



Draft decision
TasNetworks transmission determination
2015–16 to 2018–19
Attachment 13: Pass through events

November 2014

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Note

This attachment forms part of the AER's draft decision on the transmission determination for TasNetworks' 2015–19 regulatory control period. It should be read in conjunction with 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

Attachment 9 – efficiency benefit sharing scheme

Attachment 10 – capital expenditure sharing scheme

Attachment 11 – service target performance incentive scheme

Attachment 12 – pricing methodology

Attachment 13 – pass through events

Attachment 14 – negotiated services

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AASB	Australian Accounting Standards Board
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ARPC	Australian Reinsurance Pool Corporation
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
capex incentive guideline	AER, <i>Capital Expenditure Incentive Guideline for Electricity Network Service Providers</i> , November 2013
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
EMCa	Energy Market Consulting associates
ERP	equity risk premium
EUAA	Energy Users Association of Australia
MAR	maximum allowed revenue
MEU	Major Energy Users
MJA	Marsden Jacob Associates

Shortened form	Extended form
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
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
version one of the EBSS	AER, <i>Electricity transmission network service providers: Efficiency benefit sharing scheme</i> , September 2007
version two of the EBSS	AER, <i>Efficiency benefit sharing scheme for electricity network service providers</i> , November 2013

Shortened form	Extended form
WACC	weighted average cost of capital

13 Cost pass throughs

The pass through mechanism of the NER recognises that a transmission network service provider can be exposed to risks beyond its control, which may have a material impact on its costs. A cost pass through enables a service provider to recover (or pass through) the costs of defined unpredictable, high cost events that are not built into our transmission determination. The NER includes the following prescribed pass through events for all service providers:

- a regulatory change event
- a service standard event
- a tax change event
- an insurance event
- in addition to those defined events, an event specified in a determination for a regulatory control period (nominated pass through event).¹

This chapter sets out our draft decision about which of TasNetworks' nominated pass through events we will accept as an additional pass through event for the regulatory control period.

13.1 Draft decision

We accept that, in certain circumstances, a pass through of costs may be justifiable. However, we do not accept these nominated pass through events as drafted by TasNetworks. Instead, we have substituted our own definitions for the following events:

- insurance cap event
- natural disaster event
- terrorism event.

13.2 TasNetworks' proposal

TasNetworks' proposed nominated pass through events and definitions are set out in table 13.1.

Table 13.1 TasNetworks' proposed pass through events

Proposed event	Proposed definition
Insurance cap event	<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; and3. The costs beyond the relevant policy limit materially increase the costs to TasNetworks of providing prescribed transmission services. <p>For this insurance cap event:</p> <ol style="list-style-type: none">4. The relevant policy limit is the greater of:

¹ NER, cl 6A.7.3(a1).

Proposed event	Proposed definition
	<p>a. TasNetworks' actual policy limit at the time of the event that gives rise to the claim, and</p> <p>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.</p> <p>5. A relevant insurance policy is an insurance policy held during the regulatory control period or a previous regulatory control period in which TasNetworks was regulated.</p> <p>Note: For the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6A.7.3, the AER will have regard to:</p> <ul style="list-style-type: none"> i. the insurance premium proposal submitted by TasNetworks in its Revenue Proposal; ii. the forecast operating expenditure allowance approved by the AER in its Final Decision; and iii. the reasons for that decision.
Natural disaster event	<p>Any major fire, flood, earthquake or other natural disaster beyond the reasonable control of TasNetworks that occurs during the 2014–19 regulatory control period and materially increases the costs to TasNetworks of providing prescribed transmission services.</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, one per cent of the TNSP's maximum allowed revenue in that year).</p> <p>Note: In assessing a natural disaster event pass through application, the AER will have regard to the:</p> <ul style="list-style-type: none"> i. insurance premium proposal submitted in our transitional Revenue Proposal; ii. forecast expenditure allowances approved by the AER in relation to the transitional year; and iii. reasons for that decision.
Terrorism event	<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 of providing prescribed transmission services.</p>

Source: TasNetworks, *Revenue proposal*, pp. 118–120.

13.3 AER's assessment approach

We must decide which of TasNetworks' proposed nominated pass through events will apply for the 2015–19 regulatory control period. Pass through events transfer financial risks from the service providers to consumers. If one of the nominated events occurs, the costs of the event that we assess as meeting the factors set out in the NER are passed through to consumers and network charges increase.²

Our approach has been guided by the NEO and the RPP. It provides the service provider with a reasonable opportunity to recover at least the efficient costs the operator incurs³, while also providing

² NER, cl. 6A.7.3(d),(g) and (j).

³ NEL, s. 7A(2).

effective incentives to promote economic efficiency.⁴ It promotes a balance between the economic costs and risks for promoting efficient investment.⁵

The NER includes the following nominated pass through event considerations which we must have regard to when assessing nominated pass through events.⁶

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.

These considerations involve an assessment of the incentives on service providers to manage their risks efficiently.

For systemic risks, service providers are compensated through the allowed rate of return. Service providers also face business-specific, or residual, risks. These activities are generally compensated through the opex and capex allowances. Beyond this a service provider may manage other risks through a number of other strategies, including:

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

An efficient business will manage its risk by employing the most cost effective combination of these strategies. For example, if a cost is reasonably predictable a business should factor it into its opex and capex proposed expenditure. In addition, a service provider may invest in its networks to mitigate the impact of certain events occurring. Alternatively, if the probability of events occurring can be readily estimated then the event should be insurable.

⁴ NEL, s. 7A(3).

⁵ NEL, s. 7A(6).

⁶ NER, cl. 6A.6.9; NER glossary, definition of 'nominated pass through event considerations'.

Pass through events cover those limited circumstances for which the risks cannot be managed efficiently in these ways and for which the service provider should be able to recover its efficient costs.

A factor for us to consider, which is reflected in the pass through event considerations, is who is best placed to manage risk. Generally the party who is in the best position to manage the risk should bear the risk. If the service provider, or customers, are fully exposed to a risk, this may lead to adverse outcomes.

For example, where it is not possible for a service provider to insure against a risk, service providers may need to share that risk with customers, to ensure that the service can continue to be provided if the event happens. The uninsurable risk may be outside the control of the service provider and have a low probability of occurring, but it might also have a significant cost impact. The most efficient and prudent solution to manage that type of risk may be to require customers to accept some of the burden of that risk, by allowing a pass through in the unlikely event that the risk eventuates. On the other hand, if the service provider is able to pass through all the costs of such an event, this may reduce the service provider's incentive to take prudent actions to prevent or mitigate the potential cost impact of the risk. Accordingly, while customers may need to accept some of the burden of the risk, the service provider will need to share some of the risk too. That might be achieved, for example, by making a pass through conditional on the service provider demonstrating that it has acted prudently and efficiently in managing the potential impact of the event.

We consider all of these issues when assessing a nominated pass through event with the aim of achieving the right balance, in the long term interests of consumers, in accordance with the nominated pass through event considerations.

As a matter of good regulatory practice, an additional factor we take into account is consistency in our approach to assessing nominated pass through events across our determinations where possible.⁷

13.3.1 Interrelationships

As we mentioned above, pass through events are not the only mechanism in this determination by which TasNetworks can manage its risks. The nominated pass through events are interrelated with other parts of this determination, in particular with the proposed opex and capex allowances and the rate of return. These interrelationships require us to balance the incentives in the various parts of our decision.

13.4 Reasons for draft decision

This section sets out our reasons for proposing amendments to the insurance cap event, terrorism event and the natural disaster event.

Insurance cap event—propose new definition

We do not accept the proposed definition of an insurance cap event. We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

The insurance cap event would allow TasNetworks to recover material costs incurred which exceed its insurance claim limit.⁸ It is funded through its opex allowance to obtain an appropriate level of

⁷ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations' Paragraph (e).

⁸ TasNetworks, *Revenue proposal*, p. 230.

insurance for these types of risks. We accept that the insurance cap event would protect it from high cost impact events which would be uneconomical to insure against. We consider consumers benefit because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an insurance cap event occur.

We expect that TasNetworks will obtain efficient levels of insurance cover commensurate with its business risk as reflected in its opex allowance and note the following:

- The extent to which TasNetworks is able to reasonably prevent costs being incurred which exceed its insurance cap, or take steps to mitigate incurring costs above the cap is limited.
- The coverage of insurance should be capped at a level beyond which it is unable or uneconomic to insure, having regard to the cost of premiums and the likelihood of the event.

We note that if a pass through event of this kind were to occur, in assessing TasNetworks' application to pass through costs, we will consider the efficiency of TasNetworks' decisions and actions. We would consider whether it failed to take reasonable action to reduce the magnitude of the amount being claimed and whether any act or omission it took in response to the event increased the magnitude of the amount claimed.⁹ This gives TasNetworks an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.

The definition proposed should be amended to clarify some factors to which we will have regard when assessing a claim. Accordingly, we have proposed a new definition as set out at section 13.5.

After making this amendment we consider that including the insurance cap event provides an incentive for TasNetworks to obtain an efficient level of insurance.¹⁰

Terrorism event—propose new definition

We do not accept the proposed definition of a terrorism event. We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

For the 2009–14 regulatory control period, this was a prescribed pass through event. A rule change removed the terrorism event from the prescribed list of pass through events. The decision whether to accept this event is now to be made by us as part of the determination process, considering the circumstances of each network business.¹¹

In relation to the this event, we note:

- TasNetworks has a range of measures in place to prevent acts of terrorism affecting its operations, or mitigate the impacts of an event should one occur.¹² TasNetworks has forecast expenditure to address the physical protection security of its assets and the safety of employees

⁹ NER, cl. 6A.7.3(j)(3).

¹⁰ We note that we have not explicitly excluded insurance cap events that arise due to a finding of negligence. Negligence suggests the NSP may have some control over the event or some opportunity to limit the magnitude of the event. This may be a factor that we would have regard to in assessing such a pass through application. However, we do not consider it would be appropriate to exclude all events where the suggestion of negligence on behalf of the business has been raised. We further note that unlawful conduct and gross negligence would not be covered by an insurer and that acts or omissions resulting from such unlawful conduct or gross negligence would be relevant considerations when assessing a pass through event application, having regard to the relevant factors set out in the NER.

¹¹ Under the transitional rules, the terrorism event is a prescribed pass through event for the transitional regulatory control period: NER, cl. 11.49.2, 11.58.3(a)(4).

¹² NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (c).

and the public. Projects include the renewal of fire suppression systems in substations, implementation of fall arrestor systems and warning signs on transmission towers, and renewal of transmission line access tracks and access security systems.¹³

- TasNetworks has some commercial insurance and self-insurance which would be triggered if a terrorism event occurred.¹⁴ This would not likely cover all the costs associated with a natural disaster event, however taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers.

TasNetworks also advised that the costs to TasNetworks considered in this event should be net of any recoveries from either relevant insurance policies and/or the ARPC under the *Terrorism Insurance Act 2003*.¹⁵

We consider that there may be some overlap between an insurance cap event and the terrorism event, but accept the need to have both because TasNetworks may incur costs which an insurance policy would not ordinarily cover. The amendment to the pass through event definition will assist in avoiding the overlap.

We also consider that a terrorism event should be more clearly defined so that the event can be clearly identified and assessed.¹⁶ We note that TasNetworks' opex allowance includes funding for insurance and self-insurance yet it may have an incentive to keep that allowance (and not insure the risk) while managing this risk through the pass through mechanism. We consider that this disincentive to insure against terrorism can be reduced by clarifying the pass through event definition. Accordingly, we have proposed a new definition as set out at section 13.5.

Natural disaster event—propose new definition

We do not accept the proposed definition of a natural disaster event because it does not sufficiently describe whether a provider could mitigate the cost impact of the event¹⁷ and whether the provider could insure against the event.¹⁸ We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

We consider that there may be some overlap between an insurance cap event and a natural disaster event, but accept the need to have both because the service provider may incur costs which an insurance policy would not ordinarily cover.

In relation to this event, we note:

- TasNetworks has a range of measures in place to mitigate the impacts of an event should one occur.¹⁹
- TasNetworks has some commercial insurance and self-insurance which would be triggered if a natural disaster event occurred.²⁰ This would not likely cover all the costs associated with a

¹³ TasNetworks, *Revenue proposal*, p. 72.

¹⁴ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (d)(1). TasNetworks, *Revenue proposal, Appendix 15 Marsh: Quantification of Self-Insurance costs - Public*, pp. 3-5.

¹⁵ TasNetworks, *Revenue proposal, Appendix 15 Marsh: Quantification of Self-Insurance costs - Public*, p. 21.

¹⁶ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (b).

¹⁷ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (c).

¹⁸ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (d).

¹⁹ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (c). TasNetworks, *Revenue proposal*, pp. 71.

²⁰ NER, Chapter 10 (glossary), definition of 'nominated pass through event considerations', paragraph (d)(1). TasNetworks, *Revenue proposal, Appendix 15 Marsh: Quantification of Self-Insurance costs - Public*, pp. 3-5.

natural disaster event, however taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers.

However the definition of the event as proposed is not sufficiently clear. We consider that a natural disaster event should be more clearly defined so that the event can be clearly identified and assessed. We also note that TasNetworks' opex allowance includes funding for insurance yet it may have an incentive to keep that allowance (and not insure the risk) while managing this risk through the pass through mechanism. We consider that this disincentive to insure natural disasters can be reduced by clarifying the natural disaster event. Accordingly, we have proposed a new definition as set out at section 13.5.

After making this amendment, we consider that including the natural disaster event will provide an incentive for TasNetworks to mitigate the potential impact of natural disaster events.

13.5 Revisions

We propose an amendment to the definition of the insurance cap event.

An insurance cap event occurs if:

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

For this insurance cap event:

4. the relevant policy limit is the greater of:
 - 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 2015-19 regulatory control period or a previous regulatory control period in which TasNetworks was regulated.

Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6A.7.3, the AER will have regard to:

- 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.

We propose an amendment to the definition of the terrorism event.

A terrorism event occurs if:

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.

Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:

- i. whether TasNetworks has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,
- iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred, and
- iv. the extent to which a prudent provider could reasonably mitigate the impact of the event.

We propose an amendment to the definition of the natural disaster event.

A natural disaster event occurs if:

Any major fire, flood, earthquake or other natural disaster occurs during the 2015-19 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

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 TNSP's annual revenue requirement for that regulatory year).

Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:

- i. whether TasNetworks has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,
- iii. whether a relevant government authority has made a declaration that a natural disaster has occurred, and
- iv. the extent to which a prudent NSP could reasonably mitigate the impact of the event.