DRAFT DECISION
Murraylink transmission determination
2018 to 2023

Attachment 13 − Pass through events

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AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on Murraylink's transmission determination for 2018–23. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Maximum allowed revenue

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

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIA	demand management innovation allowance
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice

Shortened form	Extended form
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

13 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 transmission determinations:[2]

- a regulatory change event
- a service standard event
- a tax change event
- an insurance event.

In addition to these prescribed events, other (nominated) pass through events may be specified.[3] Murraylink proposed to include a new 'connection cost' event as a nominated pass through event for the 2018-23 regulatory control period. This attachment sets out our draft decision on the nominated pass through event.

13.1 Draft decision

Our draft decision is to accept Murraylink's proposed connection cost event.

13.2 Murraylink's proposal

Murraylink proposed a new cost pass through event to cover changes in the amount of the connection charges it pays to the adjacent transmission network service providers (TNSPs), ElectraNet and AusNet Services. Murraylink defined this as:

> [an] event … where the connection charge levied by AusNet Services and ElectraNet is different from that incurred in the 2016 base year.[4]

Connection charges for ElectraNet and AusNet Services are subject to revenue determinations which expire on 30 June 2018 and 31 March 2022 respectively. The connection charges beyond these dates will depend on new revenue determinations.

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

2 NER, cl. 6A.7.3(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

3 NER, cl. 6A.7.3(a1).

4 Murraylink Transmission Company Pty Ltd, *Murraylink Revenue Proposal (Public) Effective July 2018 to June 2023*, January 2017, p. 120.

ElectraNet's new determination will be decided at the same time as Murraylink's, but AusNet Services' new determination will not be made until after Murraylink's determination for the next regulatory control period is approved.

Murraylink has included an amount of $1.010 million per annum (real, 2018) for connection costs in its forecast operating expenditure for the next regulatory control period.[5] Murraylink stated that this is based on the connection costs incurred in 2016.[6]

13.3 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.

The NER include the following pass through events for all transmission determinations:[7]

- a regulatory change event
- a service standard event
- a tax change event
- an insurance event.

They also allow a service provider to propose other events be specified in a determination as a pass through event for that determination.[8] Our draft decision must include a decision on the additional (nominated) pass through events that are to apply for the regulatory control period.[9]

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.[10] They also provide incentives to promote economic efficiency.[11] 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.[12] In the context of pass through events, we have particular regard to the impact on price, quality, reliability and security of supply that

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5 Murraylink Transmission Company Pty Ltd, *Murraylink Revenue Proposal (Public) Effective July 2018 to June 2023*, January 2017, p. 105.

6 Murraylink Transmission Company Pty Ltd, *Murraylink Revenue Proposal (Public) Effective July 2018 to June 2023*, January 2017, p. 113.

7 NER, cl. 6A.7.3(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

8 NER, cl. 6A.7.3(a1)(5.

9 NER, cl. 6A.14.1(9).

10 NEL, s. 7A(2).

11 NEL, s. 7A(3).

12 NEL, s. 7A(6).

may arise as a result of any change in the efficient operation of, and ability and incentive if, a service provider to invest in its network.[13]

In determining whether we accept a nominated pass through event, we must take into account the nominated pass through event considerations:[14]

> 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) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to (4) (in the case of a *transmission determination*);
>
> (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;
>
> (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

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

14 NER, cl. 6A.6.9(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events[15]

- 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.[16]

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.[17] 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.[18]

As a matter of good regulatory practice, one additional matter[19] we take into account is consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.[20]

13.4 Interrelationships

The pass through mechanism is not the only way in which service providers can manage their risks under a transmission 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)

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

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

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

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

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

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

- 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.[21]

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.[22] This is reflected in the materiality threshold that applies to applications for cost pass through determinations.[23]

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.[24]

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.[25]

13.5 Reasons for draft decision

We are satisfied that the connection charge event meets the nominated pass through considerations.

We are satisfied it is not covered by another pass through event. Murraylink acknowledges the possibility that the event could be covered by the Regulatory Change Event, on the basis that a regulator's decision would be the cause of any change in connection charge costs.[26] Without dismissing this possibility, we agree there is some uncertainty and see no difficulty, in the circumstances, with determining a specific event instead.

The connection charge is clearly defined in connection agreements with AusNet Services and ElectraNet. A material increase or decrease in these costs, as compared with the quantum of these costs in the opex forecast, would trigger the event.

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

22 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.

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

24 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.

25 NER, cl. S6A.2.1(f)(1)(ii) / S6.2.1(e)(1)(ii).

26 Murraylink Transmission Company Pty Ltd, *Murraylink Revenue Proposal (Public) Effective July 2018 to June 2023*, January 2017, p. 115.

The event is beyond Murraylink's control and could not reasonably be prevented or mitigated. An increase or decrease in the connection charges would occur as a result of a regulatory decision. We accept Murraylink's submission that commercial insurance is unavailable and self-insurance is not possible due to the difficulty of calculating a premium.[27]

We also note that this pass through would operate symmetrically. If the connection charge materially decreased, this would reduce the revenue that Murraylink is able to recover. Conversely, a higher fee would lead to higher revenues, subject to the materiality threshold being met.

None of the submissions on Murraylink's proposal addressed the connection cost pass through event.

Murraylink's proposal does not discuss how significant a change in connection costs must be to trigger the event. For clarity, our draft decision is premised on the definitions of positive and negative change events under the NER, both of which require a material change in costs. That is, the change in connection costs must exceed one per cent of the maximum allowed revenue for Murraylink for the relevant regulatory year.

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[27] Murraylink Transmission Company Pty Ltd, *Murraylink Revenue Proposal (Public) Effective July 2018 to June 2023*, January 2017, p. 115.