Mr John Pierce
Mr Neville Henderson
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Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Commissioners,

Reference: ERC0137

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

A: Introduction

TRUenergy welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) "Consultation Paper" that discusses improvements in the cost pass through arrangements that apply to TNSPs as a result of low probability high impact events from natural disasters.

Grid Australia (GA) proposes this rule change to mitigate the impact of these events under the National Electricity Rules (Rules). Currently, it considers the Rules expose TNSPs to the risk of major cost impacts that arise from things like natural disasters such as earthquakes and bushfires, all of which are outside of their reasonable control.

GA postulates that the financial impact of these events could potentially be mitigated through the capital expenditure re-opener in the Rules in their submission. However, the re-opener exceeds the materiality threshold that is currently applied to TNSPs for these events under the Rules. In addition, most of the claims from these events come from third parties and reflect an operational expense. Hence, they cannot be re-covered under the capex re-opening provisions. For these reasons, Grid Australia argues this creates a significant risk for them.

GA submits this rule change to mitigate this risk of low probability high impact events from natural disasters. The rule change request:

- incorporates a new 'natural disaster event' within the definition of 'pass through event' to enable recovery of large un-expected costs arising from natural disaster events

- includes a 'new insurance cap event' within the definition of 'pass through event' to recover the costs of events that exceed insured limits

- provides the ability for TNSPs to propose additional pass through events in their revenue proposals, providing consistency with provisions currently available to electricity distributors

- addresses the so called 'dead zone' issue by enabling pass through for events that occur in a previous regulatory period, but where it is too late to include the costs of those events in a total revenue cap for the subsequent period.

B: Key recommendations

TRUenergy's positions on the Grid Australia rule change proposals which relate to improvements in the cost pass through arrangements that apply to TNSPs under the Rules for low probability high impact events form natural disasters are outlined below.

In summary:

1. We do not support any changes to the Rules that introduce a specific pass through clause that is applied on a permanent basis and incorporates:

    - a 'natural disaster event' within the definition of 'pass through event' to enable the recovery of large un-expected costs arising from natural disasters

    - a new "insurance cap event' within the definition of 'pass through event' to recover the costs of events that exceed insured limits.

    We consider that adding more specific pass through clauses in the Rules will have an adverse impact on the incentive arrangements that currently apply to TNSPs. In the long term, this may result in more frequent contentious re-openings to the revenue cap in effect importing a problem that is usually associated more with rate of return regulation.

2. We support a change in the Rules that gives TNSPs the right to propose new pass through events in their revenue proposals at the beginning of every regulatory period. Overall, this provides consistency with the provisions currently available to electricity distributors. Additionally, it allows the AER to determine whether there is any merit in a TNSP proposal.

    The AER would decide on whether to approve a pass through based on the criteria that is currently applied to distributors. In applying these criteria, the AER would need to ensure that it did not undermine the incentive arrangements in approving a pass through as part of its assessment process.

    TNSPs' would be required to submit strong evidence to demonstrate that have satisfied the relevant criteria to get an additional pass through approved. The AER would be well placed to determine whether to allow this at the beginning every regulatory term.

3. We support a change to the Rules that addresses the so called 'dead zone' issue by enabling pass through for events that occur in a previous regulatory period, but where it is too late to include the costs of those events in a total revenue cap for the subsequent period.

C: Key issues

1. **A 'natural disaster event' within the definition of 'pass through event' to enable the recovery of large un-expected costs arising from natural disasters**

TRUenergy does not support the inclusion of a clause in the Rules that incorporates a 'natural disaster event' within the definition of 'pass through event' to enable the recovery of large unexpected costs arising from natural disasters.

We consider that any change to the Rules that automatically allow TNSPs to pass through these costs could erode the incentive regime on capex. In the long run, if the Rules are changed to automatically allow more pass through events – then this could undermine the incentive properties of the regulatory arrangements. In short, the inclusion of a permanent clause in the Rules that allows these events to be passed through will result in more frequent re-openings of the revenue cap.

Currently, the AER regulates TNSPs under a low powered incentive regime on capital expenditure. As the AEMC has explained in its consultation paper, the capital expenditure regime includes a contingent project provision combined with a re-opening clause for capex. In the past as part of our submission to the Chapter 6A review, we argued that the combination of a contingent projects regime combined with a re-opening provision (coupled with generous pass through provisions) could erode the incentive properties of the regulatory arrangements.

We confirmed our support for the introduction of a contingent projects regime as part of the ex-ante revenue cap in the chapter 6A review. The contingent projects concept is designed to cater for relatively large projects that address foreseen events but where the TNSP is uncertain as to whether that project will proceed. Clause 6A.8.1 (c) (5) of the Rules requires that the trigger event nominated by the TNSP for a contingent project be one whose occurrence is probable over the regulatory period. In the past, we supported the inclusion of contingent projects on the condition that the contingent projects regime was designed carefully to protect the incentive properties of the regime. Therefore, we argued the contingent project provisions should have the following characteristics that include:

- the trigger for contingent project needed to be **material**
- the event that triggered the contingent project needs to be **limited and clearly defined**
- the contingent projects provision should be used **sparingly**.

Additionally, we confirmed our support for the AEMC's revised re-opening provisions on capex to form part of the ex ante revenue cap in the Chapter 6A review on the proviso that it could only be triggered in extreme circumstances. The AEMC designed the re-opener to protect the incentive properties of the regulatory regime. Thus, the re-opening clause would deal with foreseen/unforseen capital expenditure that could only be triggered where the contingent project's value was greater than 5% of the RAB.

Overall, we reinforced our support for the combination of a contingent projects regime with a re-opener on capex on the condition that they would be used sparingly. We were concerned that any change to the Rules that would automatically allow TNSPs to pass through any additional costs through for a wider range of events would just erode the incentive properties of the current low powered incentive regime. There was 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. So, further relaxing the pass through provisions may lead to:

- more frequent contentious re-openings through these pass through provisions
- consumers rather than the regulated firm bearing much of the business risk
- limited incentive for exceptional performance

Therefore, we consider that any additional change to the Rules that automatically allow TNSPs to pass through these costs could erode the incentive regime on capex.

2. A new "insurance cap event' within the definition of 'pass through event' to recover the costs of events that exceed insured limits

TRUenergy does 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 of events that exceed insured limits.

We consider that any change to the Rules that automatically allow TNSPs to pass through these costs would erode the incentive properties of the low powered incentive regime on opex that is in place currently. The impacts of such an erosion are outlined in 1) above.

We also note that such an automatic pass-through may undermine the incentives for regulated firms to appropriately insure. For example 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. To have 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 status quo, with any additional pass-through events having to be justified to the regulator is likely to be more efficient.

3. TNSPs to have the ability to propose additional pass through events in their revenue proposals,

TRUenergy supports the ability of TNSPs to propose additional pass through events in their revenue proposals.

This provides consistency with the provisions currently available to electricity distributors. Additionally, it allows the AER to determine whether there is any merit in a TNSP proposal.

The AER would decide on whether to approve a pass through based on the criteria that is currently applied to distributors. In applying these criteria, the AER would need to ensure that it did not undermine the incentive arrangements in approving a pass through as part of its assessment process.

TNSPs' would be required to submit strong evidence to demonstrate that have satisfied the relevant criteria to get an additional pass through approved. The AER would be well placed to determine whether to allow this at the beginning every regulatory term.

The AER would apply the following criteria to determine whether to allow a pass through. This would include:

- the event is not already provided for
    - In the defined event conditions in the NER (and does not conflict or undermine the events defined in the NER)
    - through the opex allowance (e.g. the insurance or self insurance components)
    - through the WACC
    - through any other mechanism or allowance
- the event is foreseeable – in that the nature or type of event can be clearly identified

- 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 costs impact of the event

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

- the party who is the best position to manage the risk is bearing the risk

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

The AER would apply the specified criteria to ensure that the pass through provision and ensure it does not undermine the incentive arrangements within the regulatory regime.

4. Enabling pass through for events which occur in a previous regulatory period, but where it is too late to include the costs of those events in a total revenue cap for the subsequent regulatory period

TRUenergy supports amending the cost pass through provisions to allow a TNSP to seek cost recovery for pass through events which happened in the previous regulatory period, but which have not been included in the TNSPs expenditure forecasts for the subsequent regulatory period.

Where a pass through event occurs in a previous regulatory period but which has not been included in a TNSP expenditure forecast in the next regulatory period, it may not be possible for the TNSP to amend its regulatory proposal to take these changes in costs into account.

Whilst we have outlined our concerns in this paper regarding any proposal that continually allows a TNSP to pass through additional costs during a regulatory control period, on balance, we consider that this issue needs to be addressed. Therefore, we support an amendment to the Rules that we address this issue.

C: Conclusion

TRUenergy appreciates the opportunity to comment on this Rule change proposal.

We support the following key positions on this Grid Austral rule change which relates to the improvements on the cost pass through arrangements.

In summary:

1. We do not support any changes to the Rules that introduce a specific pass through clause that is applied on a permanent basis and incorporates:

    - a 'natural disaster event' within the definition of 'pass through event' to enable the recovery of large un-expected costs arising from natural disasters

    - a new 'insurance cap event' within the definition of 'pass through event' to recover the costs of events that exceed insured limits.

We consider that adding more specific pass through clauses in the Rules will have an adverse impact on the incentive arrangements that currently apply to TNSPs. In the long term, this may result in more frequent contentious re-openings to the revenue cap in effect importing a problem that is usually associated more with rate of return regulation.

2. We support a change in the Rules that gives TNSPs the right to propose new pass through events in their revenue proposals at the beginning of every regulatory period. Overall, this provides consistency with the provisions currently available to electricity distributors. Additionally, it allows the AER to determine whether there is any merit in a TNSP proposal.

   The AER would decide on whether to approve a pass through based on the criteria that is currently applied to distributors. In applying these criteria, the AER would need to ensure that it did not undermine the incentive arrangements in approving a pass through as part of its assessment process.

   TNSP would be required to submit strong evidence to demonstrate that have satisfied the relevant criteria to get an additional pass through approved. The AER would be well placed to determine whether to allow this at the beginning every regulatory term.

3. We support a change to the Rules that addresses the so called 'dead zone' issue by enabling pass through for events that occur in a previous regulatory period, but where it is too late to include the costs of those events in a total revenue cap for the subsequent period.

We thank the AEMC for its consideration of the issues that we have raised in relation to this Rule change. For any questions regarding this submission, please contact Mr. Con Noutso - Regulatory Manager at TRUenergy on Tel: 03 8628 1240

Regards

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