Australian Energy Market Commission

RULE CHANGE

RULE DETERMINATION

National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012

Rule Proponent(s)

Grid Australia

2 August 2012

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011 COAG announced it would establish the new Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two principal functions. We make and amend the national electricity and gas rules, and we conduct independent reviews of the energy markets for the SCER.

Summary

The Australian Energy Market Commission (AEMC or Commission) has determined to make the final rule this associated rule determination, in response to Grid Australia's rule change request. The rule determination relates to the cost pass through provisions under the National Electricity Rules (NER) that apply to network service providers. The final rule is a more preferable rule, containing some elements of the rule proposed by Grid Australia and other elements that the Commission considers will, or is likely to, better contribute to achievement of the National Electricity Objective.

Grid Australia rule change request

On 14 October 2011, Grid Australia made a request to the Commission regarding the cost pass through provisions for network service providers. The rule change request consisted of four components:

- introduction of a definition for a prescribed 'natural disaster event';
- introduction of a definition for a prescribed 'insurance cap event';
- provision of the ability for transmission network service providers to nominate additional pass through events; and
- provisions to address the 'dead zone' issue for events that occur in a previous regulatory control period, but which have not been incorporated in the network service providers' forecasts for the subsequent regulatory control period.

The Commission's rule determination

The Commission considered submissions received from stakeholders in response to its consultation paper and draft rule determination, and has responded to those submissions in this rule determination.

With the exception of the capital expenditure re-opening provisions, the Commission still considers that cost pass throughs should be the last option available to network service providers with respect to risk management relating to recovery of costs associated with provision of direct control services. This is to protect the incentive mechanisms that operate under the building block approach to revenue determination. The incentive mechanisms help ensure that prices for consumers are no more than necessary to provide an appropriate level of service.

However, the Commission recognises that in order to provide network service providers with a reasonable opportunity to recover their efficient costs for providing direct control network services, network service providers should be able to recover the efficient costs associated with events that are outside of their reasonable control.

Therefore, the Commission has determined consistent with its draft determination:

- to provide transmission network service providers with the ability to nominate additional pass through events as part of their revenue proposal;
- to include a set of 'nominated cost pass through considerations' in the NER that the Australian Energy Regulator must consider when deciding whether to accept the network service provider's proposed pass through events;
- not to include a definition for a prescribed natural disaster event;
- not to include a definition for a prescribed insurance cap event;
- transitional arrangements to enable Powerlink (whose regulatory control period commenced on 1 July 2012) to nominate pass through events within 90 days of commencement of the rule;
- transitional arrangements to enable ElectraNet and Murraylink to nominate additional pass through events for the AER to take into account when preparing ElectraNet and Murraylink's draft revenue determinations; and
- to remove the terrorism event from the prescribed pass through events under the NER.[1]

In addition, the rule as made includes amendments to address the 'dead zone' issue.[2]

The Commission remains of the view that the capital expenditure re-opening provisions should be retained for 'large, shipwreck-type events' and should continue to be subordinate to cost pass throughs.

1 Other than in respect of network service providers current regulatory control periods.

2 The 'dead zone' occurs in the final year of a regulatory control period and is where an NSP may be unable to seek cost recovery under the cost pass through provisions. This is because NSPs may only seek cost recovery for costs incurred in the same regulatory control period as the pass through event.

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1 Grid Australia's rule change request

1.1 The rule change request

On 14 October 2011, Grid Australia made a request to the Australian Energy Market Commission (Commission) to make a rule regarding the cost pass through provisions under the National Electricity Rules (NER) for network service providers (rule change request).

1.2 Rationale for rule change request

Grid Australia submitted that under the NER, transmission and distribution network service providers are exposed to the risk of significant cost impacts arising from natural disasters that are outside of their reasonable control.[3]

In its rule change request, Grid Australia considered the availability of some types of cover in the commercial insurance market is thin. For some events, particularly in the case of extreme forms of natural disaster, past claims experience is very limited and subject to wide variations depending on the severity of the event. In these circumstances it is difficult to estimate the probability of occurrence, and/or the costs that may result. As a consequence, insurance may only be available at a reasonable cost up to a cap, leaving network service providers (NSPs) with residual exposure to losses above the cover limit.[4] Grid Australia also noted that the available premiums to increase the cover limit may be prohibitively priced.

In the 'dead zone' for cost pass throughs, defined as the time between when an NSP lodges its revenue/regulatory proposal for the next regulatory control period and the start of that period, there is a risk that NSPs are unable to recover their costs if an unforeseen, exogenous event occurs. For example, Grid Australia noted that where a cost pass through event occurs during the 'dead zone', there is a risk under the current rules that an NSP is unable to amend its regulatory proposal. It is also not possible for the NSP to apply for a cost pass through in the following regulatory control period.[5]

1.3 Solution proposed in the rule change request

Grid Australia proposed that the Commission resolve the issues discussed above by making a rule that seeks to:

- incorporate a prescribed 'natural disaster event' within the definition of 'pass through event' under chapter 10 of the NER, to apply to all NSPs;

3 Grid Australia rule change request, October 2011, p. 3.

4 Id., p. 4.

5 Id., p. 3.

- include a prescribed 'insurance cap event' within the definition of 'pass through event' under chapter 10 of the NER, to apply to all NSPs;
- enable transmission network service providers (TNSPs) to propose additional pass through events as part of their revenue proposals; and
- provide rules that would address the so-called 'dead-zone', to apply to all NSPs.

1.4 Relevant background

A cost pass through may occur within a regulatory control period when a pre-defined exogenous event occurs which materially increases or decreases an NSP's costs (capital and/or operating expenditure). In these circumstances, the Australian Energy Regulator (AER) may approve a positive (or negative) pass through amount under the cost pass through provisions in clauses 6.6.1 and 6A.7.3 of the NER that apply to distribution network service providers (DNSPs) and TNSPs.

Positive cost pass throughs exist in the rules as a mechanism to allow NSPs to recover their efficient costs incurred as a result of events that could not be forecast as part of their regulatory or revenue proposal that otherwise would have a significant financial effect on the ability of networks to invest in and operate their networks.

The currently prescribed pass through events are defined in Chapter 10 of the NER and include any of the following:

(a) a regulatory change event;

(b) a service standard event;

(c) a tax change event

(d) a terrorism event.

TNSPs are also eligible for a prescribed insurance event, defined under Chapter 10 of the NER, which is in addition to those above.

DNSPs are not eligible for the insurance event, but are able to nominate events (in addition to those listed above) as a pass through event for its distribution determination.

In addition, under the National Electricity (National Energy Retail Law) Amendment Rule 2012 made by the South Australian Minister as part of the National Energy Customer Framework, DNSPs are also eligible for a 'retailer insolvency event'.

For TNSPs, the NER requires that a pass through event must 'materially' impact its maximum allowed revenue for that regulatory year.[6] This materiality threshold currently does not apply to DNSPs under the NER.

Positive cost pass throughs operate by NSPs applying to the AER for a cost pass through amount if a pass through event has occurred. If the AER approves the cost pass through amount then the NSPs can recover the costs approved through their network revenue/prices in future regulatory years.

The natural incentive properties of cost pass throughs are very weak. There is no direct financial benefit to the NSP from out performing in relation to those events that are covered by cost pass throughs, unlike the incentive arrangements for operating expenditure captured in the building blocks.

Clauses 6.6.1(j)(3) and 6A.7.3(j)(3) of the NER allow the AER to take into account the efficiency of the provider's decisions and actions in relation to the risk, as an attempt to impose some incentives to not overspend in relation to cost pass throughs. However, the incentives to find cost efficiencies on matters that can be claimed as cost pass through events are very poor.

1.5 Commencement of the rule making process

On 2 February 2012, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence the rule making process and the first round of consultation in respect of the rule change request. A consultation paper prepared by Australian Energy Market Commission (AEMC) staff identifying specific issues or questions for consultation was also published with the rule change request. Submissions closed on 1 March 2012.

The Commission received seven submissions on the rule change request as part of the first round of consultation. They are available on the AEMC website.[7] A summary of the issues raised in submissions and the Commission’s response to each issue is contained in Appendix A.1.

1.6 Publication of draft rule determination and draft rule

On 12 May 2012 the Commission published a notice under section 99 of the NEL and a draft rule determination in relation to the rule change request (draft rule determination). The draft rule determination included a draft rule (draft rule).

Submissions on the draft rule determination closed on 21 June 2012. The Commission received eight submissions on the draft rule determination. They are available on the

6 Materially is defined as more than one per cent of the transmission network service providers maximum allowed revenue for that regulatory year.

7 www.aemc.gov.au

AEMC website.[8] A summary of the issues raised in submissions, and the Commission's response to each issue, is contained in Appendix A.2.

8 www.aemc.gov.au

2 Final rule determination

2.1 Commission's rule determination

In accordance with section 102 of the NEL the Commission has made this rule determination in relation to the rule proposed by Grid Australia. In accordance with section 103 of the NEL the Commission has determined not to make the rule proposed by the rule proponent and to make a more preferable rule.[9]

The Commission's reasons for making this rule determination are set out in section 3.1.

The *National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2010 No [4]* (rule as made) is published with this rule determination. The rule as made commences on 2 August 2012. Its key features are described in section 3.3.

2.2 Commission's considerations

In assessing the rule change request the Commission considered:

- the Commission's powers under the NEL to make the rule;
- the rule change request;
- the consultant's report commissioned by Grid Australia from Marsh Risk Consulting on the quantification of the cost of specific low probability, high impact events and associated availability of commercial insurance;
- the fact that there is no relevant Ministerial Council on Energy (MCE) statement of policy principles;[10]
- submissions received during first and second rounds of consultation;
- the Commission's analysis as to the ways in which the proposed rule will or is likely to, contribute to the achievement of the National Electricity Objective (NEO);
- the revenue and pricing principles under section 7A of the NEL;

9 Under section 91A of the NEL the AEMC may make a Rule that is different (including materially different) from a market initiated proposed Rule (a more preferable Rule) if the AEMC is satisfied that having regard to the issue or issues that were raised by the market initiated proposed Rule (to which the more preferable Rule relates), the more preferable Rule will or is likely to better contribute to the achievement of the National Electricity Objective.

10 Under section 33 of the NEL the AEMC must have regard to any relevant MCE statement of policy principles in making a Rule.

- the Commission's final report to the MCE on its request for advice on cost recovery for mandated smart metering infrastructure;[11] and
- various transmission and distribution determinations for NSPs published by the AER.

2.3 Commission's power to make the rule

The Commission is satisfied that the rule as made falls within the subject matter about which the Commission may make rules. The rule as made falls within the matters set out in section 34 of the NEL as it relates to sections 34(1)(a)(i), the operation of the national electricity market and 34(1)(a)(iii), the activities of persons (including Registered Participants) participating in the national electricity market or involved in the operation of the national electricity system.

Further, the rule as made falls within the matters set out in schedule 1 to the NEL as it relates to items 24 and 17, and 26A and 26H. That is, it relates to the principles to be applied, and procedures to be followed, by the AER in exercising or performing an AER economic regulatory function or power relating to the making of a transmission or distribution determination.

2.4 Rule making test

Under section 88(1) of the NEL the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

For Grid Australia's rule change request, the Commission considers that the relevant aspect of the NEO is the impact to price, quality, reliability and security of supply of electricity that may arise as a result of any change in the efficient operation of, and ability and incentive of, NSPs to invest in their network assets.[12]

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11 AEMC 2010, *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure, Final Report*, 30 November 2010, Sydney.

12 Under section 88(2), for the purposes of section 88(1) the AEMC may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.

The Commission is satisfied that the rule as made will, or is likely to, contribute to the achievement of the NEO because:

- allowing TNSPs the ability to nominate pass through events when submitting their revenue proposals would balance the allocation of risks between TNSPs to recover their efficient costs (to attract sufficient investment in their networks) and end consumers (to ensure that prices are no more than necessary to provide an appropriate level of service). It would also contribute to alignment of the incentives for transmission and distribution network service providers;
- providing the AER with the 'nominated pass through event considerations' allows the AER to adopt an appropriate hierarchy for the management of risk when approving nominated pass through events, but would also enable NSPs the opportunity to recover their efficient costs;
- addressing the 'dead zone' would provide regulatory certainty to NSPs by allowing them a reasonable opportunity to recover their efficient costs, should a pass through event occur during this period. This would promote the effective operation of, and efficient investment by, NSPs in the long-term interests of consumers; and
- providing transitional arrangements would provide regulatory certainty and transparency for NSPs in applying the cost pass through provisions, and thereby promote efficient investment in, and efficient operation of network services for the long term interests of consumers of electricity.

However, the Commission is not satisfied that all aspects of Grid Australia's proposed rule will, or are likely to, contribute to the achievement of the NEO because:

- the proposed definition for a natural disaster event adds unnecessary prescription to the NER and does not allow for differences between NSPs or for the definition to be refined over time, which is likely to result in higher than necessary prices for consumers in the long term;
- the insurance cap event could erode the incentives on NSPs to seek the prudent and efficient level of insurance cover for its circumstances, which is likely to result in higher than necessary prices for consumers in the long term; and
- removal of the subordination of the capex re-opening provisions to cost pass throughs would erode regulatory certainty for NSPs and consumers.

2.5 More preferable rule

Under section 91A of the NEL, the AEMC may make a rule that is different (including materially different) from a market initiated proposed rule (a more preferable rule), if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates), the more preferable rule will, or is likely to, better contribute to the achievement of the NEO.

In addition to the reasons outlined in section 2.4 and having regard to the issues raised by Grid Australia in the rule change request, the Commission is satisfied that the rule as made will, or is likely to, better contribute to the NEO for the following reasons:

- providing factors for consideration by the AER when approving nominated pass through events should help ensure that pass through events are only used in situations where commercial insurance and self-insurance are not available on a reasonable basis, or the NSP is unable to mitigate or avoid the event without creating unacceptable risks. This should protect the incentive regime under the NER and better promote the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers of electricity with respect to price; and
- removal of the terrorism event from the defined pass through events limits the erosion of incentives on NSPs to utilise, where available, market-based mechanisms to mitigate the cost impacts that could arise. This limitation on incentives is not in the long term interests of consumers of electricity with respect to price.

2.6 Other requirements under the NEL

In applying the rule making test in section 88 of the NEL, the Commission has taken into account the revenue and pricing principles as required under section 88B of the NEL as the rule change request relates to matters specified in items 17, 24, 26A and 26H in schedule 1 to the NEL.

Some aspects of the revenue and pricing principles relate to providing a reasonable opportunity to NSPs to recover efficient costs.[13] Other aspects of the revenue and pricing principles relate to providing network services providers with effective incentives in order to promote economic efficiency with respect to direct control network services the network operator provides.[14]

The Commission considers that the rule as made is consistent with the revenue and pricing principles as it provides an efficient and transparent mechanism for the recovery of unforeseen costs that NSPs incur as operators of their networks. While at the same time, the operation of the nominated pass through considerations in the rule as made may provide NSPs with effective incentives to promote economic efficiency in managing the risks associated with these unforeseen events.

13 NEL section 7A(2).

14 NEL section 7A(3).

3 Commission's reasons

The Commission has analysed the rule change request and assessed the issues arising out of it. For the reasons set out below, the Commission has determined to make a more preferable rule as made.

3.1 Assessment of issues

Cost pass throughs are an important mechanism under the NER in respect of economic regulation of NSPs. They are needed because of the inability of NSPs, and the AER, to forecast all possible events that could affect the ability of NSPs to provide network services at the time of setting the revenue or regulatory determinations. NSPs should be provided with the reasonable opportunity to recover, in future regulatory years, the efficient costs they incur as a result of unexpected events. The inability to recover these costs would otherwise have a significant financial effect on the ability of NSPs to invest in and operate their networks.

However, the natural incentive properties of cost pass throughs are very weak. NSPs should have effective incentives in order to promote economic efficiency with respect to the network services they provide. Therefore, cost pass throughs should, where appropriate, provide:

- flexibility for changing circumstances;
- direct application to the individual circumstances of each NSP; and
- encouragement for NSPs to utilise market-based mechanisms.

On that basis, the Commission considers that a rule is required to allow NSPs the ability to nominate pass through events specific to their circumstances, but subject to a set of nominated pass through event considerations.

The 'dead zone' occurs in the final year of a regulatory control period and is where an NSP may be unable to seek cost recovery under the cost pass through provisions. This is because NSPs may only seek cost recovery for costs incurred in the same regulatory control period as the pass through event. Currently, the 'dead zone' is the only time period where NSPs are currently unable to recover their efficient costs. Therefore, a rule is required to enable NSPs the opportunity to recover the efficient costs they incur as a result of a pass through event.

3.2 Assessment of rule

In light of the issues raised by stakeholders and assessed by the Commission in response to its draft rule determination, the Commission has decided to make a rule. The rule as made has the following key features:

- TNSPs have been given the ability to nominate pass through events as part of their revenue proposals;
- the terrorism event has been removed from the prescribed pass through events for both distribution and transmission network service providers;
- a new definition of 'nominated pass through event considerations' has been included in chapter 10 that outlines the factors the AER must consider when approving nominated pass through events for both distribution and transmission network service providers;
- drafting to address the 'dead zone' has been incorporated in chapters 6 and 6A for both distribution and transmission network service providers and transitional chapter 6 (Appendix 1 of chapter 11) for the NSW and ACT distribution network service providers;
- the defined pass through events have been moved from chapter 10 to clause 6.6.1(a1) for DNSPs, and clause 6A.7.3(a1) for TNSPs; and
- transitional arrangements have been included to:
  - retain the 'terrorism event' as a prescribed pass through event for NSP's current regulatory control periods;
  - enable Powerlink (whose regulatory control period commenced on 1 July 2012) to nominate any additional pass through events within 90 days of commencement of the rule as made;
  - provide the AER with 90 business days to assess and accept any nominated pass through events proposed by Powerlink; and
  - enable ElectraNet and Murraylink (whose draft revenue determinations must be published by the AER by 30 November 2012) to nominate any additional pass through within 30 days of commencement of the final rule for consultation and consideration by the AER in making its draft revenue determination for those TNSPs.

The key differences between the rule proposed by Grid Australia and the rule as made are:

- a natural disaster event has not been included;
- an insurance cap event has not been included;
- the terrorism event has been removed from the prescribed pass through events (except in respect of network service provider's current regulatory control periods);
- the proposed amendment to clause 6A.7.1(a)(7) to remove the current subordination of the capex re-opening provisions has not been included; and

- the AER is required to have regard to certain specified matters (nominated pass through considerations) when determining whether to accept nominated pass through events.

3.3 Specific issues relating to drafting

Nominated pass through event considerations

In response to the nominated pass through event considerations outlined in the draft rule, stakeholders provided comments on a number of specific aspects of the drafting, including:

- United Energy suggested that drafting be amended such that a pass through event can only be rejected by the AER where the prudent service provider through its actions could have reasonably prevented the event from occurring or substantially mitigated the cost impact;
- Ergon Energy identified a terminology concern where the draft rule referred to the 'potential loss' where Ergon Energy considered that this should be the 'potential cost';
- The AER was concerned that the nominated pass through event considerations were overly prescriptive and would prevent it from responding to any changes in the regulatory environment in a flexible and adaptive way; and
- Grid Australia provided a number of minor drafting amendments.

In relation to specific drafting concerns identified by stakeholders, the rule as made:

- has not been changed to reflect assessment through a negative test as suggested by United Energy because the nominated pass through event considerations are only intended to be high level considerations rather than to operate individually as an explicit basis to accept or reject a cost pass through. This is because different pass through events will require different weight to be given to different considerations;
- includes an amendment to part (d)(2)(ii) of the definition of nominated pass through event considerations under chapter 10 to substitute potential 'cost' for potential 'loss';
- includes a new part (e) in the definition of the nominated pass through event considerations under chapter 10 to allow the AER to consider matters other than the specified nominated pass through event considerations if it has notified NSPs of the other matters it will consider; and
- address drafting concerns raised by Grid Australia.

Other drafting issues identified by stakeholders

The AER raised a concern with the draft rule, where it did not consider it appropriate to mandate that an NSP submit a nominated pass through event as part of a regulatory/revenue proposal.

To address the concerns raised by the AER regarding mandating an NSP to nominate a pass through event as part of a regulatory/revenue proposal, the final rule includes amendments to clauses 6.5.10(a) and 6A.6.9(a) to clarify that NSPs have the discretion to include a proposed pass through clause with their regulatory/revenue proposals.

Due to interlinkages between various provisions in the NER necessitating the current drafting, the drafting suggested by United Energy to simplify the recovery of efficient costs across regulatory control periods has not been adopted in the rule as made.

3.4 Civil Penalties

The rule as made does not amend any rules that are currently classified as civil penalty provisions under the NEL or Regulations. The Commission does not propose to recommend to the MCE that any of the amendments in the rule as made be classified as civil penalty provisions.

4 Commission's assessment approach

This Chapter outlines the AEMC’s approach to assessing the rule change request in accordance with the requirements set out in the NEL.

In assessing any rule change request, the Commission must have regard to the extent to which the rule will, or is likely to, contribute to the achievement of the NEO. In making this assessment, weight may be given to any specific aspect of the NEO as appropriate.

Grid Australia's rule change request may potentially affect the ability of, and the efficient operation of the incentives on, NSPs to invest in their network assets. Generally, any change in the level of investment in networks is likely to impact the price, quality, reliability and security of supply of electricity. Therefore, the most relevant aspect of the NEO is whether the proposed rule would promote efficient investment in electricity services by better balancing the need to attract sufficient investment in the networks with the need to ensure that prices for consumers are no more than is necessary to provide an appropriate level of service.

In assessing the rule change request and the proposed rule, the following issues have been considered:

- Allocation of risks between NSPs and end consumers - to what degree is there an efficient trade-off between the NSP mitigating its risk through commercial, and/or self, insurance and end consumers bearing the risk? How should the risk be allocated between the NSP and end consumers?

- To what extent are the pass through events unexpected and outside of the NSPs' control, and are they consistent with standard force majeure provisions in commercial contracts? Is it appropriate to remove any incentive on NSPs to protect their equipment against natural disasters?

- Recovery of efficient costs – does the proposed rule enable the NSPs to recover appropriate costs and encourage efficient investment in, and operation of, electricity networks?

- Regulatory certainty and transparency – does the proposed rule provide an appropriate amount of regulatory certainty and transparency to reduce ambiguity and costs in defining and applying the cost pass through provisions in the rules for NSPs?

- Alignment of incentives for transmission and distribution network service providers - consistency with the rules for DNSPs is only relevant to the extent that there are benefits from that consistency, therefore, does the rule change request better contribute to achievement of the NEO compared with the current rules for TNSPs? Are there reduced compliance costs and greater administrative efficiency for a company that owns both distribution and transmission assets and increased transparency of the regulatory framework for investors?

- Any other aspects relevant in the rules - for example, to what extent does/should the regulated weighted average cost of capital (WACC) include a provision for the risk of unforeseen exogenous events occurring?

The proposed rule was also compared with the current arrangements to ascertain whether it would better meet the objectives and principles of the regulatory framework under chapters 6 and 6A of the rules, including:

- achieving a balance between the interests of TNSPs and end consumers; and

- providing transparent and timely regulatory processes.

5 Ability for TNSP's to nominate additional cost pass through events

This chapter sets out the Commission's assessment of Grid Australia's proposal to allow TNSPs the ability to propose cost pass through events as part of their revenue proposal. The chapter also assesses stakeholder feedback on the nominated pass through event considerations outlined in the Commission's draft rule determination.

5.1 Grid Australia’s view

Grid Australia noted in its rule change request that currently TNSPs are only allowed to apply to the AER to pass through the costs of the prescribed pass through events defined in Chapter 10 of the NER. Grid Australia suggested that there are a number of additional risks faced by TNSPs, associated with uncertain events outside of their reasonable control that may include, but not be limited to, events such as cyber-attacks and aviation mishaps, unrelated to terrorism.[15]

Grid Australia also noted that DNSPs are allowed to include nominated pass through events in their regulatory proposals. Once accepted by the AER, the nominated pass through event acts as a pass through event for that DNSP for the forthcoming regulatory control period.

Therefore, Grid Australia proposed that the NER be amended to provide TNSPs with the same flexibility to propose specific pass through events at the time of submitting their revenue proposals. Grid Australia submitted that this would provide TNSPs with the same flexibility to manage risks by using the pass through provisions as currently afforded under the rules to DNSPs.[16]

5.2 Stakeholder views

5.2.1 First round of consultation - consultation paper

There was general agreement among stakeholders to allow TNSPs to nominate additional pass through events at the time of submitting their revenue proposals to the AER. For example, Ergon Energy and the AER supported Grid Australia's rule change request as it would provide TNSPs with the same flexibility as afforded DNSPs in managing risks, and bring chapters 6 and 6A into greater alignment.[17]

On the other hand, while TRUenergy supported Grid Australia's proposal for greater consistency in the NER, it considered that the AER should "decide on whether to

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15 Grid Australia rule change request, October 2011, p. 19.

16 Id., p. 20.

17 Ergon Energy submission on the consultation paper, March 2012, p. 2, and AER submission on the consultation paper, March 2012, p. 3.

approve a pass through based on the criteria that is currently applied to distributors".[18] TRUenergy suggested that this would "ensure that [the AER] did not undermine the incentive arrangements in approving a pass through as part of its assessment process".[19]

In its submission the AER outlined the criteria that it utilised in approving the nominated pass through events for the Victorian distribution determinations. In particular the AER emphasised the importance of the potential loss to the DNSP being catastrophic and that in these circumstances a pass through event may be more appropriate, subject to it satisfying the other pass through criteria.[20] However, the AER did not "support the codification of these criteria in the NER on the basis that it would be more appropriate to include these criteria, which reflect high level principles, in an AER guideline".[21]

5.2.2 Second round of consultation - draft rule determination

Alignment of the cost pass through provisions for network service providers

Stakeholders were generally supportive of an amendment to the NER to align the cost pass through arrangements for transmission and distribution network service providers. This amendment would allow all NSPs to nominate additional pass through events as part of their regulatory or revenue proposals.

In particular, Grid Australia noted that the ability for TNSPs to propose additional pass through events at the same time as submitting their revenue proposal would "allow the AER to explicitly consider the trade-off between cost pass through events and forecast insurance costs (both direct insurance and self-insurance)".[22]

Nominated pass through considerations

Inclusion of the nominated pass through considerations under the NER

The draft rule included a set of high level nominated pass through considerations to be included in the NER. NSPs and the AER were obliged to take these considerations into account when nominating and accepting additional pass through events respectively.

In response to the draft rule determination, the AER was opposed to the inclusion of the nominated pass through event considerations under the NER.[23] Given that stakeholders had not raised issues regarding the AER's approach to assessing proposed nominated pass through events for this rule change or the determination process, the

18 TRUenergy submission on the consultation paper, March 2012, p. 4.

19 Ibid.

20 AER submission on the consultation paper, March 2012, p. 4.

21 Ibid.

22 Grid Australia submission on the draft rule determination, June 2012, p. 3.

23 AER submission on the draft rule determination, June 2012, pp. 1-2.

AER considered that "there is no justification, in terms of addressing uncertainty, for the AEMC's preference for further prescription in the NER given that there is no evidence of an issue to be addressed".[24]

Similarly, Energex also considered that "codification of the nominated pass through event considerations appears overly prescriptive, as the AER is well practised and best placed to determine the relevant factors and their respective weighting at the time of making a regulatory determination".[25] Furthermore, Energex noted that the considerations as currently drafted "may not permit natural disasters or terrorism events to be classified as a nominated event, given that the nature or type of event may not be any more clearly identified at that time than they currently are", as Energex considered the considerations were broadly defined.[26]

On the other hand, Grid Australia and Ausgrid were supportive of the inclusion of the nominated pass through event considerations in the NER. For example, Ausgrid noted that in the past, "the AER has varied in its application and interpretation of criteria used to determine nominated cost pass throughs".[27] Therefore, "codifying the criteria relevant to the nominated pass through considerations will provide greater certainty and guidance to NSPs".[28]

Specific issues relating to drafting of the nominated pass through considerations

United Energy suggested that drafting of the nominated pass through event considerations be amended in the negative. That is, "it is preferable to test a nominated pass through event against a negative test, that is, the prudent service provider through its actions could not have reasonably prevented the event from occurring or substantially mitigated the cost impact".[29] On the other hand, Ausgrid noted that "the criteria appear to be a set of negative criteria in the sense that the existence of any one of the criteria would be inconsistent with the need for a pass through event".[30] Ausgrid suggested that the criteria could be improved if they reflected the principle that nominated pass throughs are for events that met certain characteristics.[31]

Ergon Energy identified a concern in the draft rule's definition of nominated pass through considerations. The draft rule referred to the "...potential loss...", which Ergon Energy considered should be amended to the potential cost, as it refers to the "costs imposed on the service provider rather than the loss imposed on a service provider".[32]

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24 Ibid.

25 Energex submission on the draft rule determination, June 2012, p. 2.

26 Ibid.

27 Ausgrid submission on the draft rule determination, June 2012, p. 4.

28 Grid Australia submission on the draft rule determination, June 2012, p. 4.

29 United Energy submission on the draft rule determination, June 2012, p. 4.

30 Ausgrid submission on the draft rule determination, June 2012, p. 4.

31 Ibid.

32 Ergon Energy submission on the draft rule determination, June 2012, p. 1.

In relation to the drafting of the nominated cost pass through considerations, the AER considered that "it is not necessary to mandate that a NSP submit a nominated pass through event as part of a regulatory proposal".[33] The AER also noted its concern that "the draft rule's codification of the nominated pass through event considerations in the NER would not allow the AER to respond to any changes in the regulatory environment in a flexible and adaptive way".[34]

Grid Australia also provided a number of minor amendments that it considered would provide greater clarity to the nominated pass through event considerations.[35]

These specific issues relating to drafting of the nominated pass through event considerations have been addressed in the assessment of the rule as made under Chapter 3.3 of this rule determination.

5.3 Analysis and conclusions

5.3.1 Analysis

Alignment of the cost pass through provisions for network service providers

The introduction of rules enabling TNSPs to propose additional pass through events will aid in aligning the rules for transmission and distribution network service providers.

The draft rule determination noted that NSPs should be provided the opportunity to recover their efficient costs in those limited circumstances where insurance is limited or not available on commercial terms and self-insurance is not appropriate. Not to do so would, over the long term, be likely to affect the efficient investment in, and efficient operation of, those networks. This is because, NSPs that cannot recover their efficient costs are reluctant to invest in their networks.

Furthermore, giving TNSPs the ability to nominate additional pass through events would provide them with the same opportunity afforded to DNSPs to recover their efficient costs. This should; however, be limited to instances where efficient costs are incurred because unforeseen costs arise as a result of events outside an NSP's control.

This approach will result in an increase in administration costs in approving pass through events. However, this increase is likely to be lower than the benefits obtained from greater flexibility to account for the individual circumstances of each NSP.

As noted in the draft rule determination, the Commission's initial preference is for "a single framework across electricity distribution, electricity transmission and gas.[36]

33 AER submission on the draft rule determination, June 2012, p. 2.

34 Ibid.

35 Grid Australia submission on the draft rule determination, June 2012, pp. 4-5.

Nominated pass through event considerations

Inclusion of the nominated pass through event considerations under the NER

The draft rule determination proposed a set of factors the AER must consider when approving additional pass through events. The Commission considered that the nominated pass through event considerations should be included in the NER, as opposed to being set out in a guidelines made by the AER in accordance with its consultation procedures.

The purpose of the nominated pass through event considerations was to provide a high level hierarchy of the mechanisms available for the management of risk that NSPs and the AER must consider. That is, arriving at the most efficient allocation of the risks between NSPs and end consumers. The draft rule determination emphasised that while it was understood that a degree of flexibility would be lost, the nominated pass through event considerations in the draft rule were representative of the relevant factors in defining those events that may be nominated as a pass through event.

As the nominated pass through event considerations were not contemplated in the proposed rule, the draft rule determination sought stakeholder feedback on whether there were any other important considerations that should be included.

In response to the draft rule determination, the AER and Energex submitted that codification of the nominated pass through event considerations in the NER was overly prescriptive and the ability of the AER to be flexible would be lost.

On the other hand, Grid Australia and Ausgrid agreed with the rationale outlined in the draft rule determination. That is, codifying these considerations under the NER provides greater certainty and guidance to both NSPs and consumers. In particular, it was perceived that this codification would promote consistent application and interpretation of the criteria to be used in determining nominated cost pass throughs going forward.

As noted above, the intention of the nominated pass through event considerations was to incorporate and reflect the essential components of a cost pass through regime in the NER. It was intended that in order for appropriate incentives to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are unavailable. That is, a cost pass through is the least efficient option for managing the risk of unforeseen events.

The intention is not to negate the need for cost pass throughs, or limit the AER's ability to respond to changes in the regulatory environment in a flexible and adaptive way. The nominated pass through event considerations are of a high level and do not stipulate any specific action. In addition, under the rule as made, the nominated pass through event considerations include the prescribed matters included in the draft rule

36 AEMC 2012, *Economic regulation of network service providers, and price and revenue regulation of gas services - Direction paper*, 2 March 2012, Sydney, p. 66.

and any other matter the AER considers relevant and which the AER has notified the NSPs is a nominated pass through event consideration.

The nominated pass through event considerations in the rule as made will result in NSPs having increased certainty as to the relevant factors that must be considered when nominating additional pass through events and consumers have certainty that they will bear the risk of a pass through of costs only when it is necessary they do so.

Drafting of the nominated pass through event considerations

With reference to the comments by Ausgrid, the intention of the nominated pass through event considerations, is that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of the risks between NSPs and end consumers. However, these are considerations only, therefore the NSP and the AER can come to a mutual understanding that a cost pass through event is inconsistent with the factors for consideration, but may still be the more efficient mechanism.

5.3.2 Conclusion

The rule as made provides TNSPs with the ability to nominate additional pass through events when submitting their revenue proposals. This would provide an appropriate balance in the allocation of risks between NSPs (to recover costs to attract sufficient investment in their networks) with end customers (to ensure that prices are no more than necessary to provide an appropriate level of service).

However, as discussed in the draft rule determination, in order to provide NSPs, the AER and consumers with additional certainty, the rule as made prescribes considerations that the AER must take into account when deciding whether to accept the NSP's additional nominated pass through events.

The ability for TNSPs to nominate additional pass through events is also consistent with the Commission's intent to align the incentive arrangements for transmission and distribution network service providers

6 Proposed new prescribed pass through events

This chapter sets out the Commission's consideration of Grid Australia's proposal to introduce two additional types of prescribed cost pass through events, namely a natural disaster event and an insurance cap event. As outlined in section 1.2 above, these would be in addition to the currently prescribed pass through events are defined in Chapter 10 of the NER and include any of the following:[37]

- a regulatory change event;
- a service standard event;
- a tax change event; and
- a terrorism event.

6.1 Grid Australia's view

6.1.1 Natural disaster event

In its rule change request, Grid Australia proposed the inclusion of a new 'natural disaster event' in the list of prescribed pass through events. Grid Australia's proposed definition for the 'natural disaster event' may be found in its rule change request on the AEMC's website.[38]

The rationale put forward by Grid Australia for the inclusion of a natural disaster event is that it would capture a key category of uncertain events outside of a NSP’s reasonable control in which they typically incur substantial costs.

6.1.2 Insurance cap event

The second additional event proposed by Grid Australia in its rule change request was an 'insurance cap event'. The definition proposed by Grid Australia for the insurance cap event may be found in its rule change request on the AEMC's website.[39]

Grid Australia's rationale for its inclusion was that it would provide NSPs with an appropriate means of addressing and managing the risk associated with the costs arising from liabilities, that may be in excess of insured limits. Specifically, Grid Australia noted that NSPs generally have insurance to manage the risk of third party

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37 In addition, TNSPs are also eligible for a prescribed insurance event, defined under Chapter 10 of the NER. On the other hand, DNSPs are not eligible for the insurance event, but are able to nominate events (in addition to those listed above) as a pass through event for its distribution determination when applying to the AER as part of its regulatory proposal. DNSPs are also eligible for the retailer insolvency event as a result of the National Electricity Retail Rules.

38 www.aemc.gov.au

39 www.aemc.gov.au

liability claims, including cover where the network service provider is found to have acted negligently. However, such insurance is typically capped, with higher levels of cover above that cap generally requiring very high premiums (in the order of US$20,000-$50,000 per million dollars insured).[40]

6.2 Stakeholder views

6.2.1 First round of consultation - consultation paper

Stakeholders' views on whether to include prescribed natural disaster and insurance cap events within the definition of a pass through event were divergent.

The NSPs were largely supportive of Grid Australia's amendments, while the AER, TRUenergy and the Tasmanian Government were opposed to the changes. These stakeholders disagreed with the inclusion of these events because they considered that the events may affect the underlying incentives on NSPs to effectively and efficiently manage their risk.[41]

6.2.2 Second round of consultation - draft rule determination

Removal of Grid Australia's proposed prescribed pass through events

In the draft rule determination the Commission determined that the additional pass through events proposed by Grid Australia should not be included in the NER.

In response to the draft rule determination, NSPs were generally supportive of the notion that cost pass through applications should be limited, where possible, and used only when other forms of risk management are not available. Specifically, Ergon Energy and Energex, both expressed support for the "fact that cost pass throughs are the last option available with respect to risk management for NSPs".[42]

However, NSPs were generally sceptical that "cost pass through arrangements necessarily weaken the regulatory incentive regime given the extremely robust process involved in making and assessing a cost pass through application [by the AER]".[43]

As a result of this robust process for making and assessing pass through applications, NSPs were opposed to the decision not to include the two additional categories of pass through events proposed by Grid Australia. NSPs were concerned that being required to rely on the nominated pass through events would reduce the regulatory certainty for them.

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40 Grid Australia's rule change request, October 2011, p. 16.

41 A detailed summary of stakeholder submissions may be found in Appendix A.1 of this rule determination.

42 Ergon Energy submission on the draft rule determination, June 2012, p. 1. and Energex submission on the draft rule determination, June 2012, p. 1.

43 Energex submission on the draft rule determination, June 2012, p. 1.

Removal of the prescribed terrorism pass through event

In analysing the current cost pass through regime, the Commission proposed in the draft rule determination to remove the terrorism event from the list of prescribed pass through events under the NER. The majority of the NSPs were opposed to this.

For example, Ergon Energy did not consider that "'terrorism events' should be excluded from the statutory cost pass through events ... [as NSPs should be] given the opportunity to recover these costs, rather than having to nominate these events through the regulatory proposal process".[44]

Energex disagreed with the AEMC's reasoning, finding it "difficult to understand how the risk of a terrorism event can be differentiated between NSPs and hence, considers there is no scope for any NSP to leverage from its inclusion under the NER".[45]

United Energy stated that "the reality of a terrorism event is that there is little that an NSP can do in a forward looking manner that is sensible".[46] United Energy also submitted that it would be difficult for the AER to determine whether a NSP has effectively exhausted mitigation actions on a forward looking basis, therefore, recommended that the terrorism event should remain in the NER list of prescribed events.

6.3 Analysis and conclusion

6.3.1 Analysis

Removal of Grid Australia's proposed prescribed pass through events

The draft rule determination outlined the Commission's view that the cost pass through provisions should be the last option available with respect to risk management, with the only exception being the capex re-opener. It was considered important that other mechanisms are evaluated and utilised before cost pass through applications are used, so the incentive arrangements are maintained. For this reason, the proposed natural disaster event and insurance cap event were likely to negatively impact on the current incentive arrangements.

Providing greater flexibility in the NER would allow NSPs the ability to propose nominated pass through events, which may include events such as an insurance cap or natural disaster event. This retains the right balance of certainty for the NSP, while maintaining the incentive regimes in the NER. In addition, NSPs would have greater flexibility if they were able to tailor a nominated pass through event at the beginning of their five year regulatory control period, specific to their own circumstances.

44 Ergon Energy submission on the draft rule determination, June 2012, p. 1.

45 Energex submission on the draft rule determination, June 2012, p. 2.

46 United Energy submission on the draft rule determination, June 2012, p. 5.

Any administrative efficiency as a result of including Grid Australia's defined events in the NER is likely to be negligible given the tasks that the AER has to complete as part of the determination process. Furthermore, the introduction of nominated pass through event considerations that the AER must have regard to, will provide increased regulatory certainty to NSPs when they are applying for additional pass through events.[47]

To preserve the incentives on NSPs to manage their risk, it is still considered appropriate that efficient market based mechanisms are more suitable as risk management techniques, than either self-insurance, cost pass throughs, or capex re-openers. Furthermore, these mechanisms are apt to change over time, reflecting the changing financial and technological circumstances of the NSPs and the development of new insurance products.

Therefore, the AER should use its discretion when approving cost pass through applications, and seek justification from NSPs that a cost pass through is the most efficient method to manage the risks of the event.

Removal of the prescribed terrorism pass through event

As outlined in the draft rule determination, where possible, a cost pass through event should reflect the circumstances of the NSP. The Commission was of the view that the currently prescribed terrorism event essentially falls into the same category as that of Grid Australia's proposed natural disaster event. That is, its definition as a pass through event effectively erodes the incentives, now and in the future, on NSPs to seek alternative mechanisms to mitigate the cost impacts that may arise.

The draft rule determination noted that the rationale behind removing the terrorism event was not to imply that these events should not be treated as a pass through event. The intention was to recognize that the cost pass through regime may not always be the most efficient mechanism to manage this risk.

As opposed to the terrorism event, future changes are less likely to affect the incentive arrangements for the other three defined pass through events (regulatory change, service standard, or tax change events). Furthermore, the increase in administrative costs on both NSPs and the AER through removal of these events, is likely to be higher than any gain in flexibility by not prescribing them in the NER. The flexibility gains in relation to these events are likely to be small because the AER and NSPs are likely to focus on making sure that the currently prescribed pass through events are included in the network determinations, as nominated pass through events.

Notwithstanding, as with the natural disaster event, a terrorism event should only be accepted as a pass through event where the NSP has been able to satisfy the AER that all appropriate avenues for avoidance, mitigation and insurance have been effectively

47 Further analysis of the nominated pass through event considerations may be found in Chapter 5.3.1 of this rule determination.

exhausted. For this reason, the terrorism event should also be removed from the prescribed pass through events.

As noted above, this conclusion does not imply that these types of events should not be treated as cost pass through events, but that the decision should be made as part of the determination process, considering the circumstances of each NSP, rather than prescribed in the NER.

6.3.2 Conclusion

The Commission is of the view that the prescribed natural disaster and insurance cap events proposed by Grid Australia should not be included in the definition of a pass through event in the NER.

These events add unnecessary prescription to the NER and do not allow for differences between NSPs or for the definition to be refined over time. Furthermore, these events are likely to erode the incentives on NSPs to seek the prudent and efficient level of insurance cover for its circumstances. NSPs should justify their level of insurance cover with the AER when determining their network determinations.

Providing NSPs with the opportunity to propose nominated pass through events as part of their revenue/regulatory proposals, subject to the pass through event considerations under the NER, would provide the most efficient means of assessing any of these events. For this reason, the prescribed terrorism event should be removed from the NER defined pass through events.

This would provide an environment where NSPs are better able to balance their need to recover costs to attract sufficient investment in their networks, with the need to ensure that prices for consumers are no more than necessary to provide an appropriate level of service. In cases where the AER approves an additional nominated pass through event, it would be only for those circumstances where the consumer is the party in the most appropriate position to bear the costs associated with occurrence of the event.

7 Cost recovery for pass through events in the 'dead zone'

The 'dead zone' occurs in the final year of a regulatory control period and is where an NSP may be unable to seek cost recovery under the cost pass through provisions. This is because NSPs may only seek cost recovery for costs incurred in the same regulatory control period as the pass through event.[48]

That is, an eligible cost pass through event may occur in the last months of a regulatory control period, but the NSP is unable to recover those costs, or does not incur costs associated with that event until the next regulatory control period. In this case, where the pass through event and the ability to recover the costs occur in separate regulatory control periods. Or the actual cost associated with the pass through event occurs in separate regulatory control periods, an NSP would not be able to seek a cost pass through under the current rules.

The Commission has previously noted this issue in the context of DNSPs and made recommendations to the MCE on amendments to the rules to provide DNSPs with the ability to recover costs incurred in a previous regulatory control period resulting from the 'dead zone'.[49] This chapter considers the 'dead zone' issue in the context of both transmission and distribution network service providers.

7.1 Grid Australia's view

Grid Australia submitted that the 'dead zone' issue is also a problem for TNSPs under the current rules arrangements and should be extended to all NSPs.[50] Grid Australia noted that its proposed rule was broadly consistent with the drafting contained in the AEMC's rule change request submitted to the MCE as it related to the 'dead zone'.

7.2 Stakeholder views

7.2.1 First round of consultation - consultation paper

Ergon Energy and TRUenergy were "supportive of amendments to the rules to allow NSP's the opportunity to recover costs for pass through events which occurred in the prior regulatory control period, but which have not been incorporated into the NSPs expenditure forecasts of the following regulatory control period".[51]

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

49 AEMC 2010, *Request for Advice on Cost Recovery for Mandated Smart Metering Infrastructure* - 30 November 2010 and a draft rule change request including draft rules.

50 Grid Australia rule change request, October 2011, pp. 20-21.

51 Ergon Energy submission on the consultation paper, March 2012, p. 2., and TRUenergy submission on the consultation paper, March 2012, p. 5.

The AER also supported addressing the 'dead zone' and noted that "there are already aspects of the regulatory regime that 'carry' through cost and reliability performance between regulatory control periods".[52]

Energex noted that "allowing NSPs to potentially recover efficient costs associated with a pass through event which occurred in the 'dead zone' will not change how a NSP manages its risk". Further, it also considered that "addressing the 'dead zone' would provide NSPs with some certainty that should an uncontrollable, unexpected and high impact event occur within the 'dead zone', some recourse may be available to these them".[53]

7.2.2 Second round of consultation - draft rule determination

The majority of NSPs were supportive of the draft rule amendments to address the 'dead zone'. However, some NSPs were of the opinion that the draft rule was overly complex and would benefit from redrafting.

For example, United Energy suggested amendments to "address the original problems by simpler drafting that both current and future period costs are recoverable across regulatory periods other than costs that have been allowed in a distribution determination".[54]

United Energy raised an issue that it considered an unintended consequence of the drafting to address the 'dead zone' in the draft rule. That is, United Energy noted that the drafting of the 'dead zone' issues appears to "create an interdependency between the pass through process and the regulatory determination process".[55] That is, there is an issue of timing as to whether "an applicant needs to wait until a distribution determination is made before it can know if the determination does or does not make an allowance for costs [resulting from a pass through event]".[56]

In relation to the recovery of costs incurred over multiple regulatory control periods, Energex considered that the clauses addressing the dead zone should also "incorporate the weighted average cost of capital for the following regulatory control period, if the pass through event occurs across regulatory control periods, that is, the WACC relative to each period should apply to the respective periods".[57]

Ausgrid was strongly supportive of the amendments that allow NSPs to seek cost recovery for events occurring in the 'dead zone'. However, Ausgrid considered that these corresponding amendments should be extended to the NSW and ACT distribution network service providers currently operating under transitional chapter 6

52 AER submission on the consultation paper, March 2012, p. 6.

53 Energex submission on the consultation paper, March 2012, p. 8.

54 United Energy submission on the draft rule determination, June 2012, p. 4.

55 United Energy submission on the draft rule determination, June 2012, p. 2.

56 Ibid.

57 Energex submission on the draft rule determination, June 2012, p. 2.

in Appendix 1 of chapter 11 of the NER to ensure they are afforded the same opportunity to utilise these provisions should a pass through event occur prior to their next regulatory reset in 2014.[58]

7.3 Analysis and conclusion

7.3.1 Analysis

As outlined in the draft rule determination, NSPs are currently able to recover the costs incurred when a pass through event occurs for in a period other than the 'dead zone'. Therefore, on that basis the nature of this amendment is to remove a known anomaly from the drafting of the current rules and would enable consistent treatment of pass through events, whenever they occur.

Further, allowing NSPs the opportunity to recover the costs incurred when a pass through event occurs during the 'dead zone' is consistent with the revenue and pricing principles under section 7A(2) of the NEL, as the NSP is provided a reasonable opportunity to recover at least the efficient costs it incurs in providing network services.[59]

Where NSPs are better able to recover their efficient costs, it promotes the efficient operation of the incentives on NSP's to invest in their network assets.

In its submission on the draft rule determination, United Energy noted that the current "drafting suggests that it be left up to the AER's discretion as to whether to allow these costs to be recovered up to the end of a regulatory control period or across regulatory control periods".[60] As noted in the draft rule determination, it was the intention of these arrangements to allow NSPs to recover the costs of a pass through event over a number of years. Whether these costs are recovered over one regulatory control period, or multiple regulatory control periods should appropriately be determined by the AER.

In relation to the concerns raised by Energex regarding the weighted average cost of capital applicable to a pass through event over multiple regulatory control periods, this is currently being addressed in the AEMC's assessment of the AER's economic regulation of NSPs rule change request.[61]

In its submission, Ausgrid indicated that currently the NSW and ACT distribution network service providers operate under transitional chapter 6 (Appendix 1 to chapter 11 of the NER). The cost pass through provisions under clause 6.6.1 in transitional

58 Ausgrid submission on the draft rule determination, June 2012, p. 1.

59 Note that, the 'reasonable opportunity to recover efficient costs' is only one of the revenue and pricing principles to which the AEMC must have regard when making the rule.

60 United Energy submission on the draft rule determination, June 2012, p. 1.

61 AEMC 2012, *Economic regulation of network service providers, and price and revenue regulation of gas services - Direction paper*, 2 March 2012, Sydney, p. 53.

chapter 6 are identical to those of general chapter 6, therefore any amendments to address the 'dead zone' in general chapter 6 will need to be mirrored in transitional chapter 6. As the intention of the rules to address the 'dead zone' was for them to apply to all NSPs in their current regulatory control periods, the rule as made has been amended so that amendments to address the 'dead zone' are made to transitional chapter 6 also.

United Energy identified a concern in relation to a timing issue in the drafting of the 'dead zone'. United Energy considered that the proposed clause 6.6.1(j)(7) appears to build in an interdependency between the cost pass through and revenue/regulatory determination processes, where the NER requires these two processes to run separately.

The intention of this relevant factor was to prevent the double recovery of costs associated with a pass through event. It does this in two ways: it allows the AER to take into account a completed final determination when assessing a cost pass through; and it also allows the AER to signal its intent to take a cost pass through event into account when making a future regulatory determination.

7.3.2 Conclusion

Consistent with its draft rule determination, the Commission determines to address the 'dead zone' in the rule as made. This will provide NSPs with the reasonable opportunity to recover their efficient costs should a pass through event occur within this period.

8 Saving and transitional arrangements

This chapter sets out how the savings and transitional arrangements of the rule as made will operate under chapter 11 of the NER.

8.1 Grid Australia's view

In its rule change request, Grid Australia noted that Powerlink had already lodged its revenue proposal with the AER. As part of that proposal, Powerlink identified a number of risk exposures which it considered were not provided for in its proposed insurance premiums and self-insurance. To address these risk exposures, Powerlink flagged Grid Australia's intention to lodge a rule change request when it submitted its proposal that may include associated transitional provisions applicable to Powerlink's next regulatory control period.[62]

As a consequence, Grid Australia was concerned that if the Commission made a rule in relation to cost pass through arrangements that they would not apply to Powerlink. Grid Australia therefore suggested transitional arrangements be included in the draft rule relating to its application to Powerlink.[63]

Grid Australia also provided transitional arrangements for DNSPs in its proposed rule. The proposed transitional rule had the effect of limiting application of the changes to the cost pass through events for DNSPs until the beginning of each companies next regulatory control period.[64]

8.2 Stakeholder views

8.2.1 First round of consultation - consultation paper

No submissions were received from stakeholders regarding application of the transitional arrangements applicable to DNSPs.

However, Powerlink provided a submission regarding transitional arrangements for its next regulatory control period. Specifically, Powerlink sought confirmation from the Commission that there would be savings and transitional arrangements in the draft and final rules on the cost pass through arrangements that would apply to Powerlink's next regulatory control period from the commencement of the rule as made.[65]

62 Grid Australia rule change request, October 2011, p. 26.

63 Ibid.

64 Id,. p. 39.

65 Powerlink submission on the consultation paper, March 2012, p. 2.

8.2.2 Second round of consultation - draft rule determination

The submission from Powerlink agreed with the transitional arrangements in the draft rule.[66]

The AER however, noted that the draft rule determination "only allows the AER to either accept or reject Powerlink's nominated pass through event and not to amend the proposal".[67] The AER also suggested that the rule be amended to provide the AER with 90 business days, which it considered would be sufficient to assess any nominated pass through events put forward by Powerlink.

It is likely that at the time of making any rule as made, ElectraNet and Murraylink will be in the process of making their revenue determinations with the AER. Therefore, the AER considered it necessary for the AEMC to specify when the final rule will come into effect, with a view to specifying how the transitional arrangements will operate for ElectraNet and Murraylink.[68]

In response to a question posed in the draft rule determination, ElectraNet considered that the transitional arrangements should be extended to also allow it to propose additional pass through events in its current revenue determination being considered by the AER.[69] ElectraNet noted that these transitional arrangements would differ depending on the commencement date of the rule as made. No submission was received from Murraylink.

8.3 Analysis and conclusion

8.3.1 Analysis

Transitional arrangements for Powerlink

The draft rule determination noted that the time lag between the start of the proposed amending rule and Powerlink's next revenue determination would entail a significant delay before Powerlink could utilise the new rules. Therefore, to promote fairness between NSPs, it was proposed that Powerlink be provided the opportunity to nominate additional pass through events within 90 days of commencement of the rule as made.

In response to the draft rule determination, Powerlink was supportive of the transitional arrangements allowing it to nominate additional pass through events for consideration by the AER. Powerlink considered this would promote regulatory certainty and fairness between NSPs.

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66 Powerlink submission on the draft rule determination, June 2012, p. 1.

67 AER submission on the draft rule determination, June 2012, p. 3.

68 Ibid.

69 ElectraNet submission on the draft rule determination, June 2012, pp. 1-4.

The AER on the other hand, considered that the transitional arrangements in the draft rule only allowed the AER to either accept or reject Powerlink's nominated pass through events and not to amend the proposal. The AER also proposed that it be provided with 90 business days, which it considered would be sufficient time, to assess any additional nominated pass through events submitted by Powerlink.

The Commission considers that 90 business days is appropriate for the AER to assess and amend any additional pass through events nominated by Powerlink and inform its decision on whether to accept them.

Transitional arrangements for other network service providers

The draft rule determination noted that the AER would be in the process of making ElectraNet's revenue determination for its next regulatory control period at the time of making the final rule. In this regard, a question was posed to stakeholders asking whether it was appropriate to include transitional arrangements for any other NSPs.

In response, ElectraNet considered it appropriate to include transitional arrangements in the final rule for its current revenue determination process. ElectraNet lodged its revenue proposal for the 2013-2018 regulatory control period with the AER on 31 May 2012. In the absence of transitional arrangements, ElectraNet stated that it would be unable to nominate additional pass through events following commencement of the rule. ElectraNet considered it preferable that any transitional arrangements would enable it to nominate additional pass through events prior to the AER making its draft revenue determination.

The AER's submission noted that Murraylink would also be in the process of determining its revenue requirements for its next regulatory control period.

The intention of the transitional arrangements remains to allow any affected NSPs the opportunity to utilise the new rules. Without these transitional arrangements, ElectraNet and Murraylink would not be afforded the same opportunity as other TNSPs to incorporate additional nominated pass through events as part of their upcoming revenue determinations.

The Commission has provided ElectraNet and Murraylink with 30 days from commencement of the final rule to nominate additional pass through events. This timeframe is shorter than that provided to Powerlink in recognition of the additional time and subsequent consultation available for the additional nominated pass through events to be included in the AER's draft determination and the TNSP's revised revenue proposals.

Other transitional provisions

As noted in the draft rule determination, the transitional arrangements in the rule as made provide that the terrorism event will be a pass through event for distribution and transmission network service providers until the end of their current regulatory control periods. As the current determinations for NSPs were made on the basis that the 'terrorism event' was a prescribed pass through event under the NER, a rule that purported to remove the terrorism event as a nominated pass through event in the current regulatory control periods is retrospectively removing this ability.[70]

The provisions to address the 'dead zone' will commence for all NSPs on or about the time of the making of this rule determination.

8.3.2 Conclusion

To promote regulatory certainty and fairness between NSPs, transitional arrangements have been included to allow Powerlink, ElectraNet and Murraylink to nominate additional pass through events for consideration by the AER.

These transitional arrangements will provide Powerlink with a period of 90 days to nominate any additional pass through events it considers appropriate. In assessing those nominated pass through events, the AER must within 90 business days determine the additional cost pass through events that will apply to Powerlink taking into account the nominated pass through event considerations.[71]

The rule as made includes transitional arrangements for ElectraNet and Murraylink, allowing them to submit any additional nominated pass through events to the AER within 30 days of the commencement date. This would promote regulatory certainty and transparency by enabling stakeholders and the AER the opportunity to have regard to ElectraNet and Murraylink's nominated pass through events in conjunction with their revenue proposals.

70 Section 33(1)(c) of Schedule 2 to the NEL.

71 Further discussion on the nominated pass through event considerations may be found in Chapter 5.3.1 of this rule determination.

Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
capex	capital expenditure
Commission	See AEMC
DNSP	distribution network service providers
NEL	National Electricity Law
NEO	National Electricity Objective
NER	National Electricity Rules
NSP	network service providers
opex	operating expenditure
MCE	Ministerial Council on Energy
TNSP	transmission network service provider
WACC	weighted average cost of capital

A Summary of issues raised in submissions

A.1 First round of consultation - consultation paper

Submissions on the consultation paper closed on 1 March 2012. Seven submissions were received from the following organisations: Australian Energy Regulator; TRUenergy; Office of Energy Planning and Conservation (Tasmanian Government); Powerlink; Ergon Energy; Energex; and Grid Australia.

Issue	Stakeholder	AEMC Response
TNSPs being able to propose additional cost pass through events	Ergon Energy (p. 2) supported Grid Australia's rule change request as it would provide TNSPs with the same flexibility as afforded DNSPs in managing risks.	The draft rule included provisions to allow TNSPs the opportunity to nominate additional cost pass through events as part of their revenue proposals. However, to improve the efficient operation of pass through applications and provide NSPs with effective incentives in order to promote economic efficiency with respect to direct control network services the draft rule includes nominated pass through considerations that the AER must consider when approving nominated pass through events. The analysis in support of the amendments to the draft rule are contained in Chapter 5.3.2 of the draft rule determination.
	TRUenergy also supported Grid Australia's proposal. However, TRUenergy (p. 4) considered that the AER should "decide on whether to approve a pass through based on the criteria that is currently applied to distributors". This would "ensure that [the AER] did not undermine the incentive arrangements in approving a pass through as part of its assessment process".	
	The AER (p. 3) agreed that "the pass through provisions in the NER should be the same between chapter 6A and chapter 6". The AER (p. 4) also noted "in developing its criteria for considering additional pass through events recognised [the issue of calculating a probability for low probability high cost events] and included the consideration that where an event cannot be self-insured because a self-insurance premium cannot be calculated or the potential loss to a DNSP may be catastrophic, a pass through event may be appropriate (subject to satisfaction of other pass through criteria)". In relation to whether these criteria should be codified in the NER, the AER (p. 4) "does not support the codification of these criteria in the NER on the basis that it would be more appropriate to include these criteria, which reflect high level principles, in an AER guideline".	

Issue	Stakeholder	AEMC Response
Natural disaster event pass through event	The AER (p. 5) did not agree with Grid Australia's view that "consensus has emerged for inclusion of [a natural disaster event] in pass through provisions for DNSPs". The AER (p. 5) considered that this point was highlighted by Grid Australia amending the definition of a natural disaster event from that published in the Victorian distribution determination. Furthermore, the AER (p. 5) considered that it "highlighted the importance of the AER retaining the discretion to appropriately consider such matters when proposals from NSPs are made, rather than having a specific definition prescribed in the NER". In time when consensus has been reached the AER (p. 5) stated that "once those positions are settled they may be codified, such as in a guideline".	The draft rule did not include the prescribed definition for a natural disaster event proposed by Grid Australia. The analysis in support of this position may be found in Chapter 6.3.2 of the draft rule determination.
	TRUenergy (p. 3) did not support the inclusion of a definition for 'a natural disaster event in the NER and were concerned that "any change to the rules that would automatically allow TNSPs to pass through any additional costs for a wider range of events would just erode the incentive properties of the current low powered incentive regime". That is, there is a risk that "if we continue to clearly prescribe more pass through provisions in the rules that we would undermine the incentive arrangements and inherit some of the problems associated with rate of return regimes".	
	Energex (p. 6) and Ergon Energy (p. 1) supported Grid Australia's proposal to introduce this definition in the NER. Particularly, Ergon Energy (p. 1) noted its support for inclusion "as it provides some regulatory certainty for NSPs and is an appropriate risk management strategy". Energex (p. 6) stated that it "does not consider the inclusion of a new natural disaster pass through event will alter incentives. Energex will continue to seek to mitigate the risks of natural disaster where possible". Energex (p. 6) also noted the "inclusion of a new natural disaster event will provide greater certainty and transparency for NSPs and will be marginally more administratively efficient" as a nominated pass through event does not have to be included in regulatory determinations.	
	The Tasmanian Government (p. 3) noted "the risk from natural events is one of the reasons that the owners of networks are awarded a risk premium in their	

Issue	Stakeholder	AEMC Response
	cost of capital. Market returns go up and down for a variety of reasons, including factors related to nature. If network owners wish to pass a higher proportion of their risks to customers then they should also be prepared to accept a lower return on their equity".	
Insurance cap event pass through event	Grid Australia (p. 9) considered that "including the two new proposed cost pass through events (i.e. a natural disaster event and an insurance event) would provide a greater degree of regulatory certainty and transparency and would be more administratively efficient than relying solely on a new nominated pass through provision". Additionally, "incorporating the two new events in the NER would avoid the AER having to re-consider whether to allow these events at the time of each regulatory determination, which would be administratively inefficient and would introduce a degree of uncertainty". That is, given the degree of conformity that has emerged from the DNSP determinations, there is a strong argument to add these new events in the NER. In relation to the question on negligence, Grid Australia (p. 7) noted that "in a case where there has been 'wilful negligence' and that is not covered by the insurance policy, the NSP would not be able to apply for a cost pass through". Grid Australia further noted that the underlying issue would be more appropriately characterised as "... what level of costs customers should be bearing to address the risk of third party liability claims due to negligence: the cost of potentially excessive premiums, regardless of whether the event occurs, or the costs associated with the event if it in fact occurs".	The draft rule did not include the prescribed definition for an insurance cap event proposed by Grid Australia. The analysis in support of this position may be found in Chapter 7.3.2 of the draft rule determination.
	Ergon Energy (p. 2) supported "Grid Australia's intent to include a new insurance cap event as a defined statutory pass through event. However, Ergon Energy considers that the definition proposed by Grid Australia may be ambiguous and could benefit from being refined".	
	Energex (p. 7) supported the inclusion of a defined insurance cap pass through event. Energex's rationale for its inclusion follows that of the natural disaster pass through event.	
	The Tasmanian Government (p. 3) noted that it would be "unreasonable to	

Issue	Stakeholder	AEMC Response
	create an incentive for network companies and their owners to underinsure or to reduce the capacity for self-insurance, or be able to ignore the numerous predictions of increasing severe and frequent extreme weather events without consequences". On the other hand, the Tasmanian Government stated "it would be unreasonable if they undertake efficient best practice measures to reduce the increasing risks of fire, flood, storm and being sued, but are then unable to recover costs of doing so".	
	TRUenergy (p. 4) did not support the inclusion of a clause that includes a new 'insurance cap event' within the definition of 'pass through event' to recover the costs that exceed insured limits. TRUenergy noted that "such an automatic pass through may undermine the incentives for regulated firms to appropriately insure ... taking out lower levels of insurance on the basis of an automatic ability to pass on uninsured risks to consumers could allow higher profitability by the firm outperforming its opex allowance". Furthermore, TRUenergy considered that having "the regulator seek to determine an efficient level of insurance would cross the line into micro-management by the regulator, and likely be less efficient than a market based insurance level determined by a fully 'on risk' NSP".	
	The AER (p. 5) did not support codification of this new definition in the NER. Further, the AER referred explicitly to our question relating to whether a network service provider should be able to pass through costs where they are found to be negligent. The AER (p. 6) noted that it took this into account when determining the insurance cap event for its Victorian determination and stated "in the event of such conduct, the insurance policy would be invalidated and the cost pass through would not be invoked".	
Addressing the 'dead zone'	Ergon Energy (p. 2) and TRUenergy (p. 5) were "supportive of amendments to the rules to allow NSPs the opportunity to recover costs for pass through events which occurred in the prior regulatory control period, but which have not been incorporated into the NSPs expenditure forecasts of the following regulatory control period".	The draft rule contained provisions to address the 'dead zone' issue identified by Grid Australia in its rule change request. This is because addressing the 'dead zone' provides NSPs with the reasonable opportunity to

Issue	Stakeholder	AEMC Response
	The AER (p. 6) also supported addressing the dead zone and noted that "there are already aspects of the regulatory regime that 'carry' through cost and reliability performance between regulatory control periods".	recover their efficient costs should a pass through event occur during that time period. The analysis in support of this position may be found in Chapter 8.3.2 of the draft rule determination.
	Energex (p. 8) noted that "allowing NSPs to potentially recover efficient costs associated with a pass through event which occurred in the 'dead zone' will not change how a NSP manages its risk". Further, Energex also considered that "addressing the 'dead zone' would provide NSPs with some certainty that should an uncontrollable, unexpected and high impact event occur within the 'dead zone', some recourse may be available to these businesses".	
Allocation of risk	Energex (p. 3) noted that risk should remain with the NSP in circumstances where the business is able manage it through mechanisms such as insurance, or investment to 'weather-proof' assets. However, Energex (p. 3) stated that where it cannot be managed "consumers who are the beneficiaries of the services provided by NSPs, should reasonably be expected to bear the prudent and efficient costs associated with such non-diversifiable risk events". In relation to where an NSP has the ability to partially manage or mitigate a cost, Energex (p. 3) considered that the NER under clause 6.6.1(j)(3) already requires the AER to take into account any decisions and actions that the NSP took to mitigate the event in determining the eligible pass through amount. Thus no further amendments to the NER are required. Energex (p. 4) disagreed with the AEMC that amending the scope of the pass through provisions would transfer greater risk to customers. Specifically, "it is reasonable that beneficiaries of services bear the prudent and efficient costs incurred to address extraordinary circumstances that are outside the control of NSPs".	The draft rule was a reflection of the AEMC's view of what is an appropriate allocation of risk between NSPs and end consumers.
	The Tasmanian Government (p. 3) noted that "the risk from natural events is one of the reasons that the owners of networks are awarded a risk premium in their cost of capital". Therefore, "if network owners wish to pass a higher	

Issue	Stakeholder	AEMC Response
	proportion of their risks to customers then they should be prepared to accept a lower return on their equity".	
	Grid Australia (pp. 2-3) did not agree with the distinction drawn by the AEMC in its consultation paper about the allocation of risk between the NSP and end consumers. Grid Australia noted that "in the case of uncertain events beyond the NSPs reasonable control, it is the customers who bear the cost of that risk, whether that risk is managed by insurance or by a cost pass through". Grid Australia stated that there was one exception to this, where "the TNSP incurs costs above insurance limits". Thereby, Grid Australia submits that "the AEMCs mischaracterisation of the rule change proposal as primarily shifting the allocation of risk between NSPs and customers, rather than one which primarily alters the costs that customers are bearing to address risks outside of the reasonable control of NSPs, has led to an imbalance in the discussion in the consultation paper".	
Interaction between cost pass through events, capex re-openers and contingent events	Energex (pp. 4-5) stated that the "cost pass through mechanism should not be limited given the capex re-opener threshold", which is substantial and requires a more onerous process of revoking and substituting a revenue determination.	The draft rule retained the current subordination of the capex re-opener with respect to cost pass throughs. This is to provide NSPs with effective incentives and reserve the capex re-opening provisions for 'large shipwreck-type events'. The analysis in support of this position may be found in Chapter 5.3.2 of the draft rule determination.
	Given that most events are likely to cover both capex and opex, and the substantial threshold for utilising the capex re-opening provisions, Grid Australia (p. 8) considered that "it is likely that the appropriate mechanism in most cases would be the cost pass through mechanism". Grid Australia also noted that "as part of its rule change proposal it has suggested amending the wording of NER 6A.7.1(a)(7) to remove the current subordination of the capex re-opening provisions, whilst continuing to ensure that there can be no 'double-dipping' between the mechanisms".	
Risk profile and rate of return	Grid Australia (p. 5) and Energex (pp. 5-6) noted that "it would not be appropriate to adjust the WACC for inclusion of a new cost pass through, as the new rules provisions would not affect any part of the rules framework used	This draft rule determination did not pursue further the issue of risk profile and rate of return that was raised in the consultation

Issue	Stakeholder	AEMC Response
	to set the WACC". Grid Australia also considered that currently the cost of bearing the risk of uncertain events outside of the reasonable control of NSPs are reflected in insurance premiums incorporated in its opex. Grid Australia (p. 6) stated "the proposed rule change would remove the need to compensate NSPs for bearing this risk (in the case of self-insurance) and the need to pay commercial businesses to bear this risk". Similarly, Energex (p. 6) considered that current allowances "do not include significant uncontrollable, unexpected and high impact events such as natural disasters". The AER (p. 2) also noted that "no compensation should be provided to the network business in the cost of capital for risks" that are business specific and are expected to be diversifiable. However, for some risks "such as high cost low probability events where it may be necessary, this compensation should be reflected in the cash flows of the NSP rather than in the cost of capital". Accordingly, the AER (p. 2) considered that "where an NSP may be exposed to the risk of the costs of an event (in this case a high cost, low probability event), the consideration of whether compensation is necessary requires an assessment of the overall regulatory regime, rather than focussing on one element of the regulatory regime - e.g. cost pass throughs".	paper. This is because additional consideration of this issue was not necessary for in the Commission reaching its conclusions.
Savings and transitional arrangements	Powerlink (p. 2) sought confirmation from the Commission that there would be savings and transitional arrangements in the draft and final rules on this matter that will apply to Powerlink's next regulatory period from the commencement of the rule.	The draft rule contained transitional arrangements that retain the terrorism event as a prescribed pass through event for NSPs current regulatory control periods, and enable Powerlink (whose regulatory control period commences 1 July 2012) to nominate pass through events. The analysis in support of this position may be found in Chapter 9.3.2 of the draft rule determination.

A.2 Second round of consultation - draft rule determination

Submissions on the consultation paper closed on 1 March 2012. Seven submissions were received from the following organisations: Australian Energy Regulator; TRUenergy; Office of Energy Planning and Conservation (Tasmanian Government); Powerlink; Ergon Energy; Energex; and Grid Australia.

Issue	Stakeholder comment	AEMC response
Ability for transmission network service providers to propose additional cost pass through events		
Alignment of cost pass through provisions for network service providers	Stakeholders were generally supportive of this amendment to the NER to align the cost pass through arrangements for TNSPs with DNSPs, thereby allowing TNSPs to nominate additional pass through events as part of their regulatory proposals. In particular, Grid Australia (p. 3) noted that the ability to propose additional pass through events at the time of their revenue proposal would "allow the AER to explicitly consider the trade-off between cost pass through events and forecast insurance costs (both direct insurance and self-insurance) at the same time".	The rule as made includes provisions to allow TNSPs the opportunity to nominate additional cost pass through events as part of their revenue proposals. The analysis in support of the amendments to the rule as made are contained in Chapter 5.3.2 of this rule determination.
Nominated pass through considerations	*Inclusion of the nominated pass through considerations under the NER* The AER (pp. 1-2) were opposed to the inclusion of the nominated pass through considerations under the NER. Given that stakeholders have not raised issues regarding the AER's approach to assessing proposed nominated pass through events for this rule change or the determination process, the AER considered that "there is no justification, in terms of addressing uncertainty, for the AEMC's preference for further prescription in the NER given that there is no evidence of an issue to be addressed". Energex (p. 2) also considered that "codification of the nominated pass through event considerations appears overly prescriptive, as the AER is well practised and best placed to determine the relevant factors and their respective weighting	To improve the efficient operation of pass through applications and provide NSPs with effective incentives in order to promote economic efficiency with respect to direct control network services the rule as made includes nominated pass through considerations that the AER must consider when approving nominated pass through events. The analysis in support of the nominated pass through considerations, including the assessment of the drafting issues raised by

Issue	Stakeholder comment	AEMC response
	at the time of making a regulatory determination". Furthermore, Energex noted that the considerations as currently drafted "may not permit natural disasters or terrorism events to be classified as a nominated event, given that the nature or type of event may not be any more clearly identified at that time than they currently are". On the other hand, Grid Australia (p. 4) and Ausgrid were supportive of the inclusion of the nominated pass through considerations in the rules. For example, Ausgrid (p. 4) considered that in the past, "the AER has varied in its application and interpretation of criteria used to determine nominated cost pass throughs". Therefore, "codifying the criteria relevant to the nominated pass through considerations will provide greater certainty and guidance to NSPs". *Specific issues relating to drafting of the nominated pass through considerations* United Energy (p. 4) suggested that drafting of the pass through considerations be amended in the negative. That is, "it is preferable to test a nominated pass through event against a negative test, i.e. the prudent service provider through its actions could not have reasonably prevented the event from occurring or substantially mitigated the cost impact". On the other hand, Ausgrid (p. 4) noted that "the criteria appear to be a set of negative criteria in the sense that the existence of any one of the criteria would be inconsistent with the need for a pass through event". Ausgrid suggested that the criteria could be improved if they reflected the principle that nominated pass throughs are for events that met certain characteristics. Ergon Energy (p. 1) identified a terminology concern in the draft rule's definition of nominated pass through considerations. The draft rule refers to the "...potential loss...", which Ergon Energy considered should be amended to the potential cost, as it refers to the "costs imposed on the service provider rather than the loss imposed on a service provider". In relation to the drafting of the nominated cost pass through considerations, the AER (p. 2) considered that "it is not necessary to mandate that a NSP submit a	stakeholders may be found in Chapter 5.3.2 of this rule determination.

Issue	Stakeholder comment	AEMC response
	nominated pass through event as part of a regulatory proposal".	
Proposed new prescribed pass through events		
Removal of Grid Australia's proposed prescribed pass through events	Ausgrid and Energex did not agree with the removal of the two additional categories of pass through events proposed by Grid Australia. Ausgrid (pp. 1-2) noted its particular concerns regarding the view that the "creation of additional pass through categories or a change to the pass through provisions will erode incentives and result in an "automatic right" to pass through the costs to consumers". Ausgrid considered that given the "process under the NER is designed to impose a series of rigorous regulatory checks and balances that preclude inappropriate risk transfer to customers". For that reason, Ausgrid was of the opinion that "prescribing properly crafted pass through events which can be demonstrated to meet a risk or situation faced by all NSPs would provide greater regulatory certainty and transparency, while being administratively more efficient".	The rule as made has maintained the position outlined in the draft rule determination and has not included the prescribed events proposed by Grid Australia.
Removal of the prescribed terrorism pass through event	Ergon Energy (p. 1) and Energex (p. 1) supported the "fact that cost pass throughs are the last option available with respect to risk management for NSPs". However, Energex did not consider that "pass through arrangements necessarily weaken the regulatory incentive regime given the extremely robust process involved in making and assessing a cost pass through application". Ergon Energy (p. 1) did not consider that "'terrorism events' should be excluded from the statutory cost pass through events ... [as NSPs should be] given the opportunity to recover these costs, rather than having to nominate these events through the regulatory proposal process". Energex (p. 2) disagreed with the AEMC's reasoning, finding it "difficult to understand how the risk of a terrorism event can be differentiated between NSPs and hence, considers there is no scope for any NSP to leverage from its inclusion under the NER". United Energy (p. 5) stated that "the reality of a terrorism event is that there is little that an NSP can do in a forward looking manner that is sensible". United Energy also submitted that it would be difficult for the AER to determine whether an NSP has	The rule as made has maintained the position outlined in the draft rule determination to remove the terrorism event from the list of prescribed pass through events under the NER. The analysis in support of this position and the assessment of issues raised by stakeholders may be found in Chapter 6.3.2 of this rule determination.

Issue	Stakeholder comment	AEMC response
	effectively exhausted mitigation actions on a forward looking basis, therefore, recommend that a terrorism event should remain in the NER list of prescribed events.	
Toward greater consistency between the rules for network service providers	Ausgrid (p. 4) suggested that the 'insurance event' pass through category, which is currently available to TNSPs should also be made available to DNSPs as a prescribed pass through category. Ausgrid contended that insurance credit risk is something that could occur in any jurisdiction and consequently should be available as a core event for all NSPs.	Due to the inclusion of the nominated pass through considerations, NSPs would be able to nominate any additional pass through events relevant to their circumstances, which may include an event relating to insurance credit risk. Therefore, this rule determination does not pursue further the issue of the insurance event raised by Ausgrid.
Cost recovery for pass through events in the 'dead zone'		
Timing between revenue determination and pass through events	United Energy (p. 2) noted that the drafting of the 'dead zone' issues appears to "create an interdependency between the pass through process and the regulatory determination process". That is, there is an issue of timing as to whether "an applicant needs to wait until a distribution determination is made before it can know if the determination does or does not make an allowance for costs [resulting from a pass through event]". United Energy (p. 1) also noted that the current "drafting suggests that it be left up to the AER's discretion as to whether to allow these costs to be recovered up to the end of a regulatory control period or across regulatory control periods". Energex (p. 2) also suggested that the "drafting appeared to imply that the costs incurred in the current regulatory period and the following regulatory control period may be mutually exclusive".	The intention of this relevant factor in the rule determination was to prevent the double recovery of costs associated with a pass through event and to provide the AER with guidance where a cost pass through application is likely to interact with it making a regulatory/revenue determination. The analysis in support of the Commission's intent may be found in Chapter 7.3.2 of this rule determination.
Clarification of the 'dead	United Energy (p. 4) suggested amendments to "address the original problems by simpler drafting that both current and future period costs are recoverable	The rule as made contains provisions to address the 'dead zone' issue identified by

Issue	Stakeholder comment	AEMC response
zone' issue	across regulatory periods other than costs that have been allowed in a distribution determination". Example drafting was provided in United Energy's submission. Energex considered that the clauses addressing the dead zone should also "incorporate the weighted average cost of capital for the following regulatory control period, if the pass through event occurs across regulatory control periods, that is, the WACC relative to each period should apply to the respective periods". Grid Australia (p. 6) supported the "amendments proposed by the AEMC in its draft rule determination, which largely reflect those included in Grid Australia's rule change request". However, Grid Australia noted a number of minor drafting issues that it suggested be addressed in the final rule determination.	Grid Australia in its rule change request. This is because addressing the 'dead zone' provides NSPs with the reasonable opportunity to recover their efficient costs should a pass through event occur during that time period. The analysis in support of this position may be found in Chapter 7.3.2 of this rule determination.
Extension of applicability of 'dead zone' amendments to chapter 11 of the NER	Ausgrid (p. 1) was strongly supportive of the amendments that allow NSPs to seek cost recovery for events occurring in the 'dead zone'. However, Ausgrid considered that these corresponding amendments should be extended to the NSW and ACT distribution network service providers currently operating under Chapter 11 of the NER to ensure they are afforded the same opportunity to utilise these provisions should a pass through event occur prior to their next regulatory reset in 2014.	The rule as made has extended the application of the 'dead zone' to include the NSW and the ACT distribution network service providers currently operating under chapter 11 of the NER.
Transitional arrangements		
Arrangements in relation to Powerlink	Powerlink (p. 1) concurred with the AEMC's view that transitional arrangements allowing it to nominate possible additional cost pass through events would promote regulatory certainty and fairness between NSPs. The AER (p. 3) however, noted that the current drafting "only allows the AER to either accept or reject Powerlink's nominated pass through event and not to amend the proposal". Therefore the AER suggested that the rule be amended to provide the AER with 90 business days to assess any nominated pass through	The rule as made contains transitional arrangements that retain the terrorism event as a prescribed pass through event for NSPs current regulatory control periods, and enable Powerlink and ElectraNet and Murraylink to nominate additional pass through events if necessary.

Issue	Stakeholder comment	AEMC response
	events put forward by Powerlink.	The analysis in support of this position may be found in Chapter 8.3.2 of this rule determination.
Arrangements in relation to ElectraNet	At the time of making the rule as made, ElectraNet will be in the process of making its revenue determination with the AER. Therefore, ElectraNet (pp. 1-4) considered it necessary for the rule as made to provide transitional arrangements for it to propose possible additional pass through events prior to the AER making its draft decision.	