Australian Energy Market Commission

RULE CHANGE

CONSULTATION PAPER

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

Rule Proponent(s)
Grid Australia

2 February 2012

Inquiries

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

E: aemc@aemc.gov.au
T: (02) 8296 7800
F: (02) 8296 7899

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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.

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1 Introduction

On 14 October 2011, Grid Australia submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission) relating to improvements to the cost pass through arrangements of amounts to end consumers as a result of a range of low probability, high impact events that Grid Australia does not consider are adequately reflected under the current rules' arrangements.

This Consultation Paper has been prepared by the staff of the AEMC to facilitate public consultation on the Rule change proposal and does not necessarily represent the views of the AEMC of any individual Commissioner of the AEMC.

This paper:

- sets out a summary of, and a background to, the cost pass through arrangements for network service providers rule change request proposed by Grid Australia;
- identifies a number of questions and issues to facilitate the consultation on this rule change request; and
- outlines the process for making submissions.

2 Background

2.1 Risks for TNSPs under the existing rules

Grid Australia submits that under the current National Electricity Rules (the rules), transmission network service providers (TNSPs) are exposed to the risk of significant cost impacts arising from natural disasters that are outside of their reasonable control.

Grid Australia notes that bushfires and other natural disasters (such as earthquakes and cyclones) may result in TNSPs incurring costs as a result of property damage to towers and lines, and third party liability claims.

To mitigate some of this risk, Grid Australia states that TNSPs typically have commercial insurance coverage up to a specified limit, or self-insure for these events. However, commercial insurance for higher coverage limits is often either not readily available or available only at very high premiums. Grid Australia also considers that given the potential magnitude of the costs associated with natural disasters, that TNSPs are unable to credibly self-insure to cover the full potential costs of these events.

Grid Australia states that currently TNSPs exposure to costs (in excess of insured amounts) for natural disasters is only mitigated by the capital expenditure re-opening provisions in clause 6A.7.1 of the rules. However, Grid Australia notes that there is a substantial threshold required to trigger these re-opening provisions, which significantly exceeds the materiality threshold applied to pass through events for TNSPs. Moreover, a substantial portion of a TNSPs exposure is to third party liability claims, which are an operational expense and therefore are not able to be recovered under the capital expenditure re-opening provisions.

In the 'dead zone' for cost pass throughs, defined as the time between where a network service provider lodges its revenue proposal and 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 notes 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.

2.2 Risk mitigation mechanisms under the rules

Grid Australia notes that there are four main mechanisms under the existing rules to address the impact of uncertain, high cost events outside of the TNSPs reasonable control.[1]

1 Grid Australia rule change request, October 2011, p.4.

Commercial insurance

A TNSP may elect to purchase insurance against the cost impact of an uncertain exogenous event. The cost or premium paid by the TNSP is then incorporated into the operating expenditure forecast. There are often limits on the total costs covered by commercial insurance, but the sums insured may be increased by paying a higher premium. However, Grid Australia submits that there are limits on the amount of insurance cover available at a reasonable cost for higher sums insured.[2]

Grid Australia considers that in the case of some high impact, low probability events, the commercial insurance market is thin. For some events (including extreme forms of natural disaster), past claims experience is very limited and subject to wide fluctuations. 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 the TNSP with residual exposure to losses above the cover limit. Grid Australia also notes that premiums to increase the cover limit may be prohibitively priced and that the Australian Energy Regulator (AER) may decide that the premium charged for insuring for those events does not represent the 'efficient' cost that would be incurred by a prudent operator, as required under the rules.[3]

Self-insurance

When commercial arrangements for insurance are not utilised, the loss is retained by the TNSP. Grid Australia notes that self-insurance of retained losses is often the default position when insurance policies are not available or where a risk is unknown or underestimated. In cases where the cost of self-insurance may be reasonably forecast, Grid Australia states that TNSPs can choose to self-insure. The usual calculation for the cost self-insurance is the costs expected if the exogenous event occurs multiplied by the probability of the event occurring. Self-insurance is included as part of a TNSPs operating expenditure forecast.[4]

For self-insurance to be credible, the TNSP needs to have sufficient assets and income generating ability to bear the risk of incurring the costs, if an exogenous event occurs. In the case of third party liability claims, Grid Australia considers that the high cost involved makes self-insurance untenable. Grid Australia also notes that typically TNSPs effectively self-insure for all risks, other than those that are explicitly addressed by an alternative mechanism. Grid Australia states that this is regardless of whether an explicit self-insurance allowance was made. The costs associated with the full extent of self-insurance have not been reflected in the self-insurance allowance incorporated within the operating expenditure forecasts in Grid Australia's view.[5]

Cost pass through

2 ibid. p.5.

3 ibid. pp.6-7.

4 ibid. p.5.

5 ibid. pp.7-8.

Within a regulatory control period when a pre-defined exogenous event occurs which materially increases or decreases the TNSPs costs (capital and/or operating expenditure), the AER may approve a positive (or negative) pass through amount under the explicit cost pass through provisions set out in clause 6A.7.3. Under chapter 10 of the rules, "materially" is defined as more than one per cent of the TNSPs maximum allowed revenue (MAR) for that year. Grid Australia notes that TNSPs are required to seek the approval of the AER for any cost pass through, and the AER is required to make a determination on each application received.[6]

Grid Australia argues that the defined cost pass through events exclude many unpredictable, potentially high cost events beyond the reasonable control of TNSPs - including, most notably, natural disasters. In addition, Grid Australia notes that chapter 6A does not allow TNSPs to nominate additional cost pass through events as part of the revenue determination process.[7]

In contrast, distribution network service providers (DNSPs) are allowed to apply for a cost pass through for the four defined events under chapter 10, in addition the rules enable them to nominate additional pass throughs at the time of submission of its electricity distribution regulatory proposal to the AER.

Re-opening of a revenue determination for capital expenditure (capex)

Under clause 6A.7.1of the rules, the AER may revoke and substitute a regulatory determination where (among other things) an event occurs which is beyond the reasonable control of the TNSP and the total capital expenditure required to rectify the adverse consequences of the event exceeds five per cent of the TNSPs regulatory asset base (RAB) for the first year of the regulatory control period.[8]

There is no equivalent provisions for a capex re-opener for DNSPs.

Grid Australia submits that the current re-opening provisions in the rules may only be applied to TNSPs where the following conditions are all met:[9]

- the reliability and security of the network is threatened;
- the event requires capital costs totalling more than five per cent of the regulatory asset base; and
- the expenditure cannot be accommodated by cutting other capital expenditure programs.

That is, Grid Australia considers it unclear whether the capital expenditure re-opening provisions were intended to address the costs associated with uncertain external events.

6 ibid. p.5.

7 ibid. p.9.

8 ibid. p.6.

9 ibid. pp.10-11.

3 Details of the Rule Change Request

While the rule change request from Grid Australia is written from the perspective of TNSPs, the rule changes that they are proposing relate to both the regulation of transmission and distribution network service providers.

The rule change request from Grid Australia proposes to:[10]

- incorporate a new 'natural disaster event' within the definition of 'pass through event' to enable recovery of large unexpected costs arising from natural disaster events (would apply to DNSPs and TNSPs);

- includes a new 'insurance cap event' within the definition of 'pass through event' to recover the costs of events that exceed insured limits (would apply to DNSPs and TNSPs);

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

- 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 (would apply to DNSPs and TNSPs).

In its rule change request Grid Australia provides its rationale for the rule change. A number of key points raised in the rule change request are summarised as follows:

- natural disaster event definition - Grid Australia considers that the inclusion of a natural disaster events pass through event would allow the same treatment to be given to these uncertain, potentially high cost events outside a network service providers reasonable control as is currently given to a 'terrorism event', which is already included as a pass through event in the rules. Grid Australia also notes that the characteristics of a natural disaster event align with the Australian Energy Regulators (AERs) criteria for the risk of these events to be managed via the cost pass through provisions. Furthermore, Grid Australia considers that the inclusion of a natural disasters event would improve the alignment of regulation across the transmission and distribution businesses.

- insurance cap event definition - Grid Australia proposes that an 'insurance cap event' be included in the rules as a cost pass through event. Grid Australia considers that the inclusion of this new pass through event provides an appropriate means of addressing the risk associated with costs arising from third party liability claims, in excess of insured limits.

10 ibid. p.11.

- ability to propose additional pass through applications during the revenue determination process - Grid Australia is proposing that the rules be amended to allow TNSPs to propose additional pass through events as part of their revenue proposal. The AER would then determine whether to approve these additional events, as part of its draft and final revenue determinations. Grid Australia considers that this amendment would provide TNSPs with the same flexibility to manage risks by using pass through provisions as currently afforded under the rules to DNSPs.

- addressing the 'dead zone' - Grid Australia proposes a general amendment to the cost pass through provisions to allow network service providers to seek cost recovery for pass through events which occurred in the prior regulatory control period, but which have not been incorporated within the network service providers expenditure forecasts for the subsequent regulatory period. Grid Australia notes that this amendment considers analysis already undertaken by the AEMC.

The proponent's Rule change request includes a proposed rule.

4 Assessment Framework

The Commission's assessment of this rule change request must consider whether the proposed Rule promotes the National Electricity Objective (NEO) as set out under section 7 of the National Electricity Law (NEL). The NEO is set out under 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."

The assessment of this rule change request will also include other considerations, such as taking into account the revenue and pricing principles and any relevant MCE statements of policy principles.

The rule change request could potentially affect the efficient operation of, and affect the ability and incentive of, network service providers to invest in their network assets. Any change in the level of investment in networks is likely to impact the price, quality, reliability and security of supply of electricity. The AEMC will need to assess whether the rule change request is likely to better balance the need to attract sufficient investment in the networks with the need to minimise prices for consumers. In assessing this rule change request against the identified aspect of the NEO, the factors that we will take into consideration include:

- 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?

We will also assess whether the proposed rule, compared with the current arrangements, 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 Issues for consultation

Taking into consideration the assessment framework and the potential requirements to implement the proposed rule change, we have identified a number of issues for consultation that appear to be relevant to this rule change request.

The key issues that the consultation paper will consider in respect of this rule change request include:

- consideration of what is the appropriate allocation of risk between network businesses and consumers;
- the relationship between changes in cost pass throughs, the network services providers risk profile and network service providers rate of return;
- interaction between cost pass throughs and capex re-openers. TNSPs have capex re-opener provisions under clause 6A.7.1 of the rules;
- whether it is appropriate to include an additional prescribed definition for a 'natural disaster event' as a cost pass through event;
- whether it is appropriate to include an additional prescribed definition for a 'insurance cap event' as a cost pass through event to account for third party liability claims; and
- whether it is appropriate to allow TNSPs to propose additional pass through applications when submitting revenue proposals and give the AER discretion to approve additional cost pass throughs. Are the specific events included in the rule change request necessary if TNSPs can propose them as part of the revenue determination process? Would it be appropriate to provide the AER with criteria in assessing cost pass through applications?

These issues outlined below are provided for guidance. Stakeholders are encouraged to comment on these issues as well as any other aspect of the rule change request or this paper including the proposed assessment framework.

5.1 Allocation of risk between market participants

In the economic regulation of network services, there are two potential means of addressing the allocation of the risk of unexpected cost rises or unexpected costs on networks. They are

- allocate the risk to the network business, or
- allocate the risk to end consumers.

Where the risk is allocated to the business, it can choose to manage the risk through:

- performance of normal business operations;

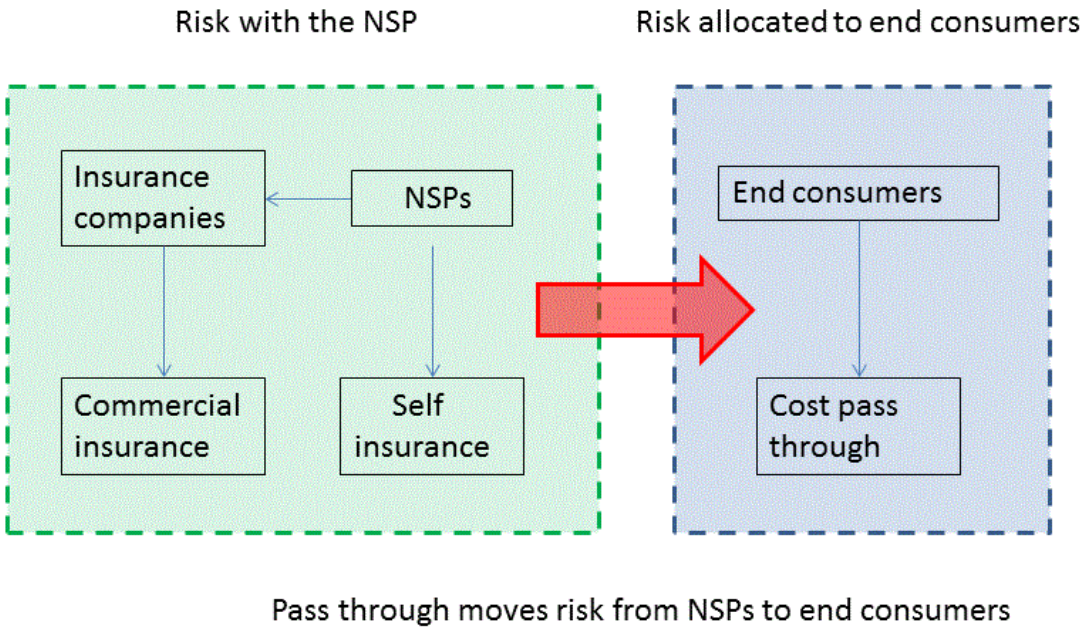
- obtaining commercial insurance; or
- undertaking self-insurance.

Where efficiently undertaken, the cost of managing the risk, obtaining commercial insurance or undertaking self-insurance will be incorporated in the regulated operating and capital expenditure (capex) allowances of the business.

A cost pass through, capex re-opener or contingent event allocates the risk to the end consumer. That is, if the event occurs the cost of the event will be incorporated into network prices and paid by the end consumer.

The separation of risk between the network service provider and the end consumer is set out in the diagram below.

Risk allocation between market participants



As noted in the assessment framework in section 4, the AEMC is considering the rule change against a number of factors including recovery of efficient costs and the allocation of risks between businesses and end consumers. In considering the effect of the cost efficiency of cost pass throughs, the previous Australian and international focus has been on the ability of the network business to control or manage the costs in order to maintain the incentive arrangements for operational expenditure (opex) and capex.

Box 5.1: Purpose of cost pass throughs

AER

The criteria applied by the AER in the final decision on the electricity distribution price review for the Victorian electricity distribution businesses were:

- the event is not already provided for
    - in the defined event definitions 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 (events which affect the market generally and not just the provider are systematic risk and already compensated through the WACC), or
    - 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 cost 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 in 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.[11]

AEMC

In considering the introduction of Chapter 6A, the Commission discussed the cost pass through provisions it was implementing. It noted that the "objective of a cost pass-through is to provide a degree of protection for the TNSP from the impact of unexpected changes in costs outside of its control. Such a mechanism lowers the risks faced by the TNSP, which would otherwise have to be compensated for in the calculation of regulated revenues."[12]

It should be noted that these comments were made by the AEMC at the time of the introduction of Chapter 6A and, therefore, prior to the introduction of Chapter 6.

Commerce Commission of New Zealand

"The intention to restrict the cost pass throughs to unexpected changes in costs outside of the business's control is consistent with trying to preserve the

11 AER, *Victorian electricity distribution network service providers - Distribution determination 2011-2015*, October 2010, p. 745.

12 AEMC, Draft Rule Determination (Economic Regulation of Transmission Networks) 2006, p 87

incentive arrangements contained in the opex and capex provisions of the rules and to only expose consumers to those risks which are beyond the network service provider's ability to foresee, manage or mitigate. It is also consistent with international practice". The Commerce Commission of New Zealand restricts cost pass throughs to cost that were "uncontrollable, unforeseeable and have a material impact" on the financial position of the network.[13]

Office of Gas and Electricity Markets (UK)

The Office of Gas and Electricity Markets expects "network companies to bear their own business risk and therefore uncertainty mechanisms should only be used where action is required due to changes outside of the network company's control".[14]

The definitions in Box 5.1 contain some common themes. Normal business costs are excluded, as the cost pass through should not be provided where the business is able to manage or control the cost. This maintains the incentives that exist in the treatment of opex and capex under the building block approach and related incentive provisions in the rules. Costs that should have been forecast as an opex step change or a forecast capex proposal, and considered by the regulator as such, are excluded as the cost pass through should be due to an unexpected or unforeseen event.[15] Again this maintains the incentive properties of the building block approach and related incentive provisions in the rules.

The New Zealand Commerce Commission explicitly requires that the cost pass through to be beyond the ability of the network service provider to mitigate. The national electricity rules operate slightly differently. Under clause 6A.7.3(j)(3) the AER must take into account the efficiency of the expenditure by the network business including whether the provider has failed to take any action that could reasonably be taken to reduce the magnitude of the pass through amount.

Clause 6A.7.3(a)(7) of the rules also limits the cost pass through to efficient costs. The efficient level of costs can, however, be difficult for the AER to determine for a one off event that is experienced by only one network service provider.

Frequently, in consideration of the network's ability to manage costs the issue of how much control a network must possess over a cost before it becomes eligible for a cost pass through arises. This is a relevant consideration for the current rule change request.

Question 1 Allocation of risk

(a) What is the appropriate level of risk to be attributed to the network

13 Commerce Commission, Decisions and Reasons for not amending Transposer's administrative settlement to include Instantaneous Reserves Fees as Pass Through costs" 22 June 2009, p 15

14 Ofgem, Handbook for implementing the RIIO model, 4 October 2010, p 89

15 While the AER use the term "foreseeable" their description clarifies that this is in reference to the ability to identify or define the event

service provider? How should the distinction be drawn between risk to be attributed to the network service provider and risk to be passed through to the end consumer?

(b) Where the business has the ability to partially manage or mitigate a cost, how should that be factored into consideration of whether to allow a cost pass through?

(c) How do the businesses currently manage and mitigate their risk profile?

(d) Amending the rules to broaden the scope of the cost pass through provisions transfers the risk to end customers. Is it appropriate for end customers to bear these risks?

(e) Is clause 6A.7.3(j)(3) sufficient to maintain the incentives to efficient manage part of the costs but still provide the business with an opportunity to recover efficient costs? Is there a more preferred mechanism to achieve this?

5.2 The interaction between cost pass throughs, capex re-openers and contingent events

As noted in section 2.2, there are a number of mechanisms in Chapter 6A to address uncertainty. TNSPs have cost pass throughs, capex re-opener and contingent events provisions.

In contrast the mechanisms to address uncertainty in Chapter 6 operate differently, the definition of a pass through event under chapter 10 of the rules allows DNSPs to propose an event nominated in a distribution determination as a pass through event for the determination (nominated cost pass through). However, the DNSPs neither have access to a capex re-opener nor a contingent event provision. The AEMC is currently considering a capex re-opener for DNSPs as part of the Economic Regulation of Network Service Providers rule change request from the Australian Energy Regulator and the Energy Users Rule Change Committee.[16]

The contingent event provisions allow cost recovery from end consumers in relation to a specific event where the "trigger event" is uncertain at the time of the TNSPs revenue proposal. Subject to review by the AER, the capex re-opener permits the recovery of unforeseen costs as part of its regulated revenue/prices. The ability to recover some costs clearly reduces the risk from unforeseen events to the network service provider. The capex re-opener and contingent event provisions mean that cost pass through events are not the sole means of dealing with uncertainty for TNSPs. For DNSPs the cost pass through provisions remain the sole means of cost recovery for unforeseen events.

16 www.aemc.gov.au/Electricity/Rule-changes/Open/Economic-Regulation-of-Network-Service-Providers-.html

The contingent event provisions operate on a limited basis where the nature of the expenditure is forecast at the time of the TNSPs revenue proposal, but is contingent on a "trigger event". These provisions do not operate on costs where the event that led to the TNSP incurring costs was unforeseen.

However, as outlined in section 2.2 there are a number of limitations to the operation of the capex re-opener. Grid Australia notes that it does not include opex and the materiality threshold is set at five per cent of the RAB. Grid Australia argues that five per cent of RAB is too high to address all the issues that led it to make this rule change proposal. Further, under clause 6A.7.1 there are additional restrictions on the operation of the capex re-opener. These other restrictions are that:

- capex must be beyond the reasonable control of the TNSP (clause 6A.7.1(1)
- capex must not be included in the forecast capex or contingent events (clause 6A.7.1(2))
- TNSP is unable reduce capex in other areas to offset the unforeseen capex (clause 6A.7.1(4)(ii))
- unforeseen capex event will increase the capex beyond the current allowance (clause 6A.7.1(5))
- event would be likely to have a material adverse effect on the reliability and security of the network (clause 6A.7.1(6))

At the time of its consideration of Chapter 6A the Commission indicated that the rules for the capex re-opener "ensures that re-openers are only triggered for large shipwreck-type events and gives weight to the use of the pass through or contingent project provisions as the primary means of redress following major unforeseen events".[17] This is reflected in the rules as the capex re-opener is made subordinate to the cost pass through provisions (clause 6A.7.1(a)(7)), by explicitly prohibiting an application for a re-opener where expenditure is a cost pass through or contingent event.

There are no explicit criteria set out in the rules governing the basis for the AERs consideration of whether to accept or reject a cost pass through application. The AER did publish a set of criteria in its final decision for the Victorian DNSPs.[18]

Question 2 Interaction between cost pass throughs, capex re-openers and contingent events

(a) Is the AEMC's intent to leave the re-opener for "large, shipwreck-type events" and make the cost pass through as the primary means of redress

17 AEMC, , Final Rule Determination (Economic Regulation of Transmission Networks) 2006, p 62

18 AER, *Victorian electricity distribution network service providers - Distribution determination 2011-2015*, October 2010, p. 745.

still appropriate?

(b) Should cost pass throughs be more limited where a capex re-opener exists?

(c) Should cost pass throughs be limited to operating expenditure and capex be left to the capex re-opener?

(d) Should the cost pass through override the capex re-opener as it currently does or should cost pass throughs only apply where the capex re-opener doesn't?

(e) Does the existence of a re-opener change the justification for the ability to propose cost pass throughs?

5.3 Cost pass throughs, network service provider risk profile and return

As noted in section 5.1, a new cost pass through takes a risk that was previously attributed to the network business, and at least in part, moves it to the end consumer. This changes the risk profile of the network business. The removal of the risk alters the risk return trade-off for that business. The forecast rate of return for TNSPs is a WACC calculation under rule 6A.6.2 utilising CAPM to calculate the return on equity.

Grid Australia indicates that an adjustment to the rate of return for the network businesses is inappropriate as the events related to its proposal are asymmetric and asymmetric risks are not captured by the capital asset pricing model (CAPM).

Question 3 Cost pass throughs, risk and return

(a) Is it appropriate to adjust the WACC for the inclusion of a new cost pass through?

(b) Are the risks referred to in the rule change request asymmetric?

(c) Are these risks or the expected value of bearing this risk reflected somewhere else in the building block approach or other incentive mechanism? Are the network businesses currently bearing this risk with no level of remuneration as is implied by the Grid Australia submission?

5.4 Specified definition for natural disaster cost pass through

In its rule change request, Grid Australia is proposing that the definition of a pass through event be amended to incorporate a new 'natural disaster event'. A 'natural disaster event' is proposed as follows:[19]

19 Grid Australia rule change request, October 2011, p12.

> "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 submits 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 notes that the Victorian distribution network service provider's 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 DNSPs in earlier distribution determinations. Grid Australia also notes that the AER has stated that it may be appropriate to codify additional pass through events once positions have been settled.[20] Therefore, in recognition of this codification and given the consensus that has emerged through the AERs distribution determination process, Grid Australia has proposed the inclusion of a dedicated natural disaster pass through event.

As noted in section 5.1 above, the inclusion of a new natural disaster pass through event may result in changes to how risk is managed between the network business and end consumers.

Question 4 Incorporation of a new natural disaster pass through event in the rules

(a) How would this new pass through event change how a network service provider manages its risk?

(b) In the event that a new pass through event is included in the rules, what is the appropriate level at which consumers bear the risk of natural disasters?

(c) Would the inclusion of a new natural disaster pass through event alter the incentives and cost structure of network service providers?

(d) Would the inclusion of a new natural disaster pass through event provide regulatory certainty and transparency to the rules?

(e) Would the inclusion of a new natural disaster pass through event be more administratively efficient, as opposed to a nominated cost pass through?

20 ibid. p13.

5.5 Specified definition for insurance cap event cost pass through

Grid Australia proposes to include an 'insurance cap event' as a new pass through event. Grid Australia considers 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 considers that this would address the more general issue of the management of risk in excess of commercial insurance limits.[21] Grid Australia's proposed definition of this event is as follows:[22]

> "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 notes 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 typically capped, where higher levels of cover above that cap generally require very high premiums (in the order of US$20,000-$50,000 per million dollars insured).[23]

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21 Grid Australia rule change request, October 2011, p16.

22 ibid.

23 ibid. p17.

Therefore, Grid Australia submits that its proposal to include an 'insurance cap event' provides an appropriate means of managing the risk of costs arising which exceed an network service providers insurance limits, including costs in relation to third party liability claims. The consultancy report by Marsh for Grid Australia estimates the likely probable costs relating to a single, discrete bushfire.[24] That is, Grid Australia considers 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.

The AEMC notes that the AER allowed a nominated insurance cap event in the Victorian distribution determinations.

Question 5 Incorporation of a new insurance cap event in the rules

(a) How would this new pass through event change how a network service provider manages its risk?

(b) In the event that a new pass through event is included in the rules, is it appropriate that consumers bear the risk of insurance liabilities?

(c) Would the inclusion of a new insurance cap pass through event alter the incentives and cost structure of network service providers?

(d) Would the inclusion of a new insurance cap pass through event provide regulatory certainty and transparency to the rules?

(e) Would the inclusion of a new insurance cap pass through event be more administratively efficient, as opposed to a nominated cost pass through?

(f) Is it appropriate that TNSPs are allowed to pass through costs to end consumers where they are found to be negligent?

5.6 Proposed additional cost pass through applications

Grid Australia notes that currently TNSPs are only allowed to apply to the AER to pass through the costs of an event defined under clause 6A.7.3 of the rules. Grid Australia notes 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 limited to) events such as cyber-attacks and aviation mishaps (unrelated to terrorism).

Once accepted, Grid Australia also notes that DNSPs are allowed to include a nominated pass through in their building block proposal. Once accepted by the AER, the nominated pass through acts as a pass through event for that DNSP for the forthcoming regulatory control period. Therefore, Grid Australia proposes that the rules be amended to provide TNSPs with the same flexibility to propose specific pass

24 Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of*

through events at the time of submitting their revenue proposals. Grid Australia argues 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.

Question 6 Ability for TNSPs to propose additional pass through events as part of its regulatory determination

(a) How would the ability of TNSPs to propose a nominated cost pass through change how it manages its risk?

(b) Would the inclusion of the ability for TNSPs to propose a nominated cost pass through alter the incentives and cost structure of TNSPs?

(c) Is it appropriate to include the natural disaster and insurance cap events as defined pass through events in the rules, if TNSPs have the ability to nominate pass through events as part of their revenue proposals?

(d) Should the criteria developed by the AER be codified in determining past through applications to promote administrative efficiency?

5.7 Provision to allow cost recovery where a pass through event occurs in the 'dead zone'

The AEMC 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'.[25] The 'dead zone' typically occurs in the final year of a regulatory control period and is where a DNSP may be unable to seek cost recovery under the cost pass through provisions, as DNSPs may only seek cost recovery for costs incurred in the same regulatory control period as the pass through event.[26] That is, an eligible cost pass through event occurs in the last 13 months of a regulatory control period, but a DNSP does not incur costs associated with that event until the next regulatory control period. Therefore, where the pass through event and the incurring of costs occur in separate regulatory control periods, a DNSP would not be able to seek cost pass through under the current rules.

Grid Australia also submits that the 'dead zone' issue is also a problem for TNSPs under the current rules arrangements.[27] 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.

commercial insurance, 16 September 2011, p8.

25 This advice consists of the AEMCs, final report to the MCE entitled *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure* - 30 November 2010 and a draft rule change request including draft rules.

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

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

Question 7 Addressing the dead zone

(a) Would addressing the 'dead zone' change how a network service provider manages its risk?

(b) How would addressing the 'dead zone' ensure that network service providers are able recover their efficient costs and encourage efficient investment in, and operation of, electricity networks?

(c) How would addressing the 'dead zone' provide regulatory certainty and transparency for network service providers?

(d) How would addressing the 'dead zone' promote administrative efficiency for network service providers?

(e) Is Grid Australia's proposal the most effective way of addressing the dead zone? Is its scope broader than is needed to address the 'dead zone'

6 Lodging a submission

The Commission has published a notice under section 95 of the NEL for this rule change proposal inviting written submission. Submissions are to be lodged online or by mail by 1 March 2012 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on rule change proposals.[28] The Commission publishes all submissions on its website subject to a claim of confidentiality.

All enquiries on this project should be addressed to James Eastcott on (02) 8296 7800.

6.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ["ERC0137"]. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

6.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0137.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

28 This guideline is available on the Commission's website.

Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
capex	capital expenditure
CAPM	capital asset pricing model
Commission	See AEMC
DNSPs	distribution network service providers
MAR	maximum allowed revenue
NEL	National Electricity Law
NEO	National Electricity Objective
opex	operational expenditure
RAB	regulatory asset base
the rules	National Electricity Rules
TNSPs	transmission network service providers
WACC	weighted average cost of capital