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## **Cost pass through arrangements for network service providers Rule 2012**

Dear Anne

United Energy (UE) welcomes the opportunity to respond to the Australian Energy Market Commission (AEMC) on the Draft Rule Determination, National Electricity Amendment (Cost pass through arrangements for network service providers) Rule 2012.

The response below covers three issues –simplified drafting to address the dead zone issue, removal of the nominated pass through considerations as these are overly prescriptive and providing certainty and continuity by maintaining the terrorism event in the NER list of pass through events.

### **The deadzone issue**

UE are appreciative of the AEMC view that amendments to address the dead zone should be made because it provides network businesses with the reasonable opportunity to recover their efficient costs over a number of years. The drafting suggests that it leaves it to the AER discretion as to whether to allow these costs to be recovered up to the end of a regulatory control period or across regulatory control periods.

UE are supportive of the Grid Australia proposal to address the deadzone issue with regard to the timing of the pass through event and the cost recovery in relation to regulatory control period. UE are supportive of drafting which does not limit pass through cost recovery to the current regulatory control period.

However UE remain concerned regarding the drafting in the following areas:

- the timing of distribution determination and cost pass through decisions;
- smoothing of recovery of costs across regulatory years/regulatory periods; and

- the complexity of the drafting of the deadzone issue.

### **Timing of the distribution determination and the pass through decision**

The deadzone problem was initially identified where an event occurred so late in a regulatory period that the process of application and AER approval could not be completed in time for the costs to be recovered in that same regulatory period. That process issue was a problem because the drafting limited recovery of costs to within the period in which the event occurred. However, there were related problems; even if the process could be completed it might be the case that it was not sensible for all the costs incurred in the period to be recovered within the same period (for example if the costs were very large) or it might be the case that some costs would be incurred both within the period that the event occurred and into the next period.

The drafting has sought to address these problems by reference to whether costs have been allowed in a distribution determination. We have some issues with the drafting of the proposed Rule, insofar as it creates an interdependency between the pass through process and the regulatory determination process, in relation to which we seek the AEMC's clarification.

Our issues stem from the drafting of the second paragraph (b) of the proposed definition of eligible pass through amount and proposed clause 6.6.1(j)(2) both of which operate such that the first enquiry is whether or not a distribution determination makes an allowance for the increase in costs. It must be the first enquiry because (using the definition of eligible pass through event) paragraph (a) begins "unless paragraph (b) applies" so one must first ask – "does paragraph (b) apply or not".

It is only if the distribution determination does not allow for the recovery that they can be recovered during the subsequent regulatory period.

The issue begins as a timing one – does an applicant need to wait until a distribution determination is made (for UE about 30 October in the final year of a regulatory period) before it can know if the determination does or does not make an allowance for the costs. If so, how can that work for a pass through process that needs to be commenced before that determination is made?

### **Smoothing of recovery of costs across periods?**

However, there is also a recovery issue – if under the definition of eligible pass through amount the costs recoverable are those under paragraph (a) (ie within period) is it clear that the AER can allow recovery of those costs over subsequent periods under proposed clause 6.6.1(d)(2)? Or might there be some suggestion that recovery across periods is limited to those circumstances where the eligible pass through amount also arises across periods?

### **Treatment of operating costs and capital costs**

These issues may not be so significant for operating costs. The distribution determination for operating costs is always forward looking, ie it cannot allow for past period operating costs, and so it can be assumed that paragraph (b) will always (and paragraph (a) will never) apply to operating costs incurred wholly within the period, whether or not there is time for a pass through decision to be made. This is also a concern where the costs straddle regulatory periods where the event occurs after the regulatory proposal date.

Is it envisaged that UE and the AER will make these assumptions rather than have to wait to see what the distribution determination does?

However the position with capital costs may be more difficult and our issue is prompted by section 4.4.5 of the AEMC's Directions Paper on the AER's proposed NER changes from which it seems the AEMC expects capital costs arising from a pass through event will, in most circumstances, be recovered over the (long) life of the assets.

Our concerns are best understood using the example of our current regulatory period (2011 – 15) and a pass through event occurring on 1 June 2014, giving rise to significant capital costs in 2014 and 2015 (for example a terrorism event that causes widespread damage to the distribution system) as well as operating costs in those years.

Capital costs in 2014 would be included in the regulatory proposal on 31 November 2014 for roll in to the opening RAB on 1 January 2016.

The pass through application would need to be made in early October 2014 with the AER pass through decision towards the end of 2014. At both of those points in time, it would not be known by UE or the AER to what extent the 2014 capital costs would be rolled in to the RAB and this raises the timing issue referred to above.

If in the regulatory determination in October 2015 those 2014 capital costs are rolled in, paragraph (b) would not apply as the distribution determination would make some allowance for the recovery of the increase in capital costs. Is it envisaged that both UE (in making its application) and the AER (in making its determination) would assume that the 2014 capital costs will be rolled into the RAB when the AER makes its regulatory determination in October 2015, with the result that the eligible pass through amount would be the 2015 capital costs and any 2014 and 2015 operating costs under paragraph (a). In these circumstances, despite the eligible pass through amount being costs incurred within the period, is it clear that the AER could provide for the recovery of the 2015 capital costs into the next period and subsequent periods under proposed clause 6.6.1(d)(2) or would it need to allow the capital costs as a 'lump sum' within the regulatory period (as the AEMC seems to think would be inappropriate)? If the 2014 and 2015 operating costs are significant, is it clear that these also could be recovered over subsequent periods?

Proposed clause 6.6.1(j)(7) provides that the AER is to consider whether costs "will be factored into the calculation of the provider's annual revenue requirement for a subsequent regulatory control period". Is it clear that the AER can foreshadow a determination it will make in the future, perhaps when that process has not even begun? How is it envisaged that the AER will address this requirement?

As a timing matter, it seems as if the clause requires waiting to see if a distribution determination deals with the costs before being able to progress a within period application.. A distributor may seek approval for a pass through amount from the AER within 90 business days of the event and the AER is required to make a determination on the pass through within 60 business days. This is a 7.5 month process which could conclude just prior to UE submitting its price review to the AER or could conclude during the AER review or after the AER final price determination. It appears that the drafting builds in an interdependency, yet the Rules require the two processes to run quite separately.

## **An alternative approach to drafting the deadzone issue**

It might be easier to address the original problems by simpler drafting that both current and future period costs are recoverable across regulatory periods other than costs that have been allowed in a distribution determination. The drafting could be simplified in the following manner:

- Remove the definition of eligible pass through amount in chapter 10. There is no need to define the amount to be claimed by reference to regulatory determinations; it can simply be the increase in costs from the event. Prevention of double recovery is a matter for consideration by the AER under paragraph (j);
- Remove 6.6.1 (c) (3) so that a DNSP seeks a positive pass through amount in sub clause (4) (the relationship between eligible pass through amount and positive pass through amount is duplicative). As noted, the amount sought would simply be the increase in costs;
- How the amount is to be recovered can still be dealt with in sub clause (5) and, as for the current proposed clause, can provide simply for recovery across periods no matter when the costs arise;
- Simplify 6.6.1 (j) (2) to the following:  

‘In the case of a positive change event, the increase in costs in the provision of direct control services that, as a result of the positive change event the provider has incurred and is likely to incur as a result of the positive change event except any costs already recoverable in a distribution determination.’
- Delete the amendment to 6.6.1 (j) (7) so that the AER when making a cost pass through determination does not need to forecast what will be factored into a distribution determination which may not be made for another year or so.

We also have a concern with clause 6.6.1 (c) (5) and similarly drafted clauses. It might be inferred from the drafting that there must be some costs that are passed through in the same year as the event before the overall pass through arises. This could be problematic where the event, pass through application and AER approval of the amount make it impossible to recover any costs from the event in the same regulatory year.

## **Nominated Pass Through events**

UE support TSNP’s also being able to nominate pass through events in their regulatory proposals as envisaged in Box 5.1 (the factors that the AER considered for the Victorian distributors). The drafting of the event in the negative (uncontrollable, unforeseeable, cannot be self insured and does not undermine the incentive arrangements) is more preferable than the proposed drafting in the Draft Determination.

It is preferable to test a nominated pass through event against a negative test ie the prudent service provider through its actions could not have reasonably prevented the event from occurring or substantially mitigated the cost impact. It is unclear how the AER may consider whether a prudent service provider could reasonably prevent an event from occurring or substantially mitigate the cost impact of such an event on a forward looking basis when determining whether an event that is described only by its type or nature may be acceptable from the nominated list.

The AEMC notes that pass through events should be limited to instances of unforeseen costs. How is the notion of an unforeseen event consistent with criteria that require the event to be foreseeable (in that its nature or type can be clearly identified in advance) and assessable on a forward looking basis?



UE does not support the new definition of nominated pass through considerations being included in Chapter 10 and the corresponding new Rule 6.5.10. The definition and Rule 6.5.10 should be removed.

### **Terrorism Events**

The AEMC suggest that the a natural disaster event should not be included in the NER list of prescribed pass through events as this adds unnecessary prescription and does not allow for differences between network businesses or for the definition to be refined over time. For this reason, the AEMC proposes that the terrorism event be removed from the NER, requiring network businesses to propose these nominated pass through events as part of their regulatory proposals each time.

Leaving a terrorism event in the NER does not erode the incentives on a network business. The reality of a terrorism event is that there is little a business can do in a forward looking manner that is sensible.

How is the AER going to determine whether a business has effectively exhausted mitigation actions on a forward looking basis in order to determine that a natural disaster or terrorism events may be a nominated event?

UE recommend that a terrorism event should remain in the NER list of prescribed pass through events.

### **Other Drafting Matters**

UE suggest the reference in the pass through event definition refer to 6.6.1 (a1) and not 6.6.6 (1) (a1).

If you would like to discuss any of the above please feel free to contact me on 8846 9856.

Yours sincerely

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