



DRAFT DECISION
Evoenergy
Distribution Determination

2019 to 2024

Attachment 14
Pass through events

September 2018

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Evoenergy for the 2019–2024 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 mechanisms

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

Contents

Note	14-2
Contents	14-3
Shortened forms	14-4
14 Pass through events	14-5
14.1 Draft decision	14-5
14.2 Evoenergy's proposal.....	14-6
14.3 Assessment approach.....	14-7
14.3.1 Interrelationships.....	14-9
14.4 Reasons for draft decision.....	14-10

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
NER	National Electricity Rules
AEMC	Australian Energy Market Commission

14 Pass through events

During the regulatory control period Evoenergy 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 Evoenergy 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 Evoenergy's ability to invest in and operate its network.¹

The 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 Evoenergy for the 2019–24 regulatory control period.

14.1 Draft decision

Our draft decision pursuant to Rule 6.12.1(14) is to accept Evoenergy's nominated pass through events.

Accordingly, we propose that the following are pass through events for the purpose of Rule 6.6.1(a1)(5):

- Terrorism event
- Natural Disaster event
- Insurance Cap event
- Insurer Credit Risk event.

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

14.2 Evoenergy's proposal

Evoenergy proposed four nominated pass through events which are set out in the following table.⁴

Table 14.1 Evoenergy's nominated pass through events

Proposed event	Proposed definition
Terrorism Event	<p>A terrorism event occurs if:</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 increases the costs to Evoenergy in providing Direct Control Services.</p> <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, among other things:</p> <ul style="list-style-type: none"> i. whether Evoenergy has insurance against the event; ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event; and iii. whether a declaration has been made by a relevant government authority that an act of terrorism has occurred.
Natural Disaster Event	<p>Natural disaster event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2019–24 regulatory control period that increases the costs to Evoenergy 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>Note: In assessing a natural disaster event pass through application, the AER will have regard to, among other things:</p> <ul style="list-style-type: none"> i. whether Evoenergy has insurance against the event; and ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Insurance Cap Event	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> a) Evoenergy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy; b) Evoenergy incurs costs beyond the policy limit of the relevant insurance policy at the time of the event that gives rise to the relevant claim; and c) the costs beyond the relevant policy limit increase the costs to Evoenergy in providing Direct Control Services. <p>For this insurance cap event:</p>

⁴ Evoenergy, Regulatory Proposal for ACT Electricity Distribution Network 2019-24, Attachment 13 Pass Through Events, January 2018, p. 13-2.

Proposed event	Proposed definition
	<p>a) a relevant insurance policy is an insurance policy held during the 2019–24 regulatory control period or a previous regulatory control period in which Evoenergy was regulated; and</p> <p>b) Evoenergy will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related body corporate of Evoenergy in relation to any aspects of Evoenergy’s Direct Control Services.</p> <p>Note: in making a determination on an insurance cap event, the AER will have regard to, among other things:</p> <ul style="list-style-type: none"> i. the insurance policy for the event; and ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Insurer Credit Risk Event	<p>An insurer’s credit risk event occurs if:</p> <p>A nominated insurer of Evoenergy becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, Evoenergy:</p> <ul style="list-style-type: none"> a) 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 b) incurs additional costs associated with self-funding an insurance claim, which would 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, among other things:</p> <ul style="list-style-type: none"> i. Evoenergy’s attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer’s track record, size, credit rating and reputation; and ii. in the event that a claim would have been made after the insurance provider became insolvent, whether Evoenergy had reasonable opportunity to insure the risk with a different provider.

14.3 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 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.⁵ They also reflect the importance of incentives to promote economic efficiency,⁶ and balance the risks of under and over investment.⁷ In the context of pass through events, we have particular regard to the

⁵ NEL, s. 7A(2).

⁶ NEL, s. 7A(3).

⁷ NEL, s. 7A(6).

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.⁸

In determining whether we accept a nominated pass through event, we must take into account the 'nominated pass through event considerations' set out in the NER, which are as follows:⁹

- (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:
 - (e) 1. the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - (f) 2. whether the event can be self-insured on the basis that:
 - (g) it is possible to calculate the self-insurance premium; and
 - (h) 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
 - (i) 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.¹⁰

⁸ NEL, s. 7; AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 6.

⁹ NER, Chapter 10, definition of nominated pass through event considerations

¹⁰ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 19.

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.¹¹

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.¹² 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.¹³

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.¹⁴

14.3.1 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 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

¹¹ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 20.

¹² AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p.8.

¹³ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p.8.

¹⁴ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, p. 18.

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.¹⁵

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.¹⁶ This is reflected in the materiality threshold that applies to cost pass throughs applications.¹⁷

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 Efficiency Benefit Sharing Scheme and Capital Expenditure Sharing Scheme.¹⁸

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 for the next regulatory period.¹⁹

14.4 Reasons for draft decision

Evoenergy's nominated events and associated definitions are substantially the same as those approved in our recent decisions.²⁰ Consistent with those decisions, we consider these events are supported by the nominated pass through event considerations set out in the NER:²¹

- 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, we accept Evoenergy's submission that, while it could take some steps to reduce its exposure to these events, expenditure beyond a certain

¹⁵ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney, pp. 19–20.

¹⁶ 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.

¹⁷ NER, Chapter 10: Glossary, definition of 'materially'.

¹⁸ 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.

¹⁹ NER, r. S6.2.1(e)(1)(ii).

²⁰ 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.

²¹ NER, Chapter 10: Glossary.

level aimed at completely eliminating the risk is likely to be imprudent or inefficient. In that context, sharing the risk between Evoenergy and its customers is appropriate and more likely to be in the long-term interests of consumers with respect to price.²²

Evoenergy's proposal includes a note to each definition setting out certain factors likely to be relevant to determining a pass through application. This is consistent with the approach taken in our recent decisions.²³ While the factors listed with each definition are not definitive or exhaustive,²⁴ we consider it improves transparency and predictability to include them.

²² Evoenergy, *Regulatory Proposal for ACT Electricity Distribution Network 2019-24, Attachment 13 Pass Through Events*, January 2018, p. 13-5.

²³ Compare e.g. AER, *Draft Decision, ElectraNet Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events*, October 2017, pp. 13-6 to 13-8; AER, *Draft Decision, TransGrid Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events*, October 2017, pp. 13-6 to 13-8.

²⁴ See NER r. 6.6.1(j), especially r. 6.6.1(j)(8).