



**FINAL DECISION**  
**TransGrid transmission**  
**determination**  
**2015–16 to 2017–18**

**Attachment 13 – Pass through**  
**events**

April 2015

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## Note

This attachment forms part of the AER's final decision on TransGrid's revenue proposal 2015–18. It should be read with other parts of the final decision.

The final 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
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
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

Shortened form	Extended form
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
WACC	weighted average cost of capital

## 13 Pass through events

The pass through mechanism of the National Electricity Rules (NER) recognises that a TNSP can be exposed to risks beyond its control. These risks may have a material impact on a TNSP's costs. A cost pass through enables a TNSP 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 TNSPs:

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

This attachment sets out our final decision on the nominated pass through events that will apply to TransGrid during the 2015–18 regulatory control period.

### 13.1 Final decision

Our final decision is that the following additional (nominated) pass through events will apply to TransGrid for the 2015–18 regulatory control period:

- terrorism event
- insurance cap event, and
- insurer's credit risk event.

These events have the definitions listed in Table 13.1 below.

**Table 13.1 Accepted event definitions**

Pass through event	Definition
<b>Terrorism event</b>	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,

<sup>1</sup> NER, clause 6A.7.3(a1).

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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 TransGrid in providing prescribed transmission services.

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

- i. whether TransGrid has insurance against the event, including coverage from the Australian Reinsurance Pool
- 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 a terrorism event has occurred.

### **Insurance cap event**

An insurance cap event occurs if:

1. TransGrid makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;
2. TransGrid incurs costs beyond the relevant policy limit: and
3. the costs beyond the relevant policy limit materially increase the costs to TransGrid in providing prescribed transmission services.

For this insurance cap event:

4. the relevant policy limit is the greater of:
    - a. TransGrid's actual policy limit at the time of the event that gives, or would have given rise to a claim; and
    - b. subject to paragraph c, 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.
    - c. the policy limit in paragraph b will not be taken as the greater policy limit if that policy limit at the time of the event that gives rise to a claim, was not available to TransGrid for reasons beyond its control.
  5. a relevant insurance policy is an insurance policy held during the 2015–18 regulatory control period or a previous regulatory control
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period in which TransGrid was regulated.

Note for avoidance of doubt, in assessing an insurance cap event cost pass through application under Rule 6A7.3, the AER will have regard to, amongst other things:

- i. the insurance policy for the event; and
- ii. the level of insurance that an efficient and prudent TNSP would obtain in respect of the event.

### **Insurer's credit risk event**

An insurer's credit risk event occurs if:

A nominated insurer of TransGrid becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, TransGrid:

1. is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or
2. incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things:

- i. TransGrid'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 TransGrid had reasonable opportunity to insure the risk with a different provider.

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## **13.2 TransGrid's revised proposal**

In its revised proposal TransGrid:

- did not accept our draft decision to reject its proposed cyber-related external attack event, gradual environmental contamination event and insurer default event
- proposed amendments to the definitions for the insurance cap and terrorism events that were set out in the draft decision to:

- enable TransGrid to make an application under the insurance cap event if it no longer has access to its current SICorp insurance
- include specific recognition that the Australian Reinsurance Pool be considered insurance for the purposes of the terrorism event.

### 13.3 AER's assessment approach

Our approach to assessing cost pass through events was described in detail in attachment 13 of our draft decision for TransGrid.<sup>2</sup>

Our approach has been guided by the NEO and the RPP. It provides the TNSP with a reasonable opportunity to recover at least the efficient costs the operator incurs<sup>3</sup>, while also providing effective incentives to promote economic efficiency.<sup>4</sup> It promotes a balance between the economic costs and risks for promoting efficient investment.<sup>5</sup>

We maintained this approach for the final decision.

#### 13.3.1 Interrelationships

As we discussed in the draft decision, the nominated pass through events are interrelated with other parts of this determination, in particular with TransGrid's proposed opex and capex allowances and the rate of return.<sup>6</sup> These interrelationships require the AER to balance the incentives to TransGrid in the various parts of our decision.

### 13.4 Reasons for final decision

This section sets out our reasons for the final decision on each pass through event. We discuss the arguments in TransGrid's revised proposal and how we have addressed them in this final decision.

For clarity, we have made two minor drafting changes to the definitions of all of TransGrid's pass through events. Specifically, we have removed the following final sentence from the factors we will consider when assessing a pass through application:

the extent to which a prudent provider could reasonably mitigate the impact of the event.<sup>7</sup>

This is because after further review we consider that it is unnecessary to include this in the definition as it is already a specified requirement in clause 6A7.3(j)(3) of the NER.

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<sup>2</sup> AER, *Draft decision, TransGrid transmission determination 2015–16: attachment 13*, November 2014, p. 8, 9.

<sup>3</sup> NEL, s. 7A(2).

<sup>4</sup> NEL, s. 7A(3).

<sup>5</sup> NEL, s. 7A(6).

<sup>6</sup> AER, *Draft Decision, TransGrid transmission determination 2015–16: attachment 13*, November 2014, p. 10.

<sup>7</sup> AER, *Draft Decision, TransGrid transmission determination 2015–16; attachment 13*, November 2014, pp. 14, 15.

That clause provides that we must take into account the efficiency of the NSP's decisions and actions when assessing cost pass through applications.

We have also consistently adopted the term "prescribed transmission services" as used in the NER across all of TransGrid's nominated pass through events.

### 13.4.1 Insurance cap event

In its initial proposal TransGrid proposed an insurance cap event. The insurance cap event allows businesses to make a pass through application if the business makes a claim under an insurance policy, and the actual costs to the business materially exceeds the policy limit.

In our draft decision for TransGrid we rejected TransGrid's definition of this event, and substituted it with our own.<sup>8</sup> Our amended definition included a definition for the relevant policy limit which requires the policy limit to be the greater of either the cap in TransGrid's policy at the time of the event, or that reflected in the insurance costs implicitly contemplated when we set TransGrid's forecast opex.

In its revised proposal TransGrid submitted that the AER's definition of the insurance cap event would unfairly limit TransGrid's ability to access this pass through event.<sup>9</sup> TransGrid stated that it is currently able to access the NSW Government's self-insurer, SICorp, which provides uncapped insurance coverage.<sup>10</sup> However, should TransGrid need to revert to the general insurance market during the regulatory control period (e.g. if it is privatised), the policy limit contemplated in our determination (which reflects its current arrangements) will likely be greater than any new, actual policy limit.

We consider that given TransGrid's circumstances, it would only need to access this event should it be required to change its policy and obtain a policy with a limit. We therefore have amended the definition of the insurance cap event to ensure that in those circumstances TransGrid is not excluded from accessing this event should its insurance arrangements change for reasons beyond its control.

TransGrid also proposed changes to clause 5 in the definition which describes what a relevant policy limit would be.<sup>11</sup> Clause 5 of the insurance cap definition in the draft decision stated:

A relevant insurance policy is an insurance policy held during the 2015–19 regulatory control period or a previous regulatory control period in which TransGrid was regulated.<sup>12</sup>

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<sup>8</sup> AER, *Draft decision, TransGrid transmission determination 2015–16; attachment 13*, November 2014, p. 14.

<sup>9</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, page 152.

<sup>10</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, page 152.

<sup>11</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, page 153.

<sup>12</sup> AER, *Draft decision, TransGrid transmission determination 2015–16; attachment 13*, November 2014, p. 14.

TransGrid considers our definition is unreasonable as it would restrict the ability to claim if TransGrid were to change its insurance arrangement with limits applying.<sup>13</sup>

We consider that TransGrid's concerns are related to the drafting of clause 4 and once our amendment is included (with the inclusion of clause 4c.) then no issue arises as to TransGrid's ability to apply for a pass through under this event should it no longer be able to obtain unlimited cover. Further, the definition does not restrict TransGrid to the insurance arrangement it had at the time of the determination. The definition is stating that a relevant policy has to be one that is held during the 2015–18 regulatory period, which could be *either* one held when the determination is made or a policy purchased later during the regulatory control period. It could also be a policy that was held in a previous period.

TransGrid also considered that 'direct control' in clause 3 in the definition should be replaced with 'prescribed transmission services'.<sup>14</sup> We agree that this wording is more relevant to a TNSP, and have amended the definition to reflect this.

Our revised definition for TransGrid's insurance cap event is in Table 13.1.

### 13.4.2 Insurer's credit risk event

In its initial proposal TransGrid proposed an insurer default event. This event would arise when an insurance allowance is provided, but as a result of the insolvency of an insurance provider, TransGrid is unable to recover outstanding insurance claims.<sup>15</sup> Other businesses have proposed similar events, and for simplicity we will refer to all of them as 'insurer's credit risk event'.

In our draft decision, we rejected this event and stated that TransGrid may be able to prevent this event occurring by purchasing insurance from reputable providers who have the capacity to satisfy any claims.<sup>16</sup> We also suggested that 'NSPs can assess the viability of an insurer by reviewing its track record, size credit rating and reputation.'<sup>17</sup>

TransGrid rejected our draft decision to reject its insurer default event.<sup>18</sup>

In its revised regulatory proposal, TransGrid submitted that the collapse of HIH Insurance was not foreseen by the market and that in the weeks prior to its collapse HIH still had an investment-grade rating.<sup>19</sup>

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<sup>13</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 153.

<sup>14</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 152.

<sup>15</sup> TransGrid, *Revenue proposal*, June 2014, p.230.

<sup>16</sup> AER, *Draft decision, TransGrid transmission determination 2015–18: attachment 13*, November 2014, p. 12.

<sup>17</sup> AER, *Draft decision, TransGrid transmission determination 2015–18: attachment 13, November 2014*, p. 13.

<sup>18</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 155.

<sup>19</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 155.

We have considered the example of HIH and how a similar event would impact TNSPs. If a similar event were to occur in the 2015–18 regulatory control period, the insurer may potentially still be unable to satisfy all insurance claims even where a TNSP had adopted the mitigation strategies we set out in our draft decision. The TNSP may therefore still potentially suffer a significant loss as a consequence of an insurer becoming insolvent and thereby unable to satisfy all insurance claims. TNSPs are also limited in the extent to which they can avoid such losses, short of taking out multiple insurance policies to cover the same risks. We accept that the options available to TNSPs to manage these risks are limited and, given the rarity of such events, may in fact result in greater expenditure than is prudent or efficient.

We therefore agree that, subject to the comments below, an 'insurer's credit risk event' can be consistent with the nominated pass through considerations.

We also do not consider that this pass through will weaken incentives for TNSPs to take out prudent insurance if appropriate balances are included in its definition. We consider a targeted definition of this event that highlights the importance of TransGrid reviewing and considering the viability of its selected insurer will maintain incentives on TransGrid to take prudent and efficient actions in relation to insurance.

We consulted with TransGrid on an appropriate definition for this event.<sup>20</sup> TransGrid stated that the proposed rewording of the event was reasonable except for the words "amongst other things" included in the Note. TransGrid submitted that these words are too broad and do not provide sufficient guidance in the factors that will be considered by us in the event of a pass through application.

We do not accept TransGrid's submission. Clause 6A.7.3(j) details the relevant factors that we must take into account when considering a pass through application, and clause 6A.7.3(j)(7) expressly provides that we must take into account any other factors the AER considers relevant. The notes detailed in the definition are to provide further clarity to all parties, but are not intended to limit clause 6A.7.3(j)(7).

We have also clarified that the definition may allow TransGrid to pass through claims that would have been made immediately after the insurer became insolvent and prior to TransGrid having had a reasonable opportunity to acquire new insurance for those risks. This amendment maintains an incentive on TransGrid to acquire new insurance as soon as reasonably possible after an insurance provider becomes insolvent.

The definition of this event is in Table 13.1.

### **13.4.3 Terrorism event**

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<sup>20</sup> TransGrid, *AER Information request - TransGrid - opex R4 - Pass through - Insurer's credit risk event*, 27 March 2015.

In its initial proposal TransGrid proposed a terrorism event. This pass through event would allow TransGrid to apply to pass through costs associated with terrorism events to consumers.

In our draft decision we rejected TransGrid's definition of this event, and substituted it with our own.

TransGrid's revised proposal adopted our definition, and asked that we also expressly state in the definition of the terrorism event, that the Australian Reinsurance Pool under the *Terrorism Insurance Act 2003* is insurance against the event. This is consistent with the intent of our draft decision.<sup>21</sup>

We accept TransGrid's proposal and have expressly referred to the Australian Reinsurance Pool in the definition of the terrorism event. The definition of this event is in Table 13.1.

#### 13.4.4 Cyber-related external attack event

TransGrid proposed this pass through event which would allow it to apply to pass through costs to consumers associated with cyber-related external attacks.<sup>22</sup> Cyber-related attacks that are as a result of a terrorist act could possibly be passed through to consumers through the terrorism event.

In our draft decision we rejected the cyber-related external attack event because:

- we did not consider the event is clearly defined
- TransGrid did not provide detailed explanation of steps it has taken to prevent or mitigate such an attack from occurring, and
- TransGrid did not satisfactorily explain why insurance would not be available.<sup>23</sup>

TransGrid did not accept this in its revised proposal.

In its revised proposal TransGrid stated that the main cyber-related risks it is referring to are those that may impact the high voltage electricity network.<sup>24</sup> However, this additional information does not provide detailed explanation of the specific risk that TransGrid is referring to, why it is a high cost risk and why it cannot take actions to prevent and mitigate the risk.<sup>25</sup> A broad range of events could still fall within this description.

TransGrid also states in its revised proposal that it continues to explore the possible relevant insurance covers available.<sup>26</sup> However, we do not consider this provides

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<sup>21</sup> AER, *Draft decision, TransGrid transmission determination 2015–18: attachment 13*, November 2014, p. 12.

<sup>22</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 156.

<sup>23</sup> AER, *Draft decision, TransGrid transmission determination 2015–18: attachment 13*, November 2014, p. 13.

<sup>24</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 156.

<sup>25</sup> NER, cl. 6A.6.9; NER glossary, definition of 'nominated pass through event considerations'.

<sup>26</sup> TransGrid, *Revised revenue proposal, 2014/15-2017/18*, January 2015, p. 156.

sufficient information to address why insurance is not available. We consider that insurance is an important consideration to limit the impact of the event.<sup>27</sup>

TransGrid is also provided an allowance for IT expenditure that should be used, in part, for securing its assets from such an event.

Consistent with the regulatory incentive framework, we consider that if there is too much reliance on ex-post measures TransGrid has disincentives to take prudent actions to manage the risk in the first place. The potential to recover costs by way of a pass through should not form the basis of any risk management decision by TransGrid.

We maintain our view that TransGrid is in a better position than consumers to prevent and mitigate the costs associated with such an event.<sup>28</sup> We therefore reject TransGrid's proposed cyber-related external attack event.

### 13.4.5 Gradual environmental contamination event

TransGrid proposed this event which would allow TransGrid to recover the costs associated with gradual environmental damage.<sup>29</sup>

In our draft decision we rejected this event because:

- the event is not clearly defined
- TransGrid did not provide detailed explanation of steps it has taken to prevent or mitigate such an attack from occurring, nor has it demonstrated any processes it has implemented to make itself aware of the risks and therefore better able to mitigate the risks of the event occurring
- the proposed event would allow TransGrid to recover costs of events caused by TransGrid and could allow it to have disregard for the consequences of its actions today, and
- TransGrid has not explained why it cannot obtain insurance for the event.<sup>30</sup>

In its revised proposal TransGrid has confirmed that its current, and previous, insurance arrangements do not cover gradual environmental damage.<sup>31</sup> It also states that while some forms of environmental pollution coverage are available, TransGrid has not taken this cover as it has been relatively narrow and at a high premium.<sup>32</sup>

Nonetheless, in its revised proposal TransGrid has not been able to clearly define the event. Nor has it demonstrated that it has implemented any processes to make itself

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<sup>27</sup> NER, cl. 6A.6.9; NER glossary, definition of 'nominated pass through event considerations'.

<sup>28</sup> NER, cl. 6A.6.9; NER glossary, definition of 'nominated pass through event considerations'.

<sup>29</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 157.

<sup>30</sup> AER, *Draft decision, TransGrid transmission determination 2015-18: attachment 13*, November 2014, p. 14.

<sup>31</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 158.

<sup>32</sup> TransGrid, *Revised revenue proposal 2014/15-2017/18*, January 2015, p. 159.

aware of environmental concerns and therefore prevent or mitigate the risk from occurring.<sup>33</sup>

Therefore we do not consider transferring the risk of a gradual environmental contamination event to consumers is appropriate, or the most efficient outcome. We consider TransGrid should face incentives to actively prevent, manage and mitigate such an event from occurring.

Our final decision is therefore to reject this event.

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<sup>33</sup> NER, cl. 6A.6.9; NER glossary, definition of 'nominated pass through event considerations'.