



DRAFT DECISION
TasNetworks distribution
determination
2017–18 to 2018–19

Attachment 15 – Pass through
events

September 2016

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Note

This attachment forms part of the AER's draft decision on TasNetworks' distribution determination for 2017–19. 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 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

Contents

Note	15-2
Contents	15-3
Shortened forms	15-4
15 Pass through events	15-6
15.1 Draft decision	15-6
15.2 TasNetworks' proposal	15-6
15.3 Assessment approach	15-8
15.3.1 Interrelationships.....	15-11
15.4 Reasons for draft decision	15-12

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure

Shortened form	Extended form
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

15 Pass through events

During the regulatory control period, a service provider can apply to us to pass material changes in its costs arising from pre-defined exogenous events through to customers, in the form of higher or lower network charges. These events are called cost pass through events. Positive pass throughs exist in the rules as a mechanism to allow service providers to recover their efficient costs incurred as a result of events that could not be forecast as part of their proposal that otherwise would have a significant financial effect on the ability of networks to invest in and operate their networks.¹

The NER include 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 'nominated' pass through events may be specified in a determination for a regulatory control period.³

This attachment sets out our draft decision on the nominated pass through events for TasNetworks' distribution networks for the 2017–19 regulatory control period.

15.1 Draft decision

Our draft decision is to accept TasNetworks' nominated pass through events.

Our draft decision also accepts TasNetworks' proposal that the pass through provisions for prescribed and nominated events apply to both standard control services and alternative control services.

15.2 TasNetworks' proposal

TasNetworks nominated the following pass through events for the 2017–19 regulatory control period:⁴

¹ AEMC, Cost Pass Through Arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 2.

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

³ NER, cl. 6.6.1(a1)(5).

⁴ TasNetworks, *Tasmanian Distribution Regulatory Proposal*, *Regulatory Control Period 1 July 2017 to 30 June 2019*, January 2016, pp. 149 - 152.

Table 15-1- TasNetworks nominated pass through events

Event	TasNetworks; proposed definition
Insurance cap event	<p>An insurance cap event occurs if:</p> <ol style="list-style-type: none"> 1. TasNetworks makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy; 2. TasNetworks incurs costs beyond the relevant policy limit; and 3. the costs beyond the relevant policy limit materially increase the costs to TasNetworks in providing direct control services. <p>For this insurance cap event:</p> <ol style="list-style-type: none"> 4. the relevant policy limit is the greater of: <ol style="list-style-type: none"> (a) TasNetworks' actual policy limit at the time of the event that gives, or would have given rise to a claim; and (b) 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. 5. A relevant insurance policy is an insurance policy held during the 2017–19 regulatory control period or a previous regulatory control period in which TasNetworks was regulated. <p>Note: for the avoidance of doubt, in assessing an insurance cap event cost pass through application under clause 6.6.1, the AER will have regard to:</p> <ol style="list-style-type: none"> i. the insurance policy for the event; ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event; and iii. the extent to which a prudent provider could reasonably mitigate the impact of the event.
Terrorism event	<p>A terrorism event is:</p> <p>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 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 TasNetworks in providing direct control services.</p> <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ol style="list-style-type: none"> i. whether TasNetworks has insurance against the event;

Event	TasNetworks; proposed definition
Natural disaster event	<p>ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event;</p> <p>iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred; and</p> <p>iv. the extent to which a prudent provider could reasonably mitigate the impact of the event.</p> <p>A natural disaster event is:</p> <p>Any major fire, flood, earthquake or other natural disaster that occurs during the 2017–19 regulatory control period and materially increases the costs to TasNetworks 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>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> <p>Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:</p> <p>i. whether TasNetworks has insurance against the event;</p> <p>ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event;</p> <p>iii. whether a relevant government authority has made a declaration that a natural disaster has occurred; and</p> <p>iv. the extent to which a prudent NSP could reasonably mitigate the impact of the event.</p>

TasNetworks proposed that the pass through provisions for defined and nominated pass through events apply to both standard control services and alternative control services.⁵

15.3 Assessment approach

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

In this decision, our task is to determine whether to accept the nominated pass through events.

⁵ TasNetworks, *Tasmanian Distribution Regulatory Proposal*, *Regulatory Control Period 1 July 2017 to 30 June 2019*, January 2016, p. 149.

The NER include the following pass through events for all distribution determinations:⁶

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

The NER also allow a service provider to propose other events be specified in a determination as a pass through event for that determination.⁷ Our draft decision must include a decision on the additional (nominated) pass through events that are to apply for the regulatory control period.⁸

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide the service provider with a reasonable opportunity to recover at least the efficient costs incurred in providing services and complying with its obligations.⁹ They also provide incentives to promote economic efficiency.¹⁰ Together, they promote a balance between the economic costs and risks of the potential for under and over investment by a service provider, to promote efficient investment.¹¹ 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.¹²

In determining whether we accept a nominated pass through event, we must take into account the nominated pass through event considerations.¹³

The nominated pass through event considerations are:

- (a) 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);
- (b) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
- (c) 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;

⁶ NER, cl. 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

⁷ NER, cl. 6.6.1(a1)(5).

⁸ NER, cl. 6.12.1(14)..

⁹ NEL, s. 7A(2).

¹⁰ NEL, s. 7A(3).

¹¹ NEL, s. 7A(6).

¹² NEL, s. 7; AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 6.

¹³ NER, cl. 6.5.10(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

(d) whether the relevant service provider could insure against the event, having regard to:

(1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or

(2) whether the event can be self-insured on the basis that:

(i) it is possible to calculate the self-insurance premium; and

(ii) 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

(e) 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.¹⁴
- 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.¹⁵

In turn, this protects the incentive regime under the NER by limiting the erosion of incentives on service providers to use market based mechanisms to mitigate the cost impacts that would arise.¹⁶ 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.¹⁷

¹⁴ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 19.

¹⁵ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 20.

¹⁶ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p.8.

¹⁷ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p.8.

15.3.1 Interrelationships

The pass through mechanism is not the only way in which service providers can manage their risks under a distribution determination. It is interrelated with other parts of this decision, in particular with the forecast 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.¹⁸

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.¹⁹ This is reflected in the materiality threshold that applies to applications for cost pass through determinations.²⁰

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 purpose of calculating efficiency carryover amounts under the EBSS and CESS.²¹

Cost pass through amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the regulatory asset base (RAB) for the next regulatory period.²²

¹⁸ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, pp. 19–20.

¹⁹ AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, Sydney, p. 186.

²⁰ NER, Chapter 10: Glossary, definition of 'materially'.

²¹ 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.

15.4 Reasons for draft decision

We accept all three pass through events nominated in TasNetworks' regulatory proposal. Having regard to the nominated pass through considerations,²³ we consider:

- The nominated events are not already covered by the pass through events already prescribed under the NER²⁴
- The nature and type of each nominated event can be clearly identified at the time of our determination²⁵
- While a prudent service provider could take steps to reduce the likelihood of these events and the cost impacts of the events should they occur,²⁶ and could in principle insure or self-insure against the event,²⁷ expenditure beyond a certain point is likely to be imprudent or inefficient. In these circumstances we consider sharing the remaining risk between TasNetworks and its customers is appropriate and more likely to be in the long term interest of consumers.

The pass through provisions for defined and nominated pass through events will apply to direct control services.

TasNetworks' proposed definitions are consistent with the nominated pass through events we approved for its transmission business in April 2015.²⁸ As TasNetworks noted in its proposal:²⁹

The alignment of the pass through definitions across transmission and distribution, while not essential, is appropriate given the merger of the two networks.

We agree that consistent treatment of common risks between the two networks is desirable. Our next reviews of TasNetworks' distribution and transmission determinations will take place concurrently, for the regulatory control period commencing 1 July 2019.

²² NER, cl. S6.2.1(f)(1)(ii).

²³ NER, cl. 6.5.10(b).

²⁴ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (a).

²⁵ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (b).

²⁶ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (c).

²⁷ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (d).

²⁸ AER, *Final decision TasNetworks transmission determination 2015-19*, April 2015, pp. 20–22.

²⁹ TasNetworks, *Tasmanian Distribution Regulatory Proposal, Regulatory Control Period 1 July 2017 to 30 June 2019*, January 2016, p. 149.