AUSTRALIAN ENERGY REGULATOR

GPO Box 3131
Canberra ACT 2601
Telephone: (02) 6243 1233
Facsimile: (02) 6243 1205
www.aer.gov.au

Our Ref: 48344
Your Ref: ERC0137
Contact Officer: Blair Burkitt
Contact Phone: 03 9290 1442

15 March 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce

Grid Australia cost pass through arrangements rule change proposal

Thankyou for the opportunity to comment on the rule change proposal from Grid Australia on cost pass through arrangements for network service providers.

The AER's comments are made in relation to the relevance of cost pass through arrangements in the regulatory regime and Grid Australia's proposed amendments to:

- provide Transmission Network Service Providers (TNSPs) with the ability to propose additional pass through events in their revenue proposals
- include additional events within the definition of a 'pass through event' in the National Electricity Rules (NER):
    - a new 'natural disaster event' to enable Network Service Providers (NSPs) to recover large unexpected costs arising from these events;
    - a new 'insurance cap event' to enable recovery of the costs of events that exceed insured limits; and
- address the 'dead zone' issue by allowing the pass through of events that occurred in a previous regulatory control period, but where it is too late to include the cost of those events in a total revenue cap for a subsequent regulatory control period.

Relevance of cost pass through arrangements in the regulatory regime

The AEMC's consultation paper notes that Grid Australia's proposal shifts risks from the network businesses to the end consumer, thereby changing the risk profile of network businesses. In view of any reallocation of risk to end consumers, the paper raises the issue as to whether it is appropriate to adjust the cost of capital for inclusion of a new pass through event.

In principle, the cost of capital provides compensation for non diversifiable risks (i.e. risks that cannot be diversified away by an investor who holds a diversified portfolio of assets). Alternatively, where a business is exposed to unique risks (or business specific risks) these risks are expected to be diversifiable. Hence no compensation should be provided to the network businesses in the cost of capital for these risks. However, there may be some risks such as 'high cost low probability events' where it may be necessary to compensate a network business. In the event that compensation is necessary, this compensation should be reflected in the cash flows of the network business rather than in the cost of capital.

In considering whether compensation should be provided in the cash flows of a network business (i.e. building block revenue requirement) for 'high cost low probability events', this will depend on whether a network business is expected to receive their expected cost of capital (i.e. their regulatory cost of capital).[1] In particular, the AER considers that if a network business is exposed to overall asymmetric downside risk (e.g. from events such as high cost low probability events) and this risk is not compensated in the required building block revenue (or through the regulatory regime), a network business may not receive their expected (ex ante) return (i.e. the regulatory cost of capital). The important point to note is that compensation is only necessary where a network business is exposed to any asymmetric downside risk after considering any asymmetric upside risks. That is, if there are offsetting risks in the regulatory regime (i.e. asymmetric upside risk), the degree to which these risks offset any downside risks will be an important consideration in assessing the need for these risks to be compensated by the regulatory regime. The AER, for example, has previously noted that the information asymmetry that exists between the regulator and the Distribution Network Service Providers (DNSPs) is likely to provide the DNSPs with some degree of asymmetric upside risk. Accordingly, the AER considers 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.[2]

All that said, the AER considers that in principle, if compensation is necessary such that a network business is not expected to receive their ex ante rate of return, this compensation could be provided either through a pass through or a self-insurance allowance. The AER's views on the interaction between a pass through and a self-insurance allowance in the

[1] The AER notes that the actual or realised rate of return received by a network service provider (NSP) will depend on several factors. This includes how effectively and efficiently the NSP manages its business within the incentive based regulatory framework.

[2] The AER would only consider a pass through (or whether to provide a self-insurance allowance) after considering, amongst other criteria, whether an NSP has already been compensated (e.g. whether the NSP is exposed to asymmetric downside risk, which would include a consideration of other aspects of the regulatory regime, including the capex reopener provisions).

regulatory regime have also been discussed in previous determinations and are summarised below.

Ability to propose additional pass through events

Grid Australia proposes amendments to the NER to allow TNSPs to nominate additional pass through events as part of a regulatory proposal. This proposal would align chapter 6A with chapter 6 of the NER, which allows DNSPs to propose additional pass through events to the AER as part of a regulatory proposal.

The NER does not contain any specific criteria that the AER is to have regard to in assessing proposed pass through events under chapter 6 of the NER. To inform the AER's assessment, the AER developed a number of criteria for assessing nominated pass through events having regard to the National Electricity Objective (NEO) and the revenue and pricing principles contained in s.7A of the National Electricity Law. These criteria have been reproduced in Box 5.1 of the AEMC's consultation paper. The AER considers that any pass through event proposal should satisfy these criteria (as currently applies to DNSPs in chapter 6 of the NER).

The AER notes that the prescribed pass through events for TNSPs and DNSPs are similar (with the exception of an insurance event in chapter 6A). The AER in previous regulatory decisions for distribution businesses has accepted some additional nominated pass through events on the basis that these pass through events satisfy the AER's pass through criteria The AER considers these criteria are equally relevant to TNSPs.

The AER also notes that in its policy document for the development of the distribution rules, the Ministerial Council of Energy – Standing Committee of Officials (SCO), noted there is no justification, given the underlying characteristics of electricity distribution networks, for the rules to differ from those applying to electricity transmission networks.[3] SCO also noted that flexibility in the NER would allow the AER to evolve its approach through distribution determinations, with a view to eventual codification. The AER therefore agrees that the pass through provisions in the NER should be the same between chapter 6A and chapter 6.

The AER also more generally supports greater consistency for pass through and re-opener arrangements between transmission and distribution. The AER's rule change proposal on *Economic regulation of transmission and distribution network service providers* includes a number of relevant proposals that are currently under consideration by the AEMC, including:

- defining the materiality threshold for pass through events for DNSPs, consistent with the definition that applies to TNSPs – that is, one per cent of Maximum Allowable Revenue; and
- extending the current re-opener provisions for TNSP to DNSPs and introducing a contingent project framework for DNSPs.

In the absence of an ability to propose additional pass through events, the TNSPs may seek to minimise the risk of some events that are expected to have a high cost but have a low probability, through proposed self-insurance allowances. The AER has previously stated that

[3] SCO, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation of electricity distribution, Explanatory Material*, April 2007, p.13.

in some cases calculating a probability for low probability but high cost events can be problematic where there is an absence of a loss history. The AER in developing its criteria for considering additional pass through events recognised this issue 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).

The AER has previously considered the interaction between self-insurance and pass throughs and the factors that may be relevant as to whether the risk of events should be mitigated in terms of a self-insurance allowance or as a pass through. These are summarised in Table 1.

Table 1: Consideration of factors in treatment of events

	Pass throughs	**Self insurance**
Foreseeability	Where an event is foreseen (in that an event of its nature could occur but is not known at the time) and the cost and timing are not known, more likely to be treated as a pass through event.	Foreseeability also relevant to self insurance (as the risks needs to be identifiable)
Probability	Probability not a relevant consideration for pass throughs, however, low probability events with a very high consequence are appropriately treated as pass throughs.	Where probability can be quantified (and used to calculate a self insurance premium), more likely to be treated as a self insurance category.
Magnitude	Where an event has high magnitude, more likely to be treated as pass through event.	Where an event has a low magnitude, more likely to be treated as a self insurance category.
Controllability	Where the event is beyond the control of the DNSP, it is more likely to be treated as a pass through event.	Where the event (or its impact) can be in part controlled or mitigated by the DNSP, more likely treated as a self insurance event.

Source: AER 2010 draft Victorian distribution decision

The AER has considered that whether an event should be treated as a pass through event or self insurance allowance will depend on the relationship of the above factors. For example, a tension may exist between these factors, such that an event could be of a high magnitude, which ordinarily would mean that it is best considered as a pass through event. However, due to its controllable nature, its may best be considered as self insurance.

Further, the consultation paper seeks comment on whether the AER's criteria for assessing a proposed pass through event should be codified in the NER to promote administrative efficiency. The AER 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. In particular, the inclusion of these criteria or principles in a guideline has the advantage that:

- these criteria can be more readily amended over time (if necessary) than if these criteria are embedded in the NER; and

- this provides the network businesses with sufficient certainty as to the AER's criteria for assessing network business pass through event proposals.

Proposed inclusion of new pass through events in the Rules

Grid Australia has proposed to prescribe two new pass through events in the NER for both TNSPs and DNSPs – a 'natural disaster event' and an 'insurance cap event'. In addition, Grid Australia has proposed that an event that has been nominated by the AER in a distribution or transmission determination should be a prescribed event under the NER.

The AER notes that the MCE SCO provided the flexibility in the NER to allow the AER to evolve its approach over distribution determinations, with a view to eventual codification. Grid Australia suggests that now is an appropriate time to codify arrangements in the NER. However, the AER does not support the codification of these events in the NER at this time on the basis that:

- there is no settled view at this time on the type of events that should be prescribed in the NER.
- the ability to nominate a pass through event (assuming the AEMC accepts this aspect of Grid Australia's rule change proposal) as part of a regulatory proposal provides the AER with the discretion to consider additional events for a TNSP taking into account the regulatory arrangements and circumstances of a TNSP
- the nature of and compensation for events proposed by Grid Australia should be considered in the context of the whole regulatory regime.

The AER considers that there is benefit in retaining the discretion to consider proposed pass throughs on a case by case basis. This will allow the AER to address the issues raised by Grid Australia without the need to introduce undue prescription into the NER that would inhibit the AER from adapting pass through arrangements in response to matters raised by network businesses or other interested parties at the time of a determination.

Natural disaster event

Grid Australia argues for codification of the 'natural disaster event' on the basis that it considers consensus has emerged for its inclusion in pass through provisions for DNSPs. However, the AER does not agree with this view. This is highlighted by Grid Australia's rule change proposal to amend the AER's pass through definition of a natural disaster event (and these amendments may be necessary), which was included in the Victorian distribution determination.

This also highlights 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.

As the AER noted in the Victorian distribution decision, the AER's regulatory approach in this area is likely to evolve over time. However, the AER noted that once those positions are settled they may be codified, such as in a guideline.

Insurance cap event

The AER approved an additional pass through event for an insurance cap event in its Victorian distribution determination. The consultation paper seeks comment on whether the TNSP should be allowed to pass through costs where they are found to be negligent. The AER considered this issue in the context of the insurance cap event in its Victorian determination. In particular, the AER took into account the view that an insurance policy would not cover illegal or grossly reckless acts or omissions. Accordingly, in the event of such conduct, the insurance policy would be invalidated and the cost pass through would not be invoked.

The AER included as part of its criteria for assessing pass through proposals whether the pass through proposal conflicts or undermines the events defined in the NER. This issue is relevant in considering Grid Australia's proposal for an insurance cap pass through event given that the insurance event defined in the NER for TNSPs includes, amongst other matters:

> Insurance becomes available to the *Transmission Network Service Provider* on terms materially different to those existing as at the time the *revenue determination* was made **(other than as a result of any act or omission of the provider which is inconsistent with good electricity industry practice).**[4] [emphasis added]

Some of the DNSPs have previously stated that any 'negligence, fault or lack of care' are motivators to take out insurance. Accordingly, an insurance cap event which allows a TNSP to recover amounts in excess of the insurance cap that may be due to negligence, fault or lack of care does not appear to be consistent with this aspect of the defined NER insurance event. The AER considers such an insurance cap event could conflict or undermine the defined NER pass through event related to insurance.

Addressing the 'Dead Zone' issue

The AER supports addressing the 'dead zone' issue raised by Grid Australia. This is a well known issue within the regime and should be addressed so that a network business is not denied the opportunity to recover legitimately incurred costs arising from a pass through event simply because of the event falling between regulatory periods (referred to as the 'dead zone'). The AER notes that there are already other aspects of the regulatory regime that 'carry' through cost and reliability performance between regulatory control periods. For example, the AER's efficiency benefit sharing scheme allows cost (in)efficiencies incurred in a regulatory control period to be carried over into the next regulatory control period.

The AER notes that a further example of a dead zone issue has been raised with the AER in the context of the Retailer of Last Resort (RoLR) Scheme that the AER is due to administer from 1 July 2012. One distributor (UED/Multinet) raised the issue of whether a distributor payment[5] could be recoverable across regulatory control periods. The concern is that if a RoLR event occurs and the distributor payment is made in the last year of the regulatory control period, the distributor may not be able to recover the amount of the payment as a cost

---

[4] See definition of insurance event in the glossary of the NER.

[5] A distributor payment is one mechanism under the Retail Law for a retailer of last resort (RoLR) to recover its RoLR costs. The Retail Law deems a distributor payment to be a cost pass through amount under the National Electricity Rules and National Gas Rules (s. 167 of the Retail Law).

pass through in that year. The AER considered that neither the NER nor National Gas Rules permitted the recovery of costs across regulatory periods.[6]

If you would like to discuss any aspect of this submission please contact Blair Burkitt on (03) 9290 1442.

Yours sincerely

for Michelle Groves
Chief Executive Officer

[6] AER, *Notice of final instruments, Retailer of Last Resort (RoLR) Guidelines, RoLR plan, RoLR statement of approach*, November 2011, pp.19–20.