



DRAFT DECISION
Ausgrid
Distribution determination

2019–24

**Attachment 14 – Pass through
events**

November 2018

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Ausgrid for the 2019–24 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanism

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 - Tariff structure statement

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
DNSP	Distribution network service provider
NER	National Electricity Rules

14 Pass through events

During the regulatory control period Ausgrid can apply to pass through to its customers, in the form of higher or lower network charges, certain material changes in its costs caused by pre-defined exogenous events. These events are called cost pass through events. 'Positive' pass throughs allow Ausgrid to recover the efficient costs incurred as a result of events that could not be forecast as part of its regulatory proposal that otherwise would have a significant financial effect on Ausgrid's ability to invest in and operate its networks.¹

The National Electricity Rules (NER) prescribe the following pass through events for all distribution determinations:²

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event.

In addition to these prescribed events, other pass through events may be 'nominated' by a service provider for a regulatory control period.³ This attachment sets out our draft decision on the nominated pass through events to apply to Ausgrid for the 2019–24 regulatory control period.

14.1 Draft decision

Our draft decision pursuant to clause 6.12.1(14) of the NER is to:

- accept the 'insurer credit risk' event as proposed by Ausgrid
- accept the application of the 'insurance cap', 'natural disaster' and 'terrorism' events, but with amended definitions so that the pass through events that apply to Ausgrid will be consistent with recent decisions for other network service providers.⁴ Our amended definitions are set out in Table 14-2.

We do not support Ausgrid's proposed modifications to the operation of the pass through mechanism as it applies to alternative control services (ACS), specifically:

- the proposal to define materiality for pass throughs affecting ACS as a percentage of ACS revenues

¹ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 2.

² NER, r. 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

³ NER, r. 6.6.1(a1)(5), r. 6A.7.3(a1)(5).

⁴ E.g. AER, Draft Decision, ElectraNet Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13-6, 13-7; AER, Draft Decision, TransGrid Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13–6, 13–7.

- the proposal that any approved ACS pass through amounts would be recovered solely from ACS customers.

14.2 Ausgrid’s proposal

Ausgrid's proposed nominated pass through events are set out in Table 14-1.⁵

Table 14-1 Ausgrid's nominated pass through events

Pass through event	DNSP proposed definition
Insurance cap	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> • Ausgrid makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, • Ausgrid incurs costs beyond the relevant policy limit, and • The costs beyond the relevant policy limit materially increase the costs to Ausgrid in providing direct control services. <p>For this insurance cap event:</p> <ul style="list-style-type: none"> • The relevant policy limit is the greater of: <ul style="list-style-type: none"> ○ Ausgrid's actual policy limit at the time for the event that gives, or would have given rise to a claim, and ○ The policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued. • A relevant insurance policy is an insurance policy held during the 2019-24 regulatory control period or a previous regulatory control period in which Ausgrid was regulated. <p>Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1(i), the AER will have regard to:</p> <ul style="list-style-type: none"> • The relevant insurance policy for the event, and • The level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Insurer's credit risk	<p>An insurer's credit risk event occurs if:</p> <ul style="list-style-type: none"> • A nominated insurer of Ausgrid becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, Ausgrid: <ul style="list-style-type: none"> ○ Is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or ○ Incurs additional costs associated with funding an insurance claim, which otherwise have been covered by the insolvent insurer. <p>Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things,</p>

⁵ Ausgrid, Regulatory Proposal, Attachment 9.02, Nominated cost pass through events, p. 14.

Pass through event	DNSP proposed definition
Natural disaster	<ul style="list-style-type: none"> • Ausgrid's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurers track record, size, credit rating and reputation. • In the event that a claim would have been made after the insurance provider became insolvent, whether Ausgrid had reasonable opportunity to insure the risk with a different provider. <p>A natural disaster event occurs if:</p> <ul style="list-style-type: none"> • Any major fire, flood, earthquake or other natural disaster occurs during the 2019-24 regulatory control period and materially increases the costs to Ausgrid in providing direct control services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider. • The term 'major' in the above paragraph means an event that is serious and significant. It does not mean material as that term is defined in the Rules (that is 1 per cent of the DNSP's annual revenue requirement for that regulatory year). <p>Note: in assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • Whether Ausgrid has insurance against the event, • The level of insurance that an efficient and prudent NSP would obtain in respect of the event, • Whether a relevant government authority has made a declaration that a natural disaster has occurred.
Terrorism	<p>A terrorism event occurs if:</p> <ul style="list-style-type: none"> • An act (including, but not limited to, the use of force or violence or the threat of force or violence), attacks or other disruptive activities against the critical infrastructure or underlying technology, or the threat of such attacks or disruptive activities, or the deliberate introduction of malware) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which materially increases the costs to Ausgrid in providing direct control services. <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • Whether Ausgrid has insurance against the event, • The level of insurance that an efficient and prudent NSP would obtain in respect of the event, and • Whether a declaration has been made by a relevant government authority that a terrorism event has occurred.

Ausgrid also proposed modifications to the assessment and recovery mechanism for pass through applications concerning ACS, specifically:⁶

⁶ Ausgrid, Regulatory Proposal, Attachment 9.02, Nominated cost pass through events, p. 18.

- Ausgrid proposed that the definition of materiality to be applied in assessing an ACS pass through application should be 1 per cent of the revenue for the impacted alternative control service, rather than 1 percent of the annual revenue requirement for the NSP
- Ausgrid proposed that any approved pass through amount be recovered via an adjustment to ACS prices to provide a more cost reflective basis for recovery.

14.3 AER's assessment approach

The NER set out how we must assess nominated pass through events, and how we must assess an application from a service provider to pass through changes in costs where an event occurs.

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide, in part, that the service provider should have a reasonable opportunity to recover at least the efficient costs of providing services and complying with regulatory obligations.⁷ They also reflect the importance of incentives to promote economic efficiency,⁸ and balance the risks of under and over investment.⁹

In the context of pass through events, we have particular regard to the impact on price, quality, reliability and security of supply that may arise as a result of any change in the efficient operation of, and ability and incentive of, a service provider to invest in its network. This is a similar approach to that taken by the AEMC when considering pass through event rule changes.¹⁰

In determining whether we accept a nominated pass through event, we must take into account the 'nominated pass through event considerations' as defined, which are as follows:¹¹

- whether the event proposed is an event covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to (4) (in the case of a transmission determination);
- whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;

⁷ NEL, s. 7A(2).

⁸ NEL, s. 7A(3).

⁹ NEL, s. 7A(6).

¹⁰ NEL, s. 7; AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 6.

¹¹ NER, Chapter 10, definition of nominated pass through event considerations.

- whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;
- whether the relevant service provider could insure against the event, having regard to:
 - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - whether the event can be self-insured on the basis that:
 - it is possible to calculate the self-insurance premium; and
 - the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services; and
- any other matter the AER considers relevant and which the AER has notified Network Service Providers is a nominated pass through event consideration.

The AEMC described the purpose of the nominated pass through event considerations as:

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 event is the least efficient option for managing the risk of unforeseen events.¹²

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 risks between a service provider and end customers.¹³

This protects the incentive regime under the NER by limiting erosion of a service provider's incentives to use market based mechanisms to mitigate the cost impacts that would arise.¹⁴ This promotes the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers with respect to price.¹⁵

¹² AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 19.

¹³ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 20.

¹⁴ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 8.

¹⁵ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 8.

As a matter of good regulatory practice, we also take into account the desirability of consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.¹⁶

14.4 Interrelationships

The pass through mechanism is not the only way service providers can manage their risks under a distribution or transmission determination. It is interrelated with other parts of this decision, in particular with the forecast operating and capital expenditure (opex and capex) and rate of return included in our revenue determination. These interrelationships require us to balance the incentives in the various parts of our decision.

For systemic risks, service providers are compensated through the allowed rate of return. Service providers also face business-specific, or residual, risks. Service providers are compensated for the prudent and efficient management of these risks through the forecast opex and capex we include in our revenue determination for strategies such as:

- prevention (avoiding the risk)
- mitigation (reducing the probability and impact of the risk)
- insurance (transferring the risk to another party)
- self-insurance (putting aside funds to manage the likely costs associated with a risk event).

An efficient business will manage its risk by employing the most cost effective combination of these strategies. In order to maintain appropriate incentives under our determinations, we only accept nominated pass through events where we are satisfied that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex are either unavailable or inappropriate.¹⁷

In general, in respect of smaller projects a service provider should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the pass through mechanisms.¹⁸ This is reflected in the materiality threshold that applies to cost pass through applications.¹⁹

Cost pass through amounts approved in a regulatory control period are added to (or in the case of a negative pass through deducted from) forecast opex and capex for the

¹⁶ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 18.

¹⁷ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, pp. 19–20.

¹⁸ AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, p. 186.

¹⁹ NER, Chapter 10: Glossary, definition of 'materially'.

purpose of calculating efficiency carryover amounts under the Efficiency Benefit Sharing Scheme and Capital Expenditure Sharing Scheme.²⁰

Capex amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the regulatory asset base for the next regulatory period.²¹

14.5 Reasons for draft decision

14.5.1 Pass through events

Ausgrid's proposed pass through events are the same as those accepted for the 2014-19 regulatory control period. For the most part, we consider they are supported by the nominated pass through event considerations set out in the NER:²²

- the proposed events are not covered by an existing category of pass through event
- the nature of the events are clearly identifiable at this time
- a prudent service provider could not reasonably prevent an event of that nature or type from occurring or substantially mitigate its cost impact, and could not insure (or self-insure) against the events.

With regard to the latter point, Ausgrid could take some steps to reduce its exposure to these events, expenditure beyond a certain level aimed at completely eliminating the risk is likely to be imprudent or inefficient. In that context, sharing the risk between Ausgrid and its customers is appropriate and more likely to be in the long-term interests of consumers with respect to price.

We have accepted Ausgrid's proposed insurer credit risk event. Ausgrid's proposed definitions for the insurance cap and natural disaster events are for the most part consistent with those in our recent decisions.²³ We have made some additional amendments to those definitions to provide greater consistency between Ausgrid and other network service providers.

Our draft decision is not to accept Ausgrid's proposed amendments to the terrorism event regarding cyber-attacks. We believe this is unnecessary and counter-productive: referring expressly to one species of terrorist attack (i.e. cyber threats) tends to raise questions as to whether other types of attack are included. Our draft decision is instead

²⁰ AER, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers, November 2013, p. 9; AER, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013, p. 18.

²¹ NER, cl. S6.2.1(e)(1)(ii).

²² NER, Chapter 10: Glossary.

²³ E.g. AER, Draft Decision, ElectraNet Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13-6, 13-7; AER, Draft Decision, TransGrid Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13-6, 13-7.

to provide Ausgrid the same terrorism pass through event that applies to other network service providers.²⁴

Our approved definitions are set out in Table 14-2.

Table 14-2 AER pass through event definitions

Pass through event	Approved definition
Insurance cap	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> • Ausgrid makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, • Ausgrid incurs costs beyond the relevant policy limit, and • The costs beyond the relevant policy limit materially increase the costs to Ausgrid in providing direct control services. • For this insurance cap event: <ul style="list-style-type: none"> ○ A relevant insurance policy is an insurance policy held during the 2019-24 regulatory control period or a previous regulatory control period in which Ausgrid was regulated ○ Ausgrid will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of Ausgrid in relation to any aspect of the network or Ausgrid's business. • Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1(i), the AER will have regard to: <ul style="list-style-type: none"> ○ The relevant insurance policy for the event, and ○ The level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Insurer's credit risk	<p>An insurer's credit risk event occurs if:</p> <ul style="list-style-type: none"> • An insurer of Ausgrid becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, Ausgrid: <ul style="list-style-type: none"> ○ Is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or ○ Incurs additional costs associated with funding an insurance claim, which otherwise have been covered by the insolvent insurer. <p>Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things,</p> <ul style="list-style-type: none"> • Ausgrid's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurers track record, size, credit rating and reputation. • In the event that a claim would have been made after the insurance provider became insolvent, whether Ausgrid had reasonable

²⁴ AER, Final Decision, ActewAGL Distribution Access Arrangement 2016 to 2021, Attachment 11 Reference Tariff Variation Mechanism, May 2016, p. 11–39.

Pass through event	Approved definition
Natural disaster	<p data-bbox="691 241 1198 271">opportunity to insure the risk with a different provider.</p> <p data-bbox="643 300 1350 439">Natural disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2019-24 regulatory control period that increases the costs to Ausgrid in providing direct control services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.</p> <p data-bbox="643 456 1331 510">Note: in assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:</p> <ul data-bbox="643 528 1350 701" style="list-style-type: none"> <li data-bbox="643 528 1166 557">• Whether Ausgrid has insurance against the event, <li data-bbox="643 575 1350 629">• The level of insurance that an efficient and prudent NSP would obtain in respect of the event, <li data-bbox="643 647 1350 701">• Whether a relevant government authority has made a declaration that a natural disaster has occurred.
Terrorism	<p data-bbox="643 730 1358 842">Terrorism event means an act (including, but not limited to, the use of force or violence or the threat of force or violence of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which:</p> <ul data-bbox="643 860 1350 1016" style="list-style-type: none"> <li data-bbox="643 860 1350 972">• from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear), and <li data-bbox="643 990 1310 1016">• increases the costs to Ausgrid in providing direct control services. <p data-bbox="643 1034 1358 1088">Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul data-bbox="643 1106 1350 1279" style="list-style-type: none"> <li data-bbox="643 1106 1166 1135">• Whether Ausgrid has insurance against the event, <li data-bbox="643 1153 1350 1207">• The level of insurance that an efficient and prudent NSP would obtain in respect of the event, and <li data-bbox="643 1225 1302 1279">• Whether a declaration has been made by a relevant government authority that a terrorism event has occurred

14.5.2 Materiality threshold for pass through events relating to ACS

We do not support Ausgrid’s proposal to define materiality for pass throughs affecting ACS as a percentage of ACS revenues. This would be complex and uncertain given the range of methodologies used to regulate individual ACS. It would also substantially lower the materiality threshold from that prescribed under the NER, potentially allowing relatively small cost increases to be passed through.

Neither do we support Ausgrid’s proposed to vary the control mechanism so that any approved ACS pass through amounts would be recovered solely from ACS customers. The proposal has some attraction from an efficiency perspective, but this is outweighed by the complexity of developing bespoke pass through mechanisms for the various ACS, in circumstances where it unlikely that an event affecting only ACS would be substantial enough to meet the materiality threshold. This is consistent with the

position taken in our final decisions for CitiPower and Powercor’s current distribution determinations.²⁵

²⁵ AER, CitiPower distribution determination final decision 2016-20, Attachment 15 - Pass-through events; AER, Powercor distribution determination final decision 2016-20, Attachment 15 - Pass through events.