grid australia
BACKBONE OF THE NEM

14 October 2011

John Pierce
Chairman
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

By email: submissions@aemc.gov.au

Dear John

Proposed Rule Change: Cost Pass Through Arrangements

Please find enclosed a Rule change proposal designed to improve arrangements for cost pass through adjustments to revenue caps for a range of low probability, high impact events.

This proposal is lodged on behalf of the members of Grid Australia.

Specifically, the proposal:

- Incorporates a new 'natural disaster event' within the definition of 'pass through event' to enable recovery of large unexpected 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 transmission network service providers 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 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 period.

The enclosed proposal contributes to the National Electricity Objective by allowing more cost efficient management of risks, and ensuring that the risk of very high impact events for which no commercial insurance is available does not threaten the viability of network businesses.

The proposal is accompanied by a report from Marsh Risk Consulting which provides expert advice on the quantification of low probability, high impact events and the corresponding availability of commercial insurance. A separate copy of this report which contains further supporting information is also provided to the AEMC, on a strictly confidential basis, as it contains sensitive commercial and proprietary information.

Grid Australia would welcome the opportunity to discuss this proposal with the AEMC, and to discuss the timetable for its consideration. If you require any further information please contact Phil Gall on (02) 9284 3434 or Simon Appleby on (08) 8404 7324.

Yours sincerely,

D L Appleby

for Rainer Korte
Chairman, Regulatory Managers Group

Rule Change Proposal: Cost Pass Through

October 2011

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1. Overview of Proposal

Grid Australia is submitting this Rule Change Proposal to the Australian Energy Market Commission (AEMC).

The Proposed Rule provides for a number of changes to the current National Electricity Rules ('the Rules') in order to allow Transmission Network Service Providers (TNSPs) to better utilise the cost pass through provisions in clause 6A.7.3 of the Rules. Specifically the Proposed Rule will allow:

- Better management of the risks of natural disasters which are outside the reasonable control of TNSPs. The Proposed Rule achieves this by incorporating a new 'natural disaster event' within the definition of 'pass through event';
- More appropriate management of the risk of events where the cost of those events exceeds the limit of a TNSP's insurance policies (including, but not limited to, events that entail third party liability claims), thereby reducing the cost of insurance premiums which need to be reflected in the TNSP's expenditure allowances. The Proposed Rule achieves this by including a new 'insurance cap event' within the definition of 'pass through event';
- Flexibility to introduce specific pass through events, the need for which is identified as part of the transmission determination process. The Proposed Rule achieves this by enabling TNSPs to propose additional pass through events as part of their revenue proposals; and
- Pass through applications to be made for events which occur in a previous regulatory period, in circumstances where it is too late to include the costs associated with those events in a TNSP's total revenue cap for the subsequent regulatory control period. The Proposed Rule achieves this by addressing the so-called 'dead zone' issue.

The Proposed Rule contributes to furthering the National Electricity Objective (the NEO). Specifically it promotes the long term interest of consumers with respect to the price of electricity by allowing for more cost efficient management of risks. It also provides greater security for the national electricity system by ensuring that the risk of very high cost events for which no commercial insurance is available does not threaten the financial viability of the TNSP.

The Proposed Rule incorporates changes to both the Rules applying to TNSPs under Chapter 6A and the Rules applying to Distribution Network Service Providers (DNSPs) under Chapter 6.

The remainder of this Rule Change Proposal is organised as follows:

- Section 2 sets out the statement of issue with the current Rules, together with Grid Australia's proposed solution;
- Section 3 describes the Proposed Rule (a more detailed Draft Rule is provided in Appendix A);
- Section 4 explains how the Proposed Rule will contribute to meeting the NEO; and
- Section 5 describes the expected benefits and costs of the proposed change, and the potential impacts on those likely to be affected.

2. Statement of Issue

2.1 Summary

Under the current Rules, TNSPs remain exposed to the risk of significant cost impacts arising from natural disasters that are outside their reasonable control.

Bushfires and other extreme weather events (such as earthquakes and cyclones) may result in TNSPs incurring extensive costs as a result of property damage to towers and lines and third party liability claims. TNSPs typically have commercial insurance coverage for natural disasters 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. The potential magnitude of the costs associated with natural disasters also means that TNSPs cannot credibly self-insure to cover the full potential costs of these events.

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 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.[1] Moreover, a substantial portion of a TNSP's 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.

Grid Australia is therefore proposing a Rule change that would allow costs resulting from natural disasters that are beyond the reasonable control of a TNSP to be addressed under the cost pass through provisions in clause 6A.7.3, where such costs are not covered by either commercial insurance or a self-insurance allowance. Grid Australia considers that the use of the cost pass through provisions provides the most cost effective means to manage TNSPs' exposure to such risks, particularly given the uncertainty surrounding the frequency of these events and the potential magnitude of their consequences. This in turn will further the long term interests of consumers with respect to the price of electricity. The Rule change would result in TNSPs' exposure to the risks associated with natural disasters being treated in the same manner under the Rules as the risks arising from 'terrorism events'. It is also consistent with the approach applied under Chapter 6 of the Rules to the DNSPs, who are able to propose additional 'nominated pass through events' as part of their regulatory proposals and have used that ability to have pass through events covering a natural disaster included in their distribution determinations.

[1] The threshold for the capital expenditure provisions is that costs exceed 5% of the RAB (which is in the order of $50m to $220m, depending upon the TNSP), whereas the materiality threshold applied to cost pass through applications is 1% of the TNSP's Maximum Allowed Revenue (MAR).

Grid Australia is also proposing to allow costs that are in excess of the limit of a TNSP's commercial insurance to be eligible for consideration under the cost pass through provisions. Again, this will provide a more cost effective means of addressing the risk of events resulting in very high costs, above the level at which insurance cover is typically available at reasonable premiums. Inclusion of an 'insurance cap event' is an effective way of managing the risk associated with third party liability claims which exceed insured limits, given that such claims often do not materialise with any certainty until a significant time after the underlying event which gives rise to the claim. The new cost pass through event would apply equally under Chapter 6A and Chapter 6. Grid Australia notes that the proposals for the 'natural disaster event' and the 'insurance cap event' are complementary and are intended to be treated as a package.

More generally, Grid Australia is proposing to allow TNSPs to be able to include in their revenue proposals, for consideration by the AER, such additional nominated pass through events as they consider appropriate. This is consistent with the current treatment of DNSPs under Chapter 6 of the Rules.

Finally, as part of this Rule Change Proposal, Grid Australia is proposing changes to the Rules to make clear that TNSPs can seek the approval of the AER to pass through the costs arising from an eligible cost pass through event occurring in an earlier regulatory period in circumstances where it is too late to include these costs in a TNSP's total revenue cap for the subsequent regulatory period. This addresses the current so-called 'dead zone' issue. Changes are proposed to both Chapter 6A and Chapter 6, in order to maintain alignment between the Rules applying to TNSPs and DNSPs in this area.

2.2 Exposure to Risks from External Events

The CPI-X regulatory framework applying to TNSPs is intended to provide incentives so that risks are appropriately managed.

However there are some aspects of a TNSP's costs which are difficult (or even impossible) to project, and which are also not under the TNSP's reasonable control. There may be additional costs or cost reductions which arise during the regulatory period as a result of external factors which were not foreseen at the time the expenditure benchmarks were established.

To the extent that there is equal uncertainty as to whether outturn costs will end up higher or lower than projected expenditure, TNSPs face both an upside and an equal downside risk. However, if it is expected that costs are more likely to increase as a result of uncertain events than to decrease, then this represents an asymmetric risk. Such asymmetric risks are not compensated for by the Weighted Average Cost of Capital (WACC), which compensates the TNSPs only for systemic or market risk.

The potential cost impact of uncertain events can be substantial. For example, work undertaken by Marsh Risk Consulting for Grid Australia has estimated that the maximum foreseeable loss associated with third party liability claims as a result of a single, discrete bushfire may be in the order of A$340m-$880m, with a most likely value of around $575m.[2] Multiple bushfires would compound this figure.

In addition, there are some high-impact risks which are very costly for TNSPs to insure against, beyond a certain level, or where the availability of commercial insurance is extremely thin or non-existent beyond that level. In these circumstances, commercial insurance or self-insurance may not be the most efficient means of risk management.

2.3 Existing Mechanisms under the Rules for Addressing this Risk

There are a number of mechanisms under the existing Rules that can be used to address the asymmetric risk faced by TNSPs as a result of uncertain high cost events that are outside the reasonable control of TNSPs, i.e. described herein as exogenous events:

1 **Commercial insurance:** A TNSP can elect to purchase insurance against the cost impact of an uncertain exogenous event. The cost of this insurance (i.e., the premium) is then incorporated into the TNSP's operating expenditure forecast. There are typically limits on the total costs which are covered by such insurance. TNSPs may be able to increase this limit by paying a higher premium. However, there may be limitations on the amount of insurance cover for higher amounts that is available at a reasonable cost;

2 **Self-insurance:** Where the cost impact of an uncertain event is not transferred to an external party the loss is retained by the TNSP. Self-insurance of retained losses is often the default position when insurance policies are not available or where a risk is unknown or underestimated. A TNSP can choose to self-insure against the cost impact of an uncertain event, where the cost of self-insurance can be reasonably forecast. The cost of self-insurance (calculated as the costs expected if the exogenous event occurs multiplied by the probability of the event occurring) is then incorporated into the TNSP's operating expenditure forecast;

3 **Cost pass through:** The AER may adjust the TNSP's revenue allowance within a regulatory period when a pre-defined exogenous event occurs which materially increases or decreases the TNSP's costs (capital and/or operating expenditure), under the explicit cost pass through provisions set out in clause 6A.7.3. 'Material' is defined as more than 1% of the TNSP's Maximum Allowed Revenue (MAR) for that year. TNSPs are required to seek the approval of the

2 Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance* , 16 September 2011, p. 2.

AER for any cost pass through, and the AER is required to make a determination on each application received; and

4 **Re-opening of a revenue determination for capital expenditure**. Under clause 6A.7.1 of the Rules, the AER may re-open 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 5% of the TNSP's Regulatory Asset Base (RAB).

2.4 Adequacy of the Existing Rules

This section considers the adequacy of each of the existing mechanisms described above in managing the risks associated with events beyond a TNSP's reasonable control.

2.4.1 Commercial insurance

As noted above, a TNSP may elect to purchase insurance against the cost impact of an exogenous event, the cost of which would then be incorporated into its operating expenditure forecast.

In the case of some high impact, low probability events, the commercial insurance market is very 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.

Commercial insurance may not be available for these events. More commonly, insurance may only be available at a reasonable cost up to a cap, leaving the TNSP with a residual exposure to losses above the cover limit. Premiums to increase the cover limit may be prohibitively priced. Where it is difficult to reliably estimate the probability of an event, or the potential costs that may result, then the 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.

Based on Marsh's inquiries into the availability and cost in the international insurance market of insurance for liability claims arising from bushfires, cover is available up to a certain level, beyond which it is either unavailable or uneconomical.[3] Generally insurance premiums up to this limit can be expected to cost around $2,000-$5,000 per million dollars insured. Above that limit, Marsh's inquiries have shown that further

[3] Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance*, 16 September 2011, p. 8

insurance for liability claims is sometimes available, but would require additional premiums of US$20,000-$50,000 per million.

In the case of insurance cover for damage to transmission and distribution lines, Marsh concludes that insurance is generally very limited, due to restrictions imposed on insurers by the reinsurance market. Insurance is sometimes available, but only up to around US$20m. However the premium cost is high, being typically 10-20% of the limit purchased. Moreover, Marsh's analysis has shown that a catastrophic loss to these assets due to an earthquake could reasonably be expected to exceed US$20m, and may possibly exceed this level for other severe weather events (i.e., a severe tropical cyclone).

As a more general point, the cost of commercial insurance for a range of events often increases substantially once beyond a certain level of cover. The payment of very high premiums to increase cover amounts may not be the most efficient way of managing the risk of incurring costs above the threshold level, and may not be regarded by the AER as efficient or prudent.

2.4.2 Self-insurance

An alternative to commercial insurance is self-insurance. As with commercial insurance, the costs of self-insurance are incorporated into the TNSP's operating expenditure forecasts.

Two forms of self-insurance can generally be distinguished. The first is where the TNSP chooses to include a 'deductible' in its commercial insurance policy, with the result that it must then pay this amount if the event occurs, before it can claim on its external insurance policy. The TNSP's choice to include deductibles in its commercial insurance policies is more properly termed 'risk retention'.

The other form of self-insurance is where the TNSP chooses to bear the risk of an event as an alternative to taking out commercial insurance. It is often difficult to substantiate this type of self-insurance costs to the regulator, given that in many cases self-insurance is due to a lack of commercial insurance offerings. This means that it is difficult to point to an independent, external market in order to establish either the probability of the event occurring or the potential cost impact. The AER has previously raised concerns about the ability of network service providers (NSPs) to predict and measure the risk of events and derive a reliable premium, in circumstances where commercial insurers are not willing to do so.[4] As a consequence, the AER may refuse to approve self-insurance costs, as not meeting the requirements of the Rules for costs to reasonably reflect the efficient costs required by a prudent operator.[5] The AER has previously commented that:

4 AER, *Queensland Draft distribution determination 2010–11 to 2014–15, Appendices*, 25 November 2009, p. 702.

5 See for example AER, *Queensland Final distribution determination 2010–11 to 2014–15,* 6 May 2010, p. 438.

> 'these types of uninsurable or difficult to insure risks, if material, are best considered as a cost pass through event.' [6]

In addition, unlimited self-insurance may simply not be credible for catastrophic losses associated with an event beyond the TNSP's reasonable control. For self-insurance to be credible, the TNSP needs to have sufficient assets and income generating ability to credibly be able to bear the risk of incurring the costs, if the event occurs. As noted previously, analysis undertaken by Marsh indicates that the maximum foreseeable loss associated with a single, discrete bushfire could be as high as $880m. If a number of bushfires occurred due to transmission line ignition in multiple locations, then the maximum loss could be much higher.[7] The AER has previously noted that:

> 'Events which occur which are likely to have large or catastrophic impact are not appropriately treated as self-insurance categories.' [8]

Further:

> '.. the AER considers that care must be taken when self-insuring key income generating assets. Once an asset is destroyed or is severely impaired, there is a risk that there will be no income or means to fund the self-insurance event. If a DNSP loses a key asset and is unable to earn income as a result, even a modest repair or replacement bill could be unpayable. [..] In general, the AER considers that events affecting key income generating assets are better dealt with through the cost pass through mechanism. This ensures that the event can be judged in terms of efficiency and scale once the costs associated with the event are known with certainty.'[9]

Finally, Grid Australia notes that the default position is that TNSPs bear the risk of uncertain events happening which increase their costs, unless those risks have been explicitly managed by taking out commercial insurance, or are eligible for recovery under the cost pass-through or re-opening provisions in the Rules. That is, the TNSP effectively self-insures for all risks, other than those that are explicitly addressed by an alternative mechanism. This is regardless of whether an explicit self-insurance allowance has been included as part of the TNSP's expenditure forecast, or whether the costs of the event exceed the costs assumed at the time a self-insurance allowance was made. To date the costs associated with the full extent of such self-insurance have not been reflected in the self-insurance allowance incorporated within the operating expenditure forecasts.

6 AER, *Queensland Draft distribution determination 2010–11 to 2014–15, Appendices*, 25 November 2009, p. 699.

7 Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance*, September 16 2011, p. 2

8 AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Draft Decision* June 2010, p.711 and p. 712.

9 AER, *Queensland Draft distribution determination 2010–11 to 2014–15, Appendices*, 25 November 2009 p.701-704.

2.4.3 Cost pass through

Clause 6A.7.3 of the Rules allows cost pass through for TNSPs for additional operating and capital expenditure costs for certain defined events which fall within the scope of a 'pass through event': a regulatory change event; a service standard event; a tax change event; a terrorism event and an insurance event.[10] A TNSP is able to apply for cost pass through where the cost of the event is 'material', which is defined as exceeding 1% of the MAR for that regulatory year.

The defined events allow TNSPs to apply for a pass through of the cost impact associated with unpredictable, potentially high-cost events which fall within the definition of a 'terrorism event'. However the defined events exclude many other unpredictable, potentially high-cost events beyond the reasonable control of TNSPs – including, most notably, natural disasters.

There is currently no scope under Chapter 6A of the Rules for a TNSP to propose additional categories of cost pass through events as part of the regulatory determination process. This is in contrast with the provisions in Chapter 6 which do allow DNSPs to propose additional pass through events. DNSPs have used this provision to propose a number of different additional pass through events, including natural disasters and the incurring of costs above insurance limits. These cost pass through events have been accepted by the AER for DNSPs.

In addition, the current cost pass through provisions are based on the concept of a single cost pass through application, where the NSP makes a forward-looking estimate of the costs it is likely to face during the remainder of the regulatory period. This application is required to be made within 90 business days of the pass through event occurring. In reality, many external events may leave an NSP open to third party liability claims. The extent of these claims is generally hard to determine on a prospective basis, and the timeframe in which claims may be made may greatly exceed 90 business days from the underlying event which leads to the claim. This leads to potential difficulties in recovering the cost of such liability claims under the current cost pass through provisions.

2.4.4 Re-opening of a revenue determination for capital expenditure

Under clause 6A.7.1 the AER may re-open and substitute a regulatory determination where an event occurs which is beyond the reasonable control of the TNSP and could not reasonably have been foreseen at the time of making the revenue determination.

The criteria which must be met before the determination can be re-opened are:

[10] In addition there is a separate provision under NER 6A.7.2 for TNSPs to pass through network support costs.

- The TNSP proposes to undertake capital expenditure to rectify the adverse consequences of the event, without which the reliability and security of the relevant transmission system would be likely to be materially adversely affected;

- The total capital expenditure required during the regulatory control period exceeds 5% of the TNSP's RAB for the first year of that period. (This implies thresholds which currently range from $50m to more than $220m, depending on the TNSP);

- That capital expenditure is not already included in the TNSP's total revenue cap;

- The TNSP is not able to reduce capital expenditure in other areas to accommodate this expenditure, without materially adversely affecting the reliability and security of the relevant transmission system; and

- The event is not a pass through event or a contingent project.

The AER is able to revoke the revenue determination and substitute a new determination for the remainder of the period which varies from the previous determination only in so far as it accommodates such additional capital expenditure 'as the AER determines is appropriate' and reflects any resulting increase in forecast operating expenditure, the MAR and the X-factor for the remainder of the regulatory control period.

The current re-opening provisions in the Rules would therefore allow a TNSP to apply to recover the costs arising from low probability, high-cost events, provided that the following conditions were all met: the reliability and security of the network was threatened; the event requires capital costs totalling more than 5% of the RAB; and the expenditure cannot be accommodated by cutting other capital expenditure programs.

These conditions will not all be met for many high cost, external events. In particular, TNSPs are exposed to a significant risk of increases in operating costs arising from third party liability claims in the context of some exogenous events, such as bushfires. These claims would not also have associated capital expenditure, and as a result would not trigger the capital expenditure re-opening provisions.

Even where the event does result in capital expenditure, the costs, although high, may not be sufficiently high to trigger the re-opening provisions, given the high threshold (i.e., $50m to $220m, depending on the TNSP). For example, a cyclone or an earthquake may lead to extensive damage to towers and lines. Marsh has estimated that the cost of damage to towers and lines from a cyclone or earthquake is potentially in the region of $15m and $31m, respectively. This is substantially below the 5% of RAB threshold, whilst still being a substantial cost impact for a TNSP. As a result, these example events would not meet the criteria for triggering the capital expenditure re-opener clause.

Indeed, it is not clear that the capital expenditure re-opening provisions were intended to address the costs associated with uncertain external events. The Rules themselves refer to events 'which may include a greater than anticipated increase in demand.'[11] The AEMC's discussion in relation to clause 6A.7.1 at the time at which the Chapter 6A Rules were drafted[12] refers to reliability investments and to sudden increases in demand (e.g., desalination plant), and does not mention uncertain exogenous events such as natural disasters.

2.4.5 Contingent projects

For completeness, Grid Australia notes that the contingent project provisions under clause 6A.8 of the Rules are not relevant to the management of the risk of potentially high cost, uncertain exogenous events. The focus of the contingent project provisions is on network investment which can be clearly defined, but where the timing of the investment is linked to an uncertain trigger.

Clause 6A.8.1(c)(5) 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 case of uncertain, external events, the event is unlikely to be considered 'probable' in the relevant regulatory period. Rather, there will often be a low probability that the event will occur.

Under the contingent project provisions, the TNSP's revenue proposal must also include proposed contingent capital expenditure. In the case of uncertain, high cost events, the amount of required expenditure is not known prior to the event occurring. Moreover, as already noted, the TNSP's exposure includes third party liability claims, which are operating rather than capital expenditure.

2.5 Proposed Solution

Grid Australia is proposing the following changes to the Rules:

- The inclusion of a 'natural disaster event' as a pass through event in the Rules;
- The inclusion of an 'insurance cap event' as a pass through event in the Rules;
- The inclusion of the ability for a TNSP to nominate new categories of pass through event as part of its revenue proposal; and

[11] NER, 6A.7.1 (a) (final sentence).

[12] AEMC, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18*, November 2006, p.60-62.

- Minor drafting amendments to allow both TNSPs and DNSPs to lodge a pass through application for an event which occurs in one regulatory period but where the cost impacts have not been incorporated within the NSP's expenditure forecasts for the subsequent regulatory period.

2.5.1 Inclusion of a 'natural disaster event' as a new pass through event

Grid Australia is proposing that the definition of pass through event in the Rules be amended to incorporate a new 'natural disaster event', defined as follows:

> '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 proposes that this additional pass through event apply for both TNSPs and DNSPs. This would codify current practice for DNSPs.

How the new pass through event addresses shortcomings in the existing Rules

This additional pass through event clearly captures a key category of uncertain, potentially high cost events outside a TNSP's reasonable control. Natural disaster events include bushfires and other extreme weather events such as earthquakes and cyclones. Such events typically result in TNSPs incurring substantial costs, including those arising from property damage to towers and lines.

Including natural disaster events as a cost pass through event would allow the same treatment to be given to these uncertain, potentially high cost events outside a TNSP's reasonable control as is currently given to a 'terrorism event', which is already included as a pass through event in the Rules. Grid Australia notes that the characteristics of a natural disaster event align with the AER's criteria for the risk of these events to be managed via the cost pass through provisions. For example, the AER has commented that:

> 'However certain events which have a very high magnitude (for example, an earthquake) but are of a low probability should be treated as pass through events.'[13]

Including natural disaster events as a cost pass through event would also improve the alignment of regulation across the transmission and distribution businesses. Costs resulting from a natural disaster are currently covered under the cost pass through provisions applying to all of the DNSPs. A 'natural disaster event' has been approved

13 AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Draft Decision June 2010*, p.711. The AER did not comment further on (or revise) this issue in its Final Decision for Victorian distributors.

by the AER for the Victorian DNSPs[14] and the AER has also been clear that natural disasters fall within the scope of the more general 'General Nominated Pass Through Event' which it earlier approved for the DNSPs in South Australia, Queensland, NSW and the ACT.[15] The AER has commented that it may be appropriate to codify additional pass through events once positions have 'settled'.[16] Grid Australia considers that a 'natural disaster event' is a prime candidate for codification, given the consensus that has emerged in its inclusion in the cost pass through provisions for DNSPs.

Proposed definition

The wording for the proposed 'natural disaster event' in this Rule Change Proposal is based upon the pass through event approved by the AER for the Victorian DNSPs, with the following modifications:

- the requirement for the flood, fire or earthquake to be 'major' has been removed as such an event will be major if its cost consequences result in the materiality threshold being met, and the materiality threshold is part of the definition of this event;
- the event is required to be beyond the 'reasonable' control of the NSP;
- the exclusion of events for which external or self-insurance has been included in the NSP's forecast operating expenditure has been removed as this could be interpreted as precluding a pass through where the event is covered by any insurance even if that insurance is not sufficient to cover the costs arising from that event (e.g. as where the natural disaster was of an unprecedented magnitude) – the existence of external insurance or self-insurance is more properly a matter that the AER must take into account in approving the pass through amount (see below); and
- the requirement that the natural disaster occur during the relevant regulatory control period has been removed as this is not a feature of the terrorism pass through event and Grid Australia's proposed amendments to the pass through provisions (see below) explicitly preclude double recovery of these costs, egg, through both a pass through application and allowance for the same costs being included in an NSP's revenue allowance.

[14] AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Final Decision,* October 2010**.**

[15] AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Final Decision,* October 2010, p. 746.

[16] AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Final Decision,* October 2010, p. 795.

Interaction with commercial insurance and self-insurance

Including natural disasters as a pass through event is more appropriate than requiring TNSPs to address the risk of these events solely via commercial insurance or self-insurance. Given the potentially high cost and uncertainty of occurrence of these events, and the fact that they are beyond the reasonable control of TNSPs, cost pass through is the most efficient way to manage exposure to these risks.

Commercial insurance and/or self-insurance may be a cost effective means of managing the risk of natural disaster events up to certain limits. However beyond these limits the cost of commercial insurance can become prohibitive and such insurance may not even be available. For example, as noted earlier, commercial insurance for damage to transmission and distribution lines is generally not available for cover above US$20m, even though the potential risk exposure to TNSPs can easily exceed that level.[17] The very high cost consequences associated with a natural disaster event means that self-insurance to cover the potential cost is unlikely to be credible, beyond a certain limit.

Grid Australia notes that including a 'natural disaster event' as an additional pass through event does not mean that TNSPs would no longer seek insurance for such events, for levels of cover where insurance represents a cost effective means of managing their risk exposure. However it would provide a more cost effective means of managing the risks associated with very high cost consequences arising from natural disasters.

The Rule Change Proposal seeks to further clarify the interaction between commercial insurance, self-insurance and a cost pass through application. Specifically the following are proposed as additional factors which the AER must take into account in determining the approved pass through amount (i.e., under clauses 6A.7.3(j) and 6.6.1(j)):

(i) any amount which the relevant NSP recovers or; if it made a claim, would be entitled to recover under an insurance policy in respect of the pass through event or any matter or circumstance relating to the pass through event;

(ii) the availability, on reasonable commercial terms, of insurance against the costs that the relevant NSP has incurred and is likely to incur, and whether, and the extent to which, a prudent operator in the circumstances of that NSP would have insured against those costs;

(iii) the extent to which the forecast operating expenditure of the relevant NSP, as approved by the AER or a predecessor regulator responsible for the economic regulation of NSPs of that type, includes:

[17] Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance* , 16 September, p. 2.

(1) an allowance for self-insurance; or

(2) an allowance for expenditure on insurance premiums that are commensurate with a particular level of insurance,

and that allowance is intended to meet, or enable that NSP to take out insurance or to take other action to meet, the costs that the NSP has incurred and is likely to incur;

(iv) the extent to which the costs that the relevant NSP has incurred and is likely to incur are the subject of a previous determination made by the AER under the pass through provisions; and

(v) in the case of TNSPs only (because DNSPs are already subject to the application of a similar factor under clause 6.6.1(j)(7)), whether the costs of the pass through event have already been factored into the calculation of the TNSP's maximum allowed revenue.

Interaction with the capital expenditure re-opening provisions

Grid Australia notes that the risks associated with natural disasters are not currently addressed by the capital expenditure re-opening provisions in clause 6A.7.1. The high threshold for re-opening required under this clause (i.e., 5% of the RAB) means that costs reaching $50m, or even $220m, would not be able to be recovered under this clause. In addition, the re-opener provisions cannot be used to address changes in operating expenditure, where these are unrelated to changes in capital expenditure.

Including natural disasters as a cost pass through event would not raise the risk of 'double-dipping' under the capital expenditure reopening provisions, since clause 6A.7.1(a)(7) explicitly provides that this clause cannot be used for events which are defined as a cost pass through event.

Third party liability claims

Finally, Grid Australia notes that the proposed definition of 'natural disaster event', together with the requirement under the cost pass through provisions for NSPs to make a single pass through application within 90 business days, means that this event can primarily be expected to cover the capital cost consequences of a natural disaster (i.e. damage to towers and wires).

As noted earlier, a substantial proportion of the potential costs associated with a natural disaster are likely to arise from third party liability claims. Such claims typically occur more than 90 business days after the occurrence of the natural disaster. Moreover, the costs of such claims typically only crystallise when the claims are made, and cannot easily be estimated on a prospective basis. Grid Australia considers that the cost impact of these third party claims are more appropriately addressed by the inclusion of a separate 'insurance cap' event in the Rules (as discussed further below), rather than through the definition of a 'natural disaster' event. These two elements of the Rule Change Proposal (i.e. the inclusion and proposed definitions of both a 'natural disaster event' and an 'insurance cap event') are complementary and are intended to be treated as a package.

2.5.2 Inclusion of an 'insurance cap event' as a new pass through event

Grid Australia proposes that an 'insurance cap event' be included in the Rules as a cost pass through event. 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. It also addresses the more general issue of the management of risks in excess of commercial insurance limits.

Grid Australia's proposed definition of this event is as follows:

> 'Either:
>
> (a) a *Transmission Network Service Provider* or a *Distribution Network Service Provider* incurs a liability or liabilities; or
>
> (b) an event occurs,
>
> where:
>
> (c) 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 that limit applies; and
>
> (d) 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 that 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 the above definition of an 'insurance cap event' requires that the occurrence of the event or liability must *materially* increase the costs incurred or expected to be incurred by the NSP. In the case of TNSPs, 'material' is defined under the Rules as exceeding 1% of the TNSP's MAR for that regulatory year. As a consequence, the proposed new pass through event will only apply when the costs faced by a TNSP above the limits of its insurance policies are themselves material, rather than for any increase in costs above the insured limit.

How the new pass through event addresses shortcomings in the existing Rules

One of the substantive risks NSPs are exposed to is the risk of third party liability claims. Such claims may arise as a result of external events, such as a natural disaster. For example, the impact of a bushfire on individual property may be affected by the vegetation management practices of the NSP in that area. If the NSP is been found to have been negligent, this is likely to result in individuals and businesses seeking compensation from the NSP. Such liability claims may only occur several years after the original bushfire.

NSPs generally have insurance to manage the risk of such liability claims, including to cover instances where the NSP is found to have acted negligently. However such insurance is typically capped. Higher levels of cover above the cap typically require very high premiums. For example, as referenced earlier, bushfire liability insurance is only available at higher limits for premiums in the order of US$20,000-$50,000 per million dollars insured. This leads to a risk that the NSP may face claims which exceed their insured amount. The cost of third party liability claims associated with bushfires can be substantial, especially where there are multiple fires.

The proposal to include an ‘insurance cap event’ provides an appropriate means of managing the risk of costs arising which exceed an NSP’s insurance limits, including costs in relation to third party liability claims. Marsh’s report highlights that cover for general liability insurance (as distinct from bushfire liability cover) is also generally only available up to a certain limit, beyond which it is unavailable or uneconomic.[18] However the proposed ‘insurance cap event’ is a general event and is not restricted to third party liability claims, or to other uncertain, potentially high cost events outside a TNSP's reasonable control. The inclusion of this event provides TNSPs 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.

Interaction with commercial insurance and self-insurance

Including an ‘insurance cap event’ as an additional pass through event does not mean that TNSPs would no longer seek insurance for such events; only that TNSPs would not be forced to pay additional premiums for increased cover where it is not prudent or efficient to do so. One of the factors the AER is able to take into account in determining the approved pass through amount is the efficiency of the TNSP’s decisions and actions in relation to the risk of the event which could reasonably be taken to reduce the magnitude of the pass through amount.[19] Grid Australia is proposing the inclusion of additional factors (described previously) that the AER will be required to take into account in determining the approved pass through amount,

[18] Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance* , 16 September, p. 8.

[19] NER 6A.7.3(j)(3) and 6.6.1(j)(3).

under this Rule Change Proposal, to clarify the interaction between insurance and cost pass through.

Grid Australia considers that including an 'insurance cap event' is a more appropriate means of addressing the risks NSPs currently face than taking out higher insurance cover. As noted earlier, insurance premiums can become excessive for higher insured limits. Where the cost pass through provisions provide an alternative means of managing this exposure, these very high premiums do not then need to be incorporated into the TNSP's operating expenditure allowance.

Grid Australia also considers that a separate 'insurance cap event' is preferable to trying to incorporate recovery of these costs via the other defined pass through events and notes that the AER recently approved an 'insurance cap event' for the Victorian DNSPs.[20]

Grid Australia further notes that the proposed definition of an 'insurance cap event', when applied in conjunction with the proposed amendments to clauses 6A.7.3(j) and 6.6.1(j), ensures that where the AER has approved the inclusion of an amount in an NSP's operating expenditure allowance to reflect the premiums for commercial insurance cover, an NSP is not able to claim via the cost pass through provisions any higher costs it incurs if it subsequently decides not to maintain a level of insurance cover that is commensurate with those premiums. Moreover, where the NSP does not meet the criteria for being able to call on its insurance cover (for example, in a case where there has been 'wilful negligence' and that is not covered by the insurance policy), the NSP would also not be able to apply for a cost pass through.

Interaction with proposed 'natural disaster' pass through event

This Rule Change Proposal includes a new 'natural disaster' pass through event (see section 2.5.1). However, as noted in that section, not all of the costs associated with a natural disaster would be recoverable under the cost pass through provisions under the proposed definition, given the 90 business day limit imposed by the Rules on an NSP making a cost pass through application. Where there are third party liability claims, the full extent of these claims is unlikely to be known within 90 business days. Any cost estimate submitted during that period is likely to be highly uncertain, as the extent of an NSP's third party liability is likely to only become clear over time, and typically after Court rulings. For the same reason, it would be difficult for an NSP to incorporate an allowance within its expenditure forecasts in subsequent regulatory periods to cover likely liability claims above insured limits.

[20] AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Final Decision,* October 2010, p. 797. Grid Australia notes that its proposed definition of an 'insurance cap event' differs from that determined by the AER. It also notes that the AER accepted in its Final Decision that there should be no exclusion under the definition for events arising as a result of an NSP's 'negligence, fault of lack of care', as these are motivators for taking out insurance. (See p. 792-793 of AER Final Decision).

In the case of liability claims, the event leading to the costs being occurred is actually the liability arising consequent on the claim (e.g. the Court ruling or the settlement agreement), rather than the original natural disaster or other external event which has led to that claim. Moreover, a single natural disaster, or other external event, may lead to multiple subsequent liability claims. It is appropriate to consider each of these subsequent claims separately under the cost pass through framework, where liability for those claims crystallises at different times.

Grid Australia notes that if liability claims are not treated as individual events which trigger the cost pass through provisions in their own right (i.e. as distinct from the external event that led to the claims), then there would be a need to seek more fundamental changes to the current cost pass through arrangements in the Rules. In particular the appropriateness of the current single, prospective nature of applications under the pass through provisions would need to be revisited, given the highly uncertain and potentially drawn-out nature of liability claims.

2.5.3 The ability for TNSPs to propose new pass through events at the time of a regulatory determination

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.

Currently the ability for TNSPs to apply to the AER to pass through the costs of an event under clause 6A.7.3 is limited to those events which are defined as pass through events under the Rules. Grid Australia notes that there are other significant risks which TNSPs are exposed to, associated with uncertain events outside their reasonable control. These include (but are not limited to) events such as cyber-attacks and aviation mishaps (unrelated to terrorism).

The current restricted nature of pass through events for TNSPs is in contrast to the provisions for DNSPs. The Chapter 6 Rules require DNSPs to include a proposed pass through clause in their building block proposal, which covers the events that should be defined as pass through events for that DNSP for the forthcoming regulatory control period.[21] One of the AER's constituent decisions as part of its distribution determination is the additional pass through events that are to apply to the relevant DNSP for the regulatory control period.[22] In support of these provisions, the definition of 'pass through event' in the Rules includes: 'An event nominated in a distribution determination as a pass through event is a pass through event for the determination (in addition to those listed above).'

[21] NER S6.1.3(2).

[22] NER 6.12.1(14).

Grid Australia therefore proposes that the Rules be amended to provide TNSPs with the same flexibility to propose specific pass through events at the time of submitting their revenue proposal. This will provide TNSPs with the same flexibility to manage risks by using the pass through provisions as currently afforded under the Rules to DNSPs.

2.5.4 Addressing the 'dead zone'

Grid Australia proposes a general amendment to the cost pass through provisions to allow NSPs to seek cost recovery for pass through events which occurred in the prior regulatory control period, but which have not been incorporated within the NSP's expenditure forecasts for the subsequent regulatory period.

There is general recognition that under the current drafting of the pass through provisions there is what has been termed a 'dead zone' between the time at which an NSP lodges its regulatory submission and the start of the next regulatory control period. Where a pass through event occurs during the dead zone, which leads to costs being incurred in the subsequent regulatory control period, it may not be possible for the NSP to amend its regulatory proposal to take these changes in costs into account. Nor is it possible under the current Rules for the NSP to apply for a cost pass through in the following regulatory control period. This is because the current wording of the Rules, and in particular the definition of 'eligible pass through amount', refers to the increase in the NSP's costs in the same period as that in which the pass through event occurs.

This issue has previously been flagged by various DNSPs.[23] The AEMC has also previously considered this issue in the context of the Chapter 6 Rules applying to DNSPs as part of its 2010 review of the cost recovery arrangements for smart meters.[24] That review concluded that:

> 'We consider that a cost recovery risk occurs where a Ministerial pilot determination is made in the last 13 months of a regulatory control period, but a DNSP does not incur costs associated with that determination until the next regulatory control period. This time period has been labeled as a 'dead zone' <u>and has been identified by DNSPs as a common cost recovery risk under the current Rules.</u> Where a Ministerial pilot determination is made in this period, a DNSP may be unable to seek cost recovery under either the cost pass through provisions or the distribution determination process.' (emphasis added)

23 For example, pass through events to address the 'dead zone' period have previously been nominated as part of the following DNSPs regulatory proposals (among others): Energy Australia, ActewAGL, ETSA Utilities and Energex.

24 AEMC, *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure – Final Report*, November 2010.

The AEMC suggested a number of drafting changes to the Rules to address this issue for all pass through events, and noted that these general amendments were supported by stakeholders.[25] The AEMC's draft Rule Change Proposal noted that:

> The proposed amendment would provide DNSPs with greater certainty regarding opportunities for cost recovery [..][26]
>
> The general amendment to address the cost recovery risk associated with the 'dead zone' would promote efficient investment and the efficient provision of services in distribution investments more generally, as this would provide an opportunity for DNSPs to seek cost recovery for all pass through events which occur during the dead zone.[27]

The AEMC's suggested changes to the Rules have not been progressed. This Rule Change Proposal therefore seeks to also address this recognised deficiency in the current Rules. Rule Changes are proposed for both Chapter 6A and Chapter 6, to address this issue for both transmission and distribution businesses.

[25] AEMC, *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure – Final Report*, November 2010, p.14.

[26] AEMC, *Cost Recovery Arrangements for Mandated Smart Metering Infrastructure Draft Rule Change Request (including draft Rules)*, November 2010, p.8.

[27] Op cit, p.12.

3. Description of the Proposed Rule

The Proposed Rule incorporates the following changes:

- amendments to the definition of *pass through event*, in order to incorporate two additional events (and associated definitions);
- amendments to Chapter 6A to provide for the ability for a TNSP to propose additional pass through events as part of its revenue proposal, and for the AER to decide whether to approve these events as part of its determination; and
- amendments to clauses 6A.7.3 and 6.6.1:
  - to explicitly require the AER to consider an NSP's insurance and self-insurance provisions in approving a pass through amount; and
  - to address the 'dead zone' issue regarding the timing of pass through applications at the end of a regulatory control period.

3.1 Proposed Amendments to the Definition of Pass Through Event

The proposed amendments to the definition of *pass through event* are as follows:

Any of the following is a *pass through event*:

(a) a *regulatory change event*;

(b) a *service standard event*;

(c) a *tax change event*;

(d) a *terrorism event;*

<u>(e) a *natural disaster event*;</u>

<u>(f) an *insurance cap event*.</u>

An *insurance event* is a *pass through event* for a *transmission determination* (in addition to those listed above).

An event nominated in a distribution determination <u>or a *transmission determination*</u> as a *pass through event* is a *pass through event* for the determination (in addition to those listed above).

In addition the inclusion of the following definitions, and amended definitions in the Rules, are proposed:

A *natural disaster event*:

> '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*.'

An *insurance cap event*:

> 'Either:
>
> (a) a Transmission Network Service Provider or a Distribution Network Service Provider incurs a liability or liabilities; or
>
> (b) an event occurs,
>
> where:
>
> (c) 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 that limit applies; and
>
> (d) 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 that 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.'

These revised definitions apply to both TNSPs under Chapter 6A and to DNSPs under Chapter 6. The detailed drafting of the Proposed Rule in Appendix A also includes resulting transitional provisions.

3.2 Amendments to allow a TNSP to Nominate Additional Pass Through Events

Grid Australia proposes the following amendments to allow a TNSP to nominate additional pass through events as part of its revenue proposal, and for the AER to decide whether to approve these additional events as part of its determination. These proposed changes only relate to Chapter 6A, since DNSPs already have this ability as part of Chapter 6.

6A.14 Requirements relating to draft and final decisions

6A.14.1 Contents of decisions

(7) in which the AER specifies the Negotiated Transmission Service Pricing Criteria for the Transmission Network Service Provider, setting out the reasons for the decision; ~~and~~

(8) on the *Transmission Network Provider's* current proposed *pricing methodology*, in which the *AER* either approves or refuses to approve that methodology and sets out reasons for its decision~~.~~<u>; and</u>

<u>(9) on the additional *pass through events* that are to apply for the *regulatory control period*.</u>

Schedule 6A.1 Contents of Revenue Proposals

S6A.1.3 Additional Information and Matters

(9) the commencement and length of the regulatory control period proposed by the Transmission Network Service Provider; ~~and~~

(10) …

(vi) the *trigger events* which are proposed in relation to the *proposed contingent project* and an explanation of how each of those conditions or events addresses the matters referred to in clause 6A.8.1(c) of the *Rules*~~.~~<u>; and</u>

<u>(11) a proposed pass through clause with a proposal as to the events that should be defined as *pass through events*.</u>

3.3 Amendments to the Factors the AER is Required to Consider

Grid Australia proposes that the list of factors in clauses 6A.7.3(j) and 6.6.1(j) to which the AER is required to have regard in making its determination on the pass through amount be amended to include the following:

Insertion of new paragraphs (3A) to (3C) and (7A) of clause 6.6.1(j):

(3A) in the case of a *positive change event*, any amount which the provider recovers or, if it made a claim, would be entitled to recover under an insurance policy in respect of the *positive change event* or any matter or circumstance relating to that *positive change event*; and

(3B) the availability, on reasonable commercial terms, of insurance against the costs that the provider has incurred and is likely to incur, and whether, and the extent to which, a prudent operator in the circumstances of that provider would have insured against those costs; and

(3C) the extent to which the forecast operating expenditure of the provider, as approved by the *AER* or a predecessor regulator responsible for the economic regulation of *Distribution Network Service Providers*, includes:

(i) an allowance for self-insurance; or

(ii) an allowance for expenditure on insurance premiums that are commensurate with a particular level of insurance,

and that allowance is intended to meet, or enable that provider to take out insurance or to take other action to meet, the costs that the provider has incurred and is likely to incur; and

(7A) the extent to which the costs that the provider has incurred and is likely to incur are the subject of a previous determination made by the *AER* under this clause 6.6.1; and

Insertion of new paragraphs (3A) to (3C) and (6A) to (6B) of clause 6A.7.3(j), with the deletion of the word "and" at the end of clause 6A.7.3(j)(6):

(3A) in the case of a *positive change event*, any amount which the provider recovers or, if it made a claim, would be entitled to recover under an insurance policy in respect of the *positive change event* or any matter or circumstance relating to that *positive change event*;

(3B) the availability, on reasonable commercial terms, of insurance against the costs that the provider has incurred and is likely to incur, and whether, and the extent to which, a prudent operator in the circumstances of that provider would have insured against those costs;

(3C) the extent to which the forecast operating expenditure of the provider, as approved by the *AER* or a predecessor regulator responsible for the economic regulation of *Transmission Network Service Providers*, includes:

(i) an allowance for self-insurance; or

(ii) an allowance for expenditure on insurance premiums that are commensurate with a particular level of insurance,

and that allowance is intended to meet, or enable that provider to take out insurance or to take other action to meet, the costs that the provider has incurred and is likely to incur;

(6A) whether the costs of the *pass through event* have already been factored into the calculation of the provider's *maximum allowed revenues* for the *regulatory control period* in which the *pass through event* occurred or will be factored into the calculation of the provider's *maximum allowed revenues* for a subsequent *regulatory control period*; and

> (6B) the extent to which the costs that the provider has incurred and is likely to incur are the subject of a previous determination made by the *AER* under this clause 6A.7.3;

3.4 Amendments to Clause 6A.7.1

Grid Australia proposes that the current clause 6A.7.1(a)(7) be deleted and replaced with the following:

> (7) the capital expenditure is not the subject of a determination made by the AER under clause 6A.7.3 and the event is not a contingent project.

The proposed rewording provides flexibility for TNSPs to seek cost recovery via the most appropriate route (i.e. cost pass through under 6A.7.3 or re-opening under 6A.7.1) for events which satisfy the conditions for both mechanisms.

3.5 Amendments to Address the 'Dead Zone'

Grid Australia is proposing amendments to both the definitions of 'eligible pass through amount' and 'required pass through amount', and associated changes to clauses 6A.7.3 and 6.6.1, in order to allow a TNSP or a DNSP to lodge a pass through application with the AER for an event which occurred in the prior regulatory period, but which has not been incorporated within the NSP's expenditure forecasts. This addresses the so-called 'dead zone' issue.

3.6 Powerlink – Transitional Provisions

Powerlink lodged its Revenue Proposal with the AER on 31 May 2011. As part of its Revenue Proposal, POwerlink identified a number of major risk exposures which were not provided for in its proposed insurance premiums and self-insurance, given the shortcomings in the Rules surrounding these matters. To address these shortcomings, Powerlink also flagged Grid Australia's intention to lodge a Rule change proposal and the potential to include associated transitional provisions applicable to Powerlink's 2013-17 regulatory period.

In the interests of efficiency of process and consistency in application across TNSPs, Powerlink and Grid Australia consider that the AEMC's determination on the Grid Australia Cost Pass Through Rule Change proposal should contain such transitional provisions.

4. How the Proposed Rule will Contribute to the National Electricity Objective

Grid Australia considers that the Rule Change Proposal will contribute to furthering the NEO.

The Proposed Rule promotes the long term interests of consumers with respect to the price of electricity. It allows for a more cost efficient management of the risk of natural disaster events outside the reasonable control of NSPs than if this risk were to be managed by either commercial insurance or self-insurance. The more general 'insurance cap event' extends this benefit to all event categories, where the cost of commercial insurance increases dramatically above certain limits.

As discussed earlier, commercial insurance becomes prohibitively expensive for very high levels of coverage. This is partly due to the thinness of the insurance market for those coverage levels.

Moreover, as discussed in section 2.4.2, the default position under the Rules is that TNSPs effectively self-insure for all risks which are not explicitly addressed by other means. The extent of these residual risks is much greater than the explicit events for which TNSPs currently receive a self-insurance allowance. In the absence of a change in the Rules to provide an alternative means of managing these risks, the self-insurance amounts sought by TNSPs will need to increase from their historic levels, to be more reflective of the risks TNSPs are in fact bearing. This is consistent with the Revenue and Pricing Principles set out in Part 7A of the National Electricity Law, which require (among other things) that regulated NSPs are given a reasonable opportunity to recover at the least the efficient costs they incur in providing direct control network services.

The Rule Change Proposal ensures that prices are reflective of efficient network operating costs, as incurring very high insurance costs (either commercial insurance or self-insurance) for uncertain events is unlikely to be viewed as 'efficient.' As a result, costs will be lower to consumers in the event that the uncertain event does not happen (since the NSPs will not be incurring the high insurance costs).

Grid Australia notes that the proposal to broaden the application of the cost pass through provisions does not require the AER to automatically approve all the applications it may receive. Under clauses 6A.7.3(j)(3) and 6.6.1(j)(3) the AER is required to consider 'the efficiency of the provider's decisions and actions in relation to the risk of the pass through event'. As a consequence, allowing a broader range of events to be eligible for treatment as a pass through does not prevent the AER assessing the efficiency of an NSP's actions in relation to a particular event.

Furthermore the Rules ensure that there can be no 'double-dipping' between different mechanisms for managing risk. Where the AER has approved an allowance for insurance as part of an NSP's expenditure forecast, then if the event occurs the cost consequences would not be eligible to be treated as a cost pass through, even if the NSP had subsequently decided to reduce its insurance cover. Similarly, where capital costs associated with a natural disaster event are recovered under the pass through provisions, they would not also be eligible to be recovered under the capital expenditure re-opening provisions of clause 6A.7.1 (see clause 6A.7.1(a)(7)).

The Rule Change Proposal also provides greater security of the national electricity system by ensuring that the risk of very high cost events for which there is no commercial insurance available is not solely borne by the NSP.[28] If the NSP is not able to obtain commercial insurance on a cost-effective basis and does not have the ability to apply for a cost pass through, then it effectively faces uninsured exposure. The potential magnitude of the costs associated with some external events means that it is possible that if the event occurred, the financial viability of the NSP could be threatened. As noted earlier, work undertaken by Marsh for Grid Australia has estimated that the maximum foreseeable loss associated with third party liability claims as a result of a single, discrete bushfire may be in the order of A$340m-$880m, with a most likely value of around $575m.[29] Multiple bushfires would compound that cost.

[28] Grid Australia notes that the AER has previously concluded that the inclusion of a 'natural disaster event' will ensure the reliability of security of electricity supply, since if not passed through costs associated with such events could potentially undermine the financial viability of a DNSP. See AER, *Victorian electricity distribution network service providers Distribution determination 2011–2015, Draft Decision,* June 2010, p. 717.

[29] Marsh, *Quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance* , 16 September 2011, p. 2.

5. Expected Benefits and Costs of the Proposed Change and Potential Impacts on those Likely to be Affected

The Rule Change Proposal is expected to have the following costs, benefits and impacts on those affected.

TNSPs will no longer need to seek commercial insurance or self-insurance to cover the full potential cost of uncertain, high-cost events outside their reasonable control. As a result the operating expenditure allowances approved by the AER will be lower than otherwise would be the case. The benefit in terms of avoided premiums is substantial. Very high levels of bushfire liability insurance would require additional premiums of US$20,000-$50,000 per million dollars insured. Insurance cover for damage to transmission and distribution lines above US$10 million, when available, generally requires a premium of 10-20% of the limit purchased.

The proposal also overcomes limitations in the availability of commercial insurance and addresses the concern that self-insurance is likely to be infeasible for high consequence events. Marsh's analysis indicates for example that insurance for damage to transmission and distribution lines arising from extreme weather events may simply not be available for levels above US$20m. At the same time their analysis has shown that the cost to NSPs could easily exceed this level.

Grid Australia notes that customers would pay more, if the event actually occurs, compared to the situation where higher levels of insurance cover had in fact been obtained. In this case the costs would be passed on rather than covered by insurance. However these higher costs need to be balanced against the low probability of the event actually occurring. Moreover, the higher level of insurance cover may simply not be available, leaving the NSP to bear the financial impact if the event does occur. As discussed in the previous section, this may potentially threaten the financial viability of the NSP, and as a consequence the security of the electricity system.

Finally, Grid Australia notes that in some cases where a cost pass through event occurs and a pass through amount is approved by the AER, the resulting impact on tariffs may constitute a 'price shock' for customers. Under the current Rules, there is no provision to smooth the price impact of a pass through event by recovering some of the approved pass through amount over one or more subsequent regulatory periods. Grid Australia has not proposed such a mechanism as part of this Rule Change Proposal. However, provided the real net present value of any pass through amount is preserved, Grid Australia considers that there may be value in allowing such longer-term 'amortisation' of pass through costs, in circumstances where there would otherwise be price shocks.

Appendix A. Proposed Draft Rules

A.1 Amendments to clause 6.6.1

Omit clause 6.6.1(c)(5) and substitute:

(5) the amount of the *positive pass through amount* that the provider proposes should be passed through to *Distribution Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *positive change event* occurred; and

Omit clause 6.6.1(d)(2) and substitute:

(2) the amount of that *approved pass through amount* that should be passed through to *Distribution Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *positive change event* occurred,

Omit clause 6.6.1(e)(2) and substitute:

(2) the amount of that *positive pass through amount* that the provider proposes in its statement under paragraph (c) should be passed through to *Distribution Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *positive change event* occurred, is the amount that should be so passed through in each such *regulatory year*.

Omit clause 6.6.1(f)(3)and substitute:

(3) the costs in the provision of *standard control services* that the provider has saved and is likely to save as a result of the *negative change event* until:

(i) unless subparagraph (ii) applies – the end of the *regulatory control period* in which the *negative change event* occurred; or

(ii) if the distribution determination for the *regulatory control period* following that in which the *negative change event* occurred does not make any allowance for the pass through of those cost savings - the end of the *regulatory control period* following that in which the *negative change event* occurred; and

Omit clause 6.6.1(f)(5) and substitute:

(5) the amount of the costs referred to in subparagraph (4) the provider proposes should be passed through to *Distribution Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *negative change event* occurred; and

Omit clause 6.6.1(g)(2)(ii) and substitute:

(ii) the amount of that *negative pass through amount* that should be passed through to *Distribution Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *negative change event* occurred.

Omit clause 6.6.1(j)(2) and substitute:

(2) in the case of a *positive change event*, the increase in costs in the provision of *standard control services* that, as a result of the *positive change event*, the provider has incurred and is likely to incur until:

(i) unless subparagraph (ii) applies – the end of the *regulatory control period* in which the *positive change event* occurred; or

(ii) if the distribution determination for the *regulatory control period* following that in which the *positive change event* occurred does not make any allowance for the recovery of that increase in costs – the end of the *regulatory control period* following that in which the *positive change event* occurred; and

In clause 6.6.1(j), insert new paragraphs (3A) to (3C) as follows:

(3A) in the case of a *positive change event*, any amount which the provider recovers or, if it made a claim, would be entitled to recover under an insurance policy in respect of the *positive change event* or any matter or circumstance relating to that *positive change event*; and

(3B) the availability, on reasonable commercial terms, of insurance against the costs that the provider has incurred and is likely to incur, and whether, and the extent to which, a prudent operator in the circumstances of that provider would have insured against those costs; and

(3C) the extent to which the forecast operating expenditure of the provider, as approved by the *AER* or a predecessor regulator responsible for the economic regulation of *Distribution Network Service Providers*, includes:

(i) an allowance for self-insurance; or

(ii) an allowance for expenditure on insurance premiums that are commensurate with a particular level of insurance,

and that allowance is intended to meet, or enable that provider to take out insurance or to take other action to meet, the costs that the provider has incurred and is likely to incur; and

Omit clause 6.6.1(j)(4) and substitute:

(4) the time cost of money based on the *weighted average cost of capital* for the provider for the *regulatory control period* in which the *pass through event* occurred;

Omit clause 6.6.1(j)(7) and substitute:

(7) whether the costs of the *pass through event* have already been factored into the calculation of the provider's *annual revenue requirements* for the *regulatory control period* in which the *pass through event* occurred or will be factored into the calculation of the provider's *annual revenue requirements* for a subsequent *regulatory control period*; and

In clause 6.6.1, insert new paragraph (7A) as follows:

(7A) the extent to which the costs that the provider has incurred and is likely to incur are the subject of a previous determination made by the *AER* under this clause 6.6.1; and

A.2 Amendments to clause 6A.7.1

Omit clause 6A.7.1(a)(7) and substitute:

(7) the capital expenditure is not the subject of a determination made by the AER under clause 6A.7.3 and the event is not a contingent project.

A.3 Amendments to clause 6A.7.3

Omit clause 6A.7.3(c)(5) and substitute:

(5) the amount of the *positive pass through amount* that the provider proposes should be passed through to *Transmission Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *positive change event* occurred;

Omit clause 6A.7.3(d)(2) and substitute:

(2) the amount of that *approved pass through amount* that should be passed through to *Transmission Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *positive change event* occurred,

Omit clause 6A.7.3(e)(2) and substitute:

(2) the amount of that *positive pass through amount* that the provider proposes in its statement under paragraph (c) should be passed through to *Transmission Network Users* in the *regulatory year* in which, and each *regulatory year* after

that in which, the *positive change event* occurred, is the amount that should be so passed through in each such *regulatory year*.

Omit clause 6A.7.3(f)(3) and substitute:

(3) the costs in the provision of *prescribed transmission services* that the provider has saved and is likely to save as a result of the *negative change event* until:

(i) unless sub paragraph (ii) applies – the end of the *regulatory control period* in which the *negative change event* occurred; or

(ii) if the *transmission determination* for the *regulatory control period* following that in which the *negative change event* occurred does not make any allowance for the pass through of the cost savings - the end of the *regulatory control period* following that in which the *negative change event* occurred;

Omit clause 6A.7.3(f)(5) and substitute:

(5) the amount of the costs referred to in subparagraph (4) the provider proposes should be passed through to *Transmission Network Users* in the *regulatory year* in which, and each *regulatory* year after that in which, the *negative change event* occurred; and

Omit clause 6A.7.3(g)(2)(ii) and substitute:

(ii) the amount of that *negative pass through amount* that should be passed through to *Transmission Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *negative change event* occurred.

Omit clause 6A.7.3(j)(2) and substitute:

(2) in the case of a *positive change event*, the increase in costs in the provision of *prescribed transmission services* that, as a result of the *positive change event*, the provider has incurred and is likely to incur until:

(i) unless subparagraph (ii) applies – the end of the *regulatory control period* in which the *positive change event* occurred; or

(ii) if the *transmission determination* for the *regulatory control period* following that in which the *positive change event* occurred does not make any allowance for the recovery of that increase in costs – the end of the *regulatory control period* following that in which the *positive change event* occurred;

In clause 6A.7.3(j), insert new paragraphs (3A) to (3C) as follows:

(3A) in the case of a *positive change event*, any amount which the provider recovers or, if it made a claim, would be entitled to recover under an insurance policy in respect of the *positive change event* or any matter or circumstance relating to that *positive change event*;

(3B) the availability, on reasonable commercial terms, of insurance against the costs that the provider has incurred and is likely to incur, and whether, and the extent to which, a prudent operator in the circumstances of that provider would have insured against those costs;

(3C) the extent to which the forecast operating expenditure of the provider, as approved by the *AER* or a predecessor regulator responsible for the economic regulation of *Transmission Network Service Providers*, includes:

(i) an allowance for self-insurance; or

(ii) an allowance for expenditure on insurance premiums that are commensurate with a particular level of insurance,

and that allowance is intended to meet, or enable that provider to take out insurance or to take other action to meet, the costs that the provider has incurred and is likely to incur;

Omit clause 6A.7.3(j)(4) and substitute:

(4) the time cost of money based on the *weighted average cost of capital* for the provider for the *regulatory control period* in which the *pass through event* occurred; and

In clause 6A.7.3(j)(6), delete the word 'and'.

In clause 6A.7.3(j), insert new paragraphs (6A) and (6B) as follows:

(6A) whether the costs of the *pass through event* have already been factored into the calculation of the provider's *maximum allowed revenues* for the *regulatory control period* in which the *pass through event* occurred or will be factored into the calculation of the provider's *maximum allowed revenues* for a subsequent *regulatory control period*;

(6B) the extent to which the costs that the provider has incurred and is likely to incur are the subject of a previous determination made by the *AER* under this clause 6A.7.3; and

A.4 Amendments to clause 6A.14.1

Amend clause 6A.14.1(7)-(8) as follows:

(7) in which the AER specifies the Negotiated Transmission Service Pricing Criteria for the Transmission Network Service Provider, setting out the reasons for the decision; ~~and~~

(8) on the *Transmission Network Provider's* current proposed *pricing methodology*, in which the *AER* either approves or refuses to approve that methodology and sets out reasons for its decision~~.~~; and

In clause 6A.14.1, insert a new paragraph (9) as follows:

(9) on the additional *pass through events* that are to apply for the *regulatory control period*.

A.5 Amendments to clause S6A.1.3

Amend clause S6A.1.3(9) as follows:

(9) the commencement and length of the regulatory control period proposed by the Transmission Network Service Provider; ~~and~~

Amend clause S6A.1.3(10)(vi) as follows:

(vi) the *trigger events* which are proposed in relation to the *proposed contingent project* and an explanation of how each of those conditions or events addresses the matters referred to in clause 6A.8.1(c) of the *Rules*~~.~~; and

In clause S6A.1.3, insert a new paragraph (11) as follows:

(11) a proposed pass through clause with a proposal as to the events that should be defined as *pass through events*.

A.6 Amendments to Definitions

Chapter 10 Substituted definitions

In Chapter 10, omit and substitute the following definitions:

eligible pass through amount

In respect of a positive change event for a Transmission Network Service Provider, the increase in costs in the provision of prescribed transmission services that, as a result of that positive change event, the Transmission Network Service Provider has incurred and is likely to incur (as opposed to the revenue impact of that event) until:

(a) unless paragraph (b) applies – the end of the *regulatory control period* in which the *positive change event* occurred; or

(b) if the *transmission determination* for the *regulatory control period* following that in which the *positive change event* occurred does not make any allowance for the recovery of that increase in costs (whether or not in the forecast operating expenditure or forecast capital expenditure accepted or substituted by the *AER* for that *regulatory control period*) – the end of the *regulatory control period* following that in which the *positive change event* occurred.

In respect of a positive change event for a Distribution Network Service Provider, the increase in costs in the provision of direct control services that, as a result of that positive change event, the Distribution Network Service Provider has incurred and is likely to incur (as opposed to the revenue impact of that event) until:

(a) unless paragraph (b) applies – the end of the *regulatory control period* in which the *positive change event* occurred; or

(b) if the distribution determination for the *regulatory control period* following that in which the *positive change event* occurred does not make any allowance for the recovery of that increase in costs (whether or not in the forecast operating expenditure or forecast capital expenditure accepted or substituted by the *AER* for that *regulatory control period*) – the end of the *regulatory control period* following that in which the *positive change event* occurred.

pass through event

Any of the following is a *pass through event*:

(a) a regulatory change event;

(b) a service standard event;

(c) a tax change event;

(d) a terrorism event;

<u>(e) a natural disaster event;</u>

<u>(f) an insurance cap event.</u>

An insurance event is a pass through event for a transmission determination (in addition to those listed above).

An event nominated in a distribution determination <u>or a *transmission determination*</u> as a *pass through event* is a *pass through event* for the determination (in addition to those listed above).

required pass through amount

In respect of a negative change event for a Transmission Network Service Provider, the costs in the provision of prescribed transmission services that, as a result of that negative change event, the Transmission Network Service Provider has saved and is likely to save (as opposed to the revenue impact of that event) until:

(a) unless paragraph (b) applies – the end of the *regulatory control period* in which the *negative change event* occurred; or

(b) if the *transmission determination* for the *regulatory control period* following that in which the *negative change event* occurred does not make any allowance for the pass through of those saved costs (whether or not in the forecast operating expenditure or forecast capital expenditure accepted or substituted by the *AER* for that *regulatory control period*) – the end of the *regulatory control period* following that in which the *negative change event* occurred.

In respect of a negative change event for a Distribution Network Service Provider, the costs in the provision of direct control services that the Distribution Network Service Provider has saved and is likely to save as a result of that negative change event (as opposed to the revenue impact of that event) until:

(a) unless paragraph (b) applies – the end of the *regulatory control period* in which the *negative change event* occurred; or

(b) if the distribution determination for the *regulatory control period* following that in which the *negative change event* occurred does not make any allowance for the pass through of those saved costs (whether or not in the forecast operating expenditure or forecast capital expenditure accepted or substituted by the *AER* for that *regulatory control period*) – the end of the *regulatory control period* following that in which the *negative change event* occurred.

Chapter 10 New definitions

In Chapter 10, insert the following new definitions:

insurance cap event

Either:

(a) a Transmission Network Service Provider or a Distribution Network Service Provider incurs a liability or liabilities; or

(b) an event occurs,

where:

(c) 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 that limit applies; and

(d) 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 that 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.

natural disaster event

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*.

Chapter 10 Amended definitions

In Chapter 10, amend the definition of ***approved pass through amount*** by substituting 'clause 6A.7.3(d)' for 'clause 6A.7.3(d)(2)' and 'clause 6.6.1(d)' for 'clause 6.6.1(d)(2)'.

In Chapter 10, amend the definition of ***materially*** by substituting '*a regulatory control period*' for 'the *regulatory control period*.'

A.7 Transitional Provisions

Insert the following new Part ZM in Chapter 11:

Part ZM

11.43 Rules consequent on making of the [Name of Amending Rule]

11.43.1 Definitions

In this rule 11.43:

Amending Rule means the [Name of Amending Rule]

commencement date means the day on which the Amending Rule commences operation.

new distribution clauses means clause 6.6.1 of the *Rules* and the definition of *pass through event* as in force immediately after the commencement date.

old distribution clauses means clause 6.6.1 of the *Rules* and the definition of *pass through event* as in force immediately before the commencement date.

11.43.2 Application of new distribution clauses

The *new distribution clauses* do not apply during the term of the distribution determinations for:

(1) the NSW and ACT Distribution Network Service Providers for the period from 1 July 2009 to 30 June 2014;

(2) the Queensland and South Australian Distribution Network Service Providers for the period from 1 July 2010 to 30 June 2015;

(3) the Tasmanian Distribution Network Service Provider for the period from 1 July 2007 to 30 June 2012; or

(4) the Victorian Distribution Network Service Providers for the period from 1 January 2011 to 31 December 2015,

and the *old distribution clauses* continue to apply during the term of those distribution determinations.