

Therefore, in recognition of this codification and given the consensus that has emerged through the AERs distribution determination process, Grid Australia proposed the inclusion of a prescribed natural disaster pass through event to apply to both distribution and transmission businesses.

6.2 Stakeholder views

Stakeholder's views on whether to include a prescribed natural disaster event within the definition of a pass through event were divergent. The network businesses were by and largely supportive of Grid Australia's amendments, while the AER, TRUenergy and the Tasmanian Government opposed the changes.

ENERGEX and Ergon Energy supported Grid Australia's proposal to introduce this definition in the NER. In particular, Ergon Energy noted its support for inclusion "as it provides some regulatory certainty for network service providers and is an appropriate

26 Grid Australia rule change request, October 2011, p. 12.

27 Id., p. 13.

risk management strategy".[28] ENERGEX stated that it does not consider the inclusion of a new natural disaster pass through event would alter incentives, and that it will continue to seek to mitigate the risks of natural disaster where possible.[29] ENERGEX also noted the "inclusion of a new natural disaster event will provide greater certainty and transparency for NSPs and will be marginally more administratively efficient", as a nominated pass through event does not have to be included in regulatory determinations.[30]

On the other hand, TRUenergy did not support the inclusion of a definition for a natural disaster event in the NER, and was concerned that "any change to the NER that would automatically allow TNSPs to pass through any additional costs for a wider range of events would just erode the incentive properties of the current low powered incentive regime".[31] That is, there is a risk that "if we continue to clearly prescribe more pass through provisions in the rules that we would undermine the incentive arrangements and inherit some of the problems associated with rate of return regimes".[32]

Similarly, the AER did not agree with Grid Australia's view that "consensus has emerged for inclusion of [a natural disaster event] in pass through provisions for DNSPs".[33] The AER considered that this point was highlighted by Grid Australia having marginally amended the definition of a natural disaster event from that published in the Victorian distribution determination.

Furthermore, the AER considered that this "highlighted the importance of the AER retaining the discretion to appropriately consider such matters when proposals from network businesses are made, rather than having a specific definition prescribed in the NER".[34] In time "once those positions are settled they may be codified, such as in a guideline".[35]

6.3 Analysis and conclusion

6.3.1 Conclusion

A new natural disaster event should not be included within the definition of a pass through event. Grid Australia's proposed definition adds unnecessary prescription and does not allow for differences between network businesses or for the definition to be refined over time.

28 Ergon Energy submission on the consultation paper, March 2012, p. 1.

29 ENERGEX submission on the consultation paper, March 2012, p. 6.

30 Ibid.

31 TRUenergy submission on the consultation paper, March 2012, p. 3.

32 Ibid.

33 AER submission on the consultation paper, March 2012, p. 5.

34 Ibid.

35 Ibid.

For the same reasons, the prescribed terrorism event should be removed from the definition of a pass through event in the NER.

Providing network businesses with the opportunity to propose nominated pass through events as part of their revenue/regulatory proposals, subject to the pass through considerations under the NER, would provide the most efficient means of assessing both natural disaster and terrorism events.

6.3.2 Analysis

Natural disaster event

The types of natural disasters faced by network businesses in Australia are diverse and, owing to the size and scale of the Australian network, vary from network to network. Given this uniqueness, it is difficult to draft a single definition that encompasses these subtle differences inherent to each network business. Therefore, as noted by the AER, the wording of any definition is, by necessity, broader and more general than it needs to be for each individual business.[36]

There would be greater flexibility for network businesses if they were able to tailor a nominated pass through event at the beginning of their five year regulatory control period specific, to their own circumstances.

When considering any pass through event, efficient market based mechanisms are more appropriate to preserve the incentive regime than either self-insurance, cost pass throughs, or capex re-openers. Furthermore, these mechanisms are apt to change over time, reflecting the changing technological circumstances of the businesses and the development of new insurance products.

Therefore, it is more appropriate that the AER uses its discretion when approving cost pass through applications, and seek justification from network businesses that a cost pass through is the most efficient method to account for the event.

Terrorism event

Where possible, a cost pass through event should reflect the circumstances of the business. The currently prescribed terrorism event essentially falls into the same category as that of Grid Australia's proposed natural disaster event. That is, its definition as a pass through event effectively erodes the incentives, now and in the future, on network businesses to seek alternative mechanisms to mitigate the cost impacts that may arise.

On the other hand, future changes are less likely to affect the incentive arrangements for the other three defined pass through events - regulatory change, service standard, or tax change events. Furthermore, the increase in administrative costs on both

36 AER submission on the consultation paper, March 2012, p. 5.

network businesses and the AER through removal of these events, is likely to be higher than any gain in flexibility by not prescribing them in the NER. The flexibility gains are likely to be small because the AER and network businesses are likely to focus on making sure that the currently prescribed pass through events are included in the network determinations, as nominated pass through events.

Notwithstanding, as with the natural disaster event, a terrorism event should only be accepted as a pass through event where the business has been able to satisfy the AER that all appropriate avenues for avoidance, mitigation and insurance have been effectively exhausted. For this reason, the terrorism event should also be removed from the prescribed pass through events.

This conclusion does not imply that these types of events should not be treated as cost pass through events, but that the decision should be made as part of the determination process, considering the circumstances of each network business, rather than prescribed in the NER.

7 Defined insurance cap event under the NER

7.1 Grid Australia's view

Grid Australia proposed to include an 'insurance cap event' as a new pass through event. Grid Australia considered that this new pass through event would provide network service providers with an appropriate means of addressing the risk associated with the costs arising from third party liability claims, that are in excess of insured limits. Grid Australia also considered that this would address the more general issue of the management of risk in excess of commercial insurance limits.[37] Grid Australia's proposed definition of this event is as follows:[38]

> "Either:
>
> (a) a Transmission Network Service Provider or a Distribution Network Service Provider incurs a liability or liabilities; or
>
> (b) an event occurs,
>
> where:
>
> (a) the incurring of that liability or those liabilities or the occurrence of that event would, but for the existence of a relevant policy limit, entitle the provider (or another person on its behalf) to receive a payment, or a greater payment, under the insurance policy to which the limit applies; and
>
> (b) the costs that are incurred or are likely to be incurred by the provider in respect of that liability or those liabilities or in respect of that event, and that would be covered by the insurance policy, but for the relevant policy limit, are such as to materially increase the costs to the Transmission Network Service Provider of providing prescribed transmission services or the costs to the Distribution Network Service Provider of providing direct control services.
>
> For the purpose of this event, the relevant policy limit for an insurance policy means any limit on the maximum amount that can be claimed under an insurance policy, including a limit set on the maximum amount of a single claim or on the maximum amount of a number of claims over a certain period of time."

Grid Australia noted that network service providers generally have insurance to manage the risk of third party liability claims, including cover where the network service provider is found to have acted negligently. However, such insurance is

37 Grid Australia rule change request, October 2011, p. 16.

38 Ibid.

typically capped, with higher levels of cover above that cap generally requiring very high premiums (in the order of US$20,000-$50,000 per million dollars insured).[39]

Grid Australia considered that the inclusion of an insurance cap event provides network service providers with additional flexibility in managing their risk exposure generally, such that they do not need to incur excessive insurance premiums in order to increase the limits of their insurance cover.

7.2 Stakeholders views

ENERGEX supported the inclusion of a defined insurance cap pass through event.[40] ENERGEX's rationale for its inclusion followed that of the natural disaster pass through event. Similarly, Ergon Energy supported "Grid Australia's intent to include a new insurance cap event as a defined statutory pass through event. However, Ergon Energy considered that the definition proposed by Grid Australia may be ambiguous and could benefit from being refined".[41]

Grid Australia, in its submission, considered that "including the two new proposed cost pass through events (i.e. a natural disaster event and an insurance event) would provide a greater degree of regulatory certainty and transparency and would be more administratively efficient than relying solely on a new nominated pass through provision".[42]

Additionally, "incorporating the two new events in the NER would avoid the AER having to re-consider whether to allow these events at the time of each regulatory determination, which would be administratively inefficient and would introduce a degree of uncertainty".[43] That is, given the degree of conformity that has emerged from the DNSP determinations, there is a strong argument to add these new events in the NER.

On the other hand, TRUenergy did not support the inclusion of a clause that includes a new 'insurance cap event' within the definition of 'pass through event' to recover the costs that exceed insured limits. TRUenergy noted that "such an automatic pass through may undermine the incentives for regulated firms to appropriately insure ... taking out lower levels of insurance on the basis of an automatic ability to pass on uninsured risks to consumers could allow higher profitability by the firm outperforming its opex allowance".[44]

Furthermore, TRUenergy considered that having "the regulator seek to determine an efficient level of insurance would cross the line into micro-management by the

39 Id., p. 17.

40 ENERGEX submission on the consultation paper, March 2012, p. 7.

41 Ergon Energy submission on the consultation paper, March 2012, p. 2.

42 Grid Australia submission on the consultation paper, March 2012, p. 9.

43 Ibid.

44 TRUenergy submission on the consultation paper, March 2012, p. 4.

regulator, and likely be less efficient than a market based insurance level determined by a fully 'on risk' NSP".[45]

The AER did not support codification of this new definition in the NER, and referred explicitly to the AEMC's question relating to whether a network service provider should be able to pass through costs where they are found to be negligent.[46] The AER noted that it took this into account when determining the insurance cap event for its Victorian determination and stated "in the event of such conduct, the insurance policy would be invalidated and the cost pass through would not be invoked".[47]

The Tasmanian Government noted that it would be "unreasonable to create an incentive for network companies and their owners to underinsure or to reduce the capacity for self-insurance, or be able to ignore the numerous predictions of increasing severe and frequent extreme weather events without consequences". On the other hand, the Tasmanian Government stated "it would be unreasonable if they undertake efficient best practice measures to reduce the increasing risks of fire, flood, storm and being sued, but are then unable to recover costs of doing so".[48]

In relation to the issue of negligence, Grid Australia noted that "in a case where there has been 'wilful negligence' and that is not covered by the insurance policy, the NSP would not be able to apply for a cost pass through".[49] Grid Australia further noted that the underlying issue would be more appropriately characterised as "... what level of costs customers should be bearing to address the risk of third party liability claims due to negligence: the cost of potentially excessive premiums, regardless of whether the event occurs, or the costs associated with the event if it in fact occurs".[50]

7.3 Analysis and conclusion

7.3.1 Conclusion

A prescribed insurance cap event should not be included in the definition of a pass through event in the NER.

The insurance cap event proposed by Grid Australia would erode the incentives on network businesses to seek the prudent and efficient level of insurance cover for its circumstances. Network businesses should justify their level of insurance cover with the AER when determining their network determinations.

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45 Ibid.

46 AER submission on the consultation paper, March 2012, p. 5.

47 Id,. p. 6.

48 Office of Energy Planning and Conservation submission on the consultation paper, March 2012, p. 2.

49 Id., p. 7.

50 Grid Australia submission on the consultation paper, March 2012, p. 9.

This would provide an environment where network businesses are better able to balance their need to recover costs to attract sufficient investment in their networks, with the need to ensure that prices for consumers are no more than necessary to provide an appropriate level of service. In cases where the AER approves an additional insurance cap pass through event, it would be only for those circumstances where the consumer is the party in the best position to bear the costs associated with occurrence of the event.

7.3.2 Analysis

Cost pass through provisions should be the last option available with respect to risk management, with the only exception being the capex re-opener. It is imperative that other mechanisms are considered and utilised before cost pass through applications are used, so the incentive arrangements are maintained. The proposed insurance cap event may negatively impact on the current incentive arrangements.

Grid Australia has commented that a degree of conformity has emerged from the distribution determinations, and that there is a strong argument to add these new events in the NER for the benefit of transmission businesses. However as the AER has noted, given that the definition proposed by Grid Australia differs from that in the Victorian distribution determinations, that true consensus has yet to be reached. This is further substantiated by Ergon Energy's statement that the definition proposed by Grid Australia may be ambiguous and could benefit from being refined.

Retaining flexibility in the NER, which will provide network businesses with the ability to propose nominated pass through events - this may include an insurance cap event - is the right balance of certainty for the network business while maintaining the incentive regimes in the NER. TRUenergy and the Tasmanian Government made similar points on this matter in their submissions. This would make sure that an insurance cap event is not an automatic right, but would require the network business to justify to the AER the reasons behind its level of insurance cover and why an insurance cap event is prudent and efficient for its circumstances.

In relation to administrative efficiency, Grid Australia considered that incorporating the natural disaster and insurance cap events in the NER would avoid the AER having to re-consider whether to allow these events at the time of each regulatory determination.

Any administrative efficiency as a result of defining these events under the NER is likely to be negligible given the tasks that the AER has to complete as part of the determination process. Furthermore, the introduction of factors that the AER must consider in approving nominated pass through events will provide regulatory certainty to the businesses when applying for additional pass through events.

8 Cost recovery for pass through events in the 'dead zone'

The 'dead zone' typically occurs in the final year of a regulatory control period and is where a network service provider may be unable to seek cost recovery under the cost pass through provisions. This is because network service providers may only seek cost recovery for costs incurred in the same regulatory control period as the pass through event.[51]

That is, an eligible cost pass through event may occur in the last months of a regulatory control period, but the network service provider is unable to recover those costs, or does not incur costs associated with that event until the next regulatory control period. In this case, where the pass through event, and the ability to recover the costs, or the incurring of costs, occur in separate regulatory control periods, a network service provider would not be able to seek a cost pass through under the current rules.

The Commission has previously noted this issue in the context of distribution network service providers and made recommendations to the MCE on amendments to the rules to provide DNSPs with the ability to recover costs incurred in a previous regulatory control period resulting from the 'dead zone'.[52]

8.1 Grid Australia's view

Grid Australia submitted that the 'dead zone' issue is also a problem for transmission businesses under the current rules arrangements and should be extended to all network businesses.[53] It noted that the draft rule proposed by Grid Australia is broadly consistent with the drafting that was submitted to the MCE by the AEMC as part of its rule change request.

8.2 Stakeholder views

Ergon Energy and TRUenergy were "supportive of amendments to the rules to allow NSP's the opportunity to recover costs for pass through events which occurred in the prior regulatory control period, but which have not been incorporated into the NSPs expenditure forecasts of the following regulatory control period".[54]

The AER also supported addressing the 'dead zone' and noted that "there are already aspects of the regulatory regime that 'carry' through cost and reliability performance between regulatory control periods".[55]

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51 See the definition of an '*eligible pass through event*' in chapter 10 of the rules.

52 AEMC 2010, *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure* - 30 November 2010 and a draft rule change request including draft rules.

53 Grid Australia rule change request, October 2011, pp20-21.

54 Ergon Energy submission on the consultation paper, March 2012, p. 2., and TRUenergy submission on the consultation paper, March 2012, p. 5.

55 AER submission on the consultation paper, March 2012, p. 6.

ENERGEX noted that "allowing NSPs to potentially recover efficient costs associated with a pass through event which occurred in the 'dead zone' will not change how a NSP manages its risk". Further, it also considered that "addressing the 'dead zone' would provide NSPs with some certainty that should an uncontrollable, unexpected and high impact event occur within the 'dead zone', some recourse may be available to these businesses".[56]

8.3 Analysis and conclusion

8.3.1 Conclusion

Amendments to address the 'dead zone' issue should be made because it provides network businesses with the reasonable opportunity to recover their efficient costs should a pass through event occur within this period. The amendments also promote regulatory certainty and transparency for the network businesses.

8.3.2 Analysis

Network businesses are currently able to recover the costs incurred when a pass through event occurs for all time periods other than the 'dead zone'. Therefore, on that basis the nature of this amendment is administrative, as it removes a known anomaly from the drafting of the current rules and would create consistency for all time periods.

Further, allowing network service providers the opportunity to recover the costs incurred when a pass through event occurs during the 'dead zone' is consistent with the revenue and pricing principles under section 7A(2) of the NEL, as the network business is provided a reasonable opportunity to recover at least the efficient costs it incurs in providing direct control network services.[57]

Where network businesses are better able to recover their costs, it promotes the efficient operation of the incentives on network service providers to invest in their network assets.

The proposed rule would allow network businesses to recover the costs of a pass through event over a number of years. This is appropriate and leaves it to the discretion of the AER as to whether to allow these costs to be recovered up to the end of a regulatory control period or across regulatory control periods.

56 ENERGEX submission on the consultation paper, March 2012, p. 8.

57 Note that, the 'reasonable opportunity to recover efficient costs' is only one of the revenue and pricing principles to which the AEMC must have regard when making the rule.

9 Saving and transitional arrangements

9.1 Grid Australia's view

In its rule change request, Grid Australia noted that Powerlink had already lodged its revenue proposal with the AER. As part of that proposal, Powerlink identified a number of risk exposures which it considered were not provided for in its proposed insurance premiums and self-insurance. To address these risk exposures, Powerlink flagged Grid Australia's intention to lodge a rule change request when it submitted its proposal that may include associated transitional provisions applicable to Powerlink's next regulatory control period.[58]

As a consequence, Grid Australia was concerned that if the Commission made a rule in relation to cost pass through arrangements that they would not apply to Powerlink. Grid Australia therefore suggested transitional arrangements are included in the draft rule relating to its application to Powerlink.[59]

Grid Australia also provided transitional arrangements for distribution network service providers in its proposed rule. The proposed transitional rule had the effect of limiting application of the changes to the cost pass through events for distribution network service providers until the beginning of each businesses next regulatory control period.[60]

9.2 Stakeholder views

No submissions were received from stakeholders regarding application of the amending rule applicable to distribution network service providers.

Powerlink provided a submission regarding transitional arrangements for its next regulatory control period. Specifically, Powerlink sought confirmation from the Commission that there would be savings and transitional arrangements in the draft and final rules on the cost pass through arrangements that would apply to Powerlink's next regulatory control period from the commencement of the amending rule.[61]

9.3 Analysis and conclusion

9.3.1 Conclusion

To promote regulatory certainty and fairness between network businesses, transitional arrangements have been included to allow Powerlink to nominate additional pass

58 Grid Australia rule change request, October 2011, p. 26.

59 Ibid.

60 Id,. p. 39.

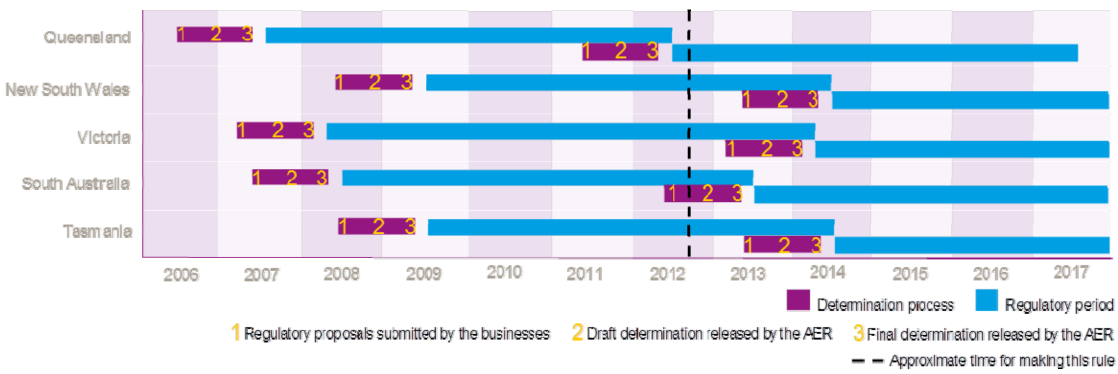
61 Powerlink submission on the consultation paper, March 2012, p. 2.

through events for consideration by the AER. In deciding whether to accept those nominated cost pass through events, the AER must take into account the new nominated pass through considerations (described in Chapter 5).

9.3.2 Analysis

The current timetable for approving transmission determinations by the AER is set out in Figure 9.1 below.

Figure 9.1 Transmission determination timetable



Adapted from Australian Energy Regulator, *State of the energy market 2011*, p. 59.

The time lag between the start of the proposed amending rule and Powerlink's next revenue determination would entail a significant delay before Powerlink could utilise the new rules. For reasons of transparency and fairness between network businesses, Powerlink should be given the opportunity to nominate additional pass through events following consultation with the AER, in accordance with the amending rule.

Any additional nominated pass through events for Powerlink should be in writing and contain the basis for allowing the pass through event consistent with the NER, including the new nominated pass through event considerations introduced by the amending rule.

Question 2 Are there any additional requirements that need to be taken into account in the transitional arrangements?

The proposed transitional arrangements also provide that the terrorism event will be a pass through event for distribution and transmissions businesses until the end of their current respective regulatory control periods. As the current determinations for network businesses were made on the basis that the 'terrorism event' was a prescribed pass through event under the NER, a rule that purported to remove the terrorism event as a nominated pass through event in the current regulatory control periods is likely to be ineffective.[62]

With further reference to Figure 9.1, at the time of making the amending rule, it is noted that ElectraNet will be in the process of making its revenue determination with the AER for its next regulatory control period. Therefore, transitional arrangements to allow ElectraNet to nominate additional pass through events in its revised revenue proposal may be included if necessary.

The provisions to address the 'dead zone' will commence for all network businesses on or about the time of making of the amending rule.

Question 3	**Is it necessary to included transitional arrangements for any other network businesses?**

62 Section 33(1)(c) of Schedule 2 to the NEL.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
capex	capital expenditure
Commission	See AEMC
DNSP	distribution network service provider
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NSP	network service provider
opex	operating expenditure
TNSP	transmission network service provider
WACC	weighted average cost of capital

A Summary of issues raised in submissions

Issue	Stakeholder	AEMC Response
TNSPs being able to propose additional cost pass through events	Ergon Energy (p. 2) supported Grid Australia's rule change request as it would provide TNSPs with the same flexibility as afforded DNSPs in managing risks.	The draft rule includes provisions to allow transmission businesses the opportunity to nominate additional cost pass through events as part of their revenue proposals. However, to improve the efficient operation of pass through applications and provide network businesses with effective incentives in order to promote economic efficiency with respect to direct control network services the draft rule includes nominated pass through considerations that the AER must consider when approving nominated pass through events. The analysis in support of the amendments to the draft rule are contained in Chapter 5.3.2 of this draft rule determination.
	TRUenergy also supported Grid Australia's proposal. However, TRUenergy (p. 4) considered that the AER should "decide on whether to approve a pass through based on the criteria that is currently applied to distributors". This would "ensure that [the AER] did not undermine the incentive arrangements in approving a pass through as part of its assessment process".	
	The AER (p. 3) agreed that "the pass through provisions in the NER should be the same between chapter 6A and chapter 6". The AER (p. 4) also noted "in developing its criteria for considering additional pass through events recognised [the issue of calculating a probability for low probability high cost events] and included the consideration that where an event cannot be self-insured because a self-insurance premium cannot be calculated or the potential loss to a DNSP may be catastrophic, a pass through event may be appropriate (subject to satisfaction of other pass through criteria)". In relation to whether these criteria should be codified in the NER, the AER (p. 4) "does not support the codification of these criteria in the NER on the basis that it would be more appropriate to include these criteria, which reflect high level principles, in an AER guideline".	
Natural disaster event pass through event	The AER (p. 5) did not agree with Grid Australia's view that "consensus has emerged for inclusion of [a natural disaster event] in pass through provisions for DNSPs". The AER (p. 5) considered that this point was highlighted by Grid Australia amending the definition of a natural disaster event from that published in the Victorian distribution determination. Furthermore, the AER (p. 5) considered that it "highlighted the importance of the AER retaining the discretion to appropriately consider such matters when proposals from	The draft rule does not include the prescribed definition for a natural disaster event proposed by Grid Australia. The analysis in support of this position may be found in Chapter 6.3.2 of this draft rule

Issue	Stakeholder	AEMC Response
	network businesses are made, rather than having a specific definition prescribed in the NER". In time when consensus has been reached the AER (p. 5) stated that "once those positions are settled they may be codified, such as in a guideline".	determination.
	TRUenergy (p. 3) did not support the inclusion of a definition for 'a natural disaster event in the NER and were concerned that "any change to the rules that would automatically allow TNSPs to pass through any additional costs for a wider range of events would just erode the incentive properties of the current low powered incentive regime". That is, there is a risk that "if we continue to clearly prescribe more pass through provisions in the rules that we would undermine the incentive arrangements and inherit some of the problems associated with rate of return regimes".	
	ENERGEX (p. 6) and Ergon Energy (p. 1) supported Grid Australia's proposal to introduce this definition in the NER. Particularly, Ergon Energy (p. 1) noted its support for inclusion "as it provides some regulatory certainty for network service providers and is an appropriate risk management strategy". ENERGEX (p. 6) stated that it "does not consider the inclusion of a new natural disaster pass through event will alter incentives. ENERGEX will continue to seek to mitigate the risks of natural disaster where possible". ENERGEX (p. 6) also noted the "inclusion of a new natural disaster event will provide greater certainty and transparency for NSPs and will be marginally more administratively efficient" as a nominated pass through event does not have to be included in regulatory determinations.	
	The Tasmanian Government (p. 3) noted "the risk from natural events is one of the reasons that the owners of networks are awarded a risk premium in their cost of capital. Market returns go up and down for a variety of reasons, including factors related to nature. If network owners wish to pass a higher proportion of their risks to customers then they should also be prepared to accept a lower return on their equity".	
Insurance cap event pass	Grid Australia (p. 9) considered that "including the two new proposed cost	The draft rule does not include the prescribed

Issue	Stakeholder	AEMC Response
through event	pass through events (i.e. a natural disaster event and an insurance event) would provide a greater degree of regulatory certainty and transparency and would be more administratively efficient than relying solely on a new nominated pass through provision". Additionally, "incorporating the two new events in the NER would avoid the AER having to re-consider whether to allow these events at the time of each regulatory determination, which would be administratively inefficient and would introduce a degree of uncertainty". That is, given the degree of conformity that has emerged from the DNSP determinations, there is a strong argument to add these new events in the NER. In relation to the question on negligence, Grid Australia (p. 7) noted that "in a case where there has been 'wilful negligence' and that is not covered by the insurance policy, the NSP would not be able to apply for a cost pass through". Grid Australia further noted that the underlying issue would be more appropriately characterised as "... what level of costs customers should be bearing to address the risk of third party liability claims due to negligence: the cost of potentially excessive premiums, regardless of whether the event occurs, or the costs associated with the event if it in fact occurs".	definition for an insurance cap event proposed by Grid Australia. The analysis in support of this position may be found in Chapter 7.3.2 of this draft rule determination.
	Ergon Energy (p. 2) supported "Grid Australia's intent to include a new insurance cap event as a defined statutory pass through event. However, Ergon Energy considers that the definition proposed by Grid Australia may be ambiguous and could benefit from being refined".	
	ENERGEX (p. 7) supported the inclusion of a defined insurance cap pass through event. ENERGEXs rationale for its inclusion follows that of the natural disaster pass through event.	
	The Tasmanian Government (p. 3) noted that it would be "unreasonable to create an incentive for network companies and their owners to underinsure or to reduce the capacity for self-insurance, or be able to ignore the numerous predictions of increasing severe and frequent extreme weather events without consequences". On the other hand, the Tasmanian Government stated "it would be unreasonable if they undertake efficient best	

Issue	Stakeholder	AEMC Response
	practice measures to reduce the increasing risks of fire, flood, storm and being sued, but are then unable to recover costs of doing so".	
	TRUenergy (p. 4) did not support the inclusion of a clause that includes a new 'insurance cap event' within the definition of 'pass through event' to recover the costs that exceed insured limits. TRUenergy noted that "such an automatic pass through may undermine the incentives for regulated firms to appropriately insure ... taking out lower levels of insurance on the basis of an automatic ability to pass on uninsured risks to consumers could allow higher profitability by the firm outperforming its opex allowance". Furthermore, TRUenergy considered that having "the regulator seek to determine an efficient level of insurance would cross the line into micro-management by the regulator, and likely be less efficient than a market based insurance level determined by a fully 'on risk' NSP".	
	The AER (p. 5) did not support codification of this new definition in the NER. Further, the AER referred explicitly to our question relating to whether a network service provider should be able to pass through costs where they are found to be negligent. The AER (p. 6) noted that it took this into account when determining the insurance cap event for its Victorian determination and stated "in the event of such conduct, the insurance policy would be invalidated and the cost pass through would not be invoked".	
Addressing the 'dead zone'	Ergon Energy (p. 2) and TRUenergy (p. 5) were "supportive of amendments to the rules to allow NSPs the opportunity to recover costs for pass through events which occurred in the prior regulatory control period, but which have not been incorporated into the NSPs expenditure forecasts of the following regulatory control period".	The draft rule contains provisions to address the 'dead zone' issue identified by Grid Australia in its rule change request. This is because addressing the 'dead zone' provides network businesses with the reasonable opportunity to recover their efficient costs should a pass through event occur during that time period. The analysis in support of this position may be found in Chapter 8.3.2 of this draft rule
	The AER (p. 6) also supported addressing the dead zone and noted that "there are already aspects of the regulatory regime that 'carry' through cost and reliability performance between regulatory control periods".	
	ENERGEX (p. 8) noted that "allowing NSPs to potentially recover efficient	

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	costs associated with a pass through event which occurred in the 'dead zone' will not change how a NSP manages its risk". Further, ENERGEX also considered that "addressing the 'dead zone' would provide NSPs with some certainty that should an uncontrollable, unexpected and high impact event occur within the 'dead zone', some recourse may be available to these businesses".	determination.
Allocation of risk	ENERGEX (p. 3) noted that risk should remain with the NSP in circumstances where the business is able manage it through mechanisms such as insurance, or investment to 'weather-proof' assets. However, ENERGEX (p. 3) stated that where it cannot be managed "consumers who are the beneficiaries of the services provided by NSPs, should reasonably be expected to bear the prudent and efficient costs associated with such non-diversifiable risk events". In relation to where a business has the ability to partially manage or mitigate a cost, ENERGEX (p. 3) considered that the NER under clause 6.6.1(j)(3) already requires the AER to take into account any decisions and actions that the NSP took to mitigate the event in determining the eligible pass through amount. Thus no further amendments to the NER are required. ENERGEX (p. 4) disagreed with the AEMC that amending the scope of the pass through provisions would transfer greater risk to customers. Specifically, "it is reasonable that beneficiaries of services bear the prudent and efficient costs incurred to address extraordinary circumstances that are outside the control of network service providers".	The draft rule is a reflection of the AEMC's view of what is an appropriate allocation of risk between network businesses and end consumers.
	The Tasmanian Government (p. 3) noted that "the risk from natural events is one of the reasons that the owners of networks are awarded a risk premium in their cost of capital". Therefore, "if network owners wish to pass a higher proportion of their risks to customers then they should be prepared to accept a lower return on their equity".	
	Grid Australia (pp. 2-3) did not agree with the distinction drawn by the AEMC	

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	in its consultation paper about the allocation of risk between the business and end consumers. Grid Australia noted that "in the case of uncertain events beyond the NSPs reasonable control, it is the customers who bear the cost of that risk, whether that risk is managed by insurance or by a cost pass through". Grid Australia stated that there was one exception to this, where "the TNSP incurs costs above insurance limits". Thereby, Grid Australia submits that "the AEMCs mischaracterisation of the rule change proposal as primarily shifting the allocation of risk between NSPs and customers, rather than one which primarily alters the costs that customers are bearing to address risks outside of the reasonable control of NSPs, has led to an imbalance in the discussion in the consultation paper".	
Interaction between cost pass through events, capex re-openers and contingent events	ENERGEX (pp. 4-5) stated that the "cost pass through mechanism should not be limited given the capex re-opener threshold", which is substantial and requires a more onerous process of revoking and substituting a revenue determination.	The draft rule retains the current subordination of the capex re-opener with respect to cost pass throughs. This is to provide network businesses with effective incentives and reserve the capex re-opening provisions for 'large shipwreck-type events'. The analysis in support of this position may be found in Chapter 5.3.2 of this draft rule determination.
	Given that most events are likely to cover both capex and opex, and the substantial threshold for utilising the capex re-opening provisions, Grid Australia (p. 8) considered that "it is likely that the appropriate mechanism in most cases would be the cost pass through mechanism". Grid Australia also noted that "as part of its rule change proposal it has suggested amending the wording of NER 6A.7.1(a)(7) to remove the current subordination of the capex re-opening provisions, whilst continuing to ensure that there can be no 'double-dipping' between the mechanisms".	
Risk profile and rate of return	Grid Australia (p. 5) and ENERGEX (pp. 5-6) noted that "it would not be appropriate to adjust the WACC for inclusion of a new cost pass through, as the new rules provisions would not affect any part of the rules framework used to set the WACC". Grid Australia also considered that currently the cost of bearing the risk of uncertain events outside of the reasonable control of NSPs are reflected in	This draft rule determination has not pursued further the issue of risk profile and rate of return that was raised in the consultation paper. Current research indicates that asymmetrical risk is not captured in the WACC, in particular the capital asset pricing model for calculating

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	insurance premiums incorporated in its opex. Grid Australia (p. 6) stated "the proposed rule change would remove the need to compensate NSPs for bearing this risk (in the case of self-insurance) and the need to pay commercial businesses to bear this risk". Similarly, ENERGEX (p. 6) considered that current allowances "do not include significant uncontrollable, unexpected and high impact events such as natural disasters".	the cost of equity. Therefore, it is not necessary to adjust for the removal of asymmetric risk.
	The AER (p. 2) also noted that "no compensation should be provided to the network business in the cost of capital for risks" that are business specific and are expected to be diversifiable. However, for some risks "such as high cost low probability events where it may be necessary, this compensation should be reflected in the cash flows of the network business rather than in the cost of capital". Accordingly, the AER (p. 2) considered that "where a network business may be exposed to the risk of the costs of an event (in this case a high cost, low probability event), the consideration of whether compensation is necessary requires an assessment of the overall regulatory regime, rather than focussing on one element of the regulatory regime - e.g. cost pass throughs".	
Savings and transitional arrangements	Powerlink (p. 2) sought confirmation from the Commission that there would be savings and transitional arrangements in the draft and final rules on this matter that will apply to Powerlink's next regulatory period from the commencement of the rule.	The draft rule contains transitional arrangements that retain the terrorism event as a prescribed pass through event for network service providers current regulatory control periods, and enable Powerlink (whose regulatory control period commences 1 July 2012) to nominate pass through events. The analysis in support of this position may be found in Chapter 9.3.2 of this draft rule determination.