



FINAL DECISION
AusNet Services distribution
determination
2016 to 2020

Attachment 15 – Pass through
events

May 2016

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Note

This attachment forms part of the AER's final decision on AusNet Services' distribution determination for 2016–20. It should be read with all other parts of the final decision.

The final 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 – f-factor scheme

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
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

Shortened form	Extended form
repex	replacement expenditure
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 event³.

In addition to these prescribed events, other (nominated) pass through events may be specified in a determination for a regulatory control period.⁴

This attachment sets out our decision on the nominated pass through events that will apply to AusNet Services for the 2016-20 regulatory control period.

15.1 Final decision

Our final decision is that the nominated pass through events set out in Table 15.1 will apply to direct control services provided by AusNet Services for the 2016–20 regulatory control period.

Table 15.1 Approved nominated pass through events

Pass through event	Definition
Insurance cap event	An insurance cap event occurs if: (a) AusNet Services makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy; (b) AusNet Services incurs costs beyond the policy limit; and

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

² NER, cl. 6A.7.3(a1)(1)–(4) / 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

³ The retailer insolvency event is not available to Victorian DNSPs until the commencement of the National Energy Retail Law in Victoria.

⁴ NER, cl. 6A.7.3(a1)(5) / 6.6.1(a1)(5).

Pass through event	Definition
	<p>(c) the costs beyond the policy limit increase the costs to AusNet Services in providing direct control services.</p> <p>For this Insurance Cap Event:</p> <p>(d) a relevant insurance policy is an insurance policy held during the 2016-20 regulatory control period or a previous regulatory control period in which AusNet Services was regulated.</p> <p>Note in making a determination on an Insurance Cap Event, the AER will have regard to, amongst other things:</p> <ul 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) any assessment by the AER of AusNet Services' insurance in making its distribution determination for the relevant period.
Natural disaster event	<p>Natural disaster event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2016-20 regulatory control period that increases the costs to AusNet Services 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, amongst other things:</p> <ul style="list-style-type: none"> (i) whether AusNet Services has insurance against the event (ii) the level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Terrorism event	<p>Terrorism event means 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:</p> <ul style="list-style-type: none"> (a) 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 (b) increases the costs to AusNet Services in providing direct

Pass through event	Definition
	<p>control services.</p> <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> (i) whether AusNet Services 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.
Retailer insolvency event	<p>Until such time as the National Energy Retail Law set out in the Schedule to the National Energy Retail Law (South Australia) Act 2011 of South Australia is applied as a law of Victoria, retailer insolvency event has the meaning set out in the NER as in force from time to time, except that:</p> <ul style="list-style-type: none"> (a) where used in the definition of 'retailer insolvency event' in the NER, the term 'retailer' means the holder of a licence to sell electricity under the Electricity Industry Act 2000 (Vic); and (b) other terms used in the definition of retailer insolvency event in the Rules as a consequence of amendments made to that definition from time to time, which would otherwise take their meaning by reference to provisions of the NER or National Energy Retail Law not in force in Victoria, take their ordinary meaning and natural meaning, or their technical meaning (as the case may be). <p>For the purposes of this definition the terms 'eligible pass through amount' and 'positive change event' where they appear in the NER are modified in respect of this retailer insolvency event in the same manner as those terms are modified in respect of the retailer insolvency event prescribed in the NER from time to time.</p> <p>Note: This retailer insolvency event will cease to apply as a nominated pass through event on commencement of the National Energy Retail Law in Victoria.</p>
Insurer credit risk event	<p>An insurer credit risk event occurs if:</p> <p>An insurer of AusNet Services becomes insolvent, and as a result, in respect of an existing or potential insurance claim for a risk that was insured by the insolvent insurer, AusNet Services:</p> <ul style="list-style-type: none"> • is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under

Pass through event	Definition
	<p>the insolvent insurer's policy; or</p> <ul style="list-style-type: none"> incurs additional costs associated with 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, amongst other things,</p> <ul style="list-style-type: none"> AusNet Services' attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation. In the event that a claim would have been made after the insurance provider became insolvent, whether AusNet Services' had reasonable opportunity to insure the risk with a different provider.

15.2 AusNet Services' revised proposal

Our preliminary decision approved the following nominated pass through events for AusNet Services:⁵

- Insurance cap event
- Natural disaster event
- Terrorism event.

We also agreed with AusNet's proposal that the pass through provisions apply to direct control services, encompassing both standard and alternative control services.

Our draft decision did not approve AusNet Services' proposed Power of Choice event. AusNet Services did not include the Power of Choice pass through event in its revised proposal, but provided further discussion with respect to the recovery of this category of costs.⁶

AusNet Service's revised regulatory proposal included two new nominated pass through events:⁷

- Retailer insolvency event

⁵ AER, *Preliminary Decision AusNet Services distribution determination 2016 to 2020, Attachment 15 - Pass through events*, October 2015.

⁶ AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, 6 January 2016, p. 6-2.

⁷ AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, 6 January 2016, p. 6-2

- Insurer credit risk event.

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. However, in doing so we also consider factors that may be relevant to our assessment of an application made in respect of an event, to test the workability of the event under the pass through mechanism.

15.3.1 Assessment of nominated pass through events

The NER include the following pass through events for all distribution determinations:⁸

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

They also allow a service provider to propose other events be specified in a determination as a pass through event for that determination.⁹ Our final decision must include a decision on the additional (nominated) pass through events that are to apply for the regulatory control period.¹⁰

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide that the service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing services and complying with its obligations.¹¹ They also provide incentives to promote economic efficiency.¹² 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.¹³ 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.¹⁴

⁸ NER, cll. 6A.7.3(a1)(1)–(4) / 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in NER Chapter 10: Glossary.

⁹ NER, cll. 6A.7.3(a1)(5) / 6.6.1(a1)(5).

¹⁰ NER, cll. 6A.14.1(9) / 6.12.1(14).

¹¹ NEL, s. 7A(2).

¹² NEL, s. 7A(3).

¹³ NEL, s. 7A(6).

¹⁴ NEL, s. 7; AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 6.

In determining whether we accept a nominated pass through event, we must take into account the nominated pass through event considerations:¹⁵

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 unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events.¹⁶
- 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

¹⁵ NER, cl. 6A.6.9(b) / 6.5.10(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

¹⁶ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 19.

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.¹⁷

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.¹⁸ 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.¹⁹

As a matter of good regulatory practice, one additional matter²⁰ we take into account is consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.²¹

Another additional matter we take into account²² is how an application to pass through costs after an event occurs will be assessed, and the workability of the nominated pass through event in the context of the NER cost pass through mechanism. This is discussed in section 15.3.2 below.

15.3.2 Assessment of pass through applications

A pass through event is triggered when a defined event occurs, and entails the service provider incurring materially higher (or lower) costs than it would have occurred but for that event.²³ When the change in costs is positive (that is, costs increase), the service provider may seek our approval to pass through an increase in the costs that it has incurred and is likely to incur over the regulatory control period to its users.²⁴ When the change in costs is negative (and costs decrease), the service provider must provide us with a statement of the amount to be passed through.²⁵

The pass through mechanism does not allow a service provider to pass through any change in its actual costs resulting from an event. As the AEMC has noted:²⁶

The natural incentive properties of cost pass throughs are very weak. There is no direct financial benefit to the [service provider] from out performing in relation to those events that are covered by cost pass throughs, unlike the incentive arrangements for operating expenditure captured in the building blocks.

¹⁷ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 20.

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

¹⁹ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p.8.

²⁰ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (e).

²¹ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 18.

²² NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (e).

²³ NER, Chapter 10: Glossary, definitions of 'positive change event' and 'negative change event'.

²⁴ NER, cll. 6A.7.3(c) / 6.6.1(c).

²⁵ NER, cll. 6A.7.3(f) / 6.6.1(f).

²⁶ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 3.

...the NER allow the AER to take into account the efficiency of the provider's decisions and actions in relation to the risk, as an attempt to impose some incentives to not overspend in relation to cost pass throughs. However, the incentives to find cost efficiencies on matters that can be claimed as cost pass through events are very poor.

A materiality threshold is first applied so that an application to pass through costs (whether positive or negative) can only be made where the total change in costs resulting from the event is more than one per cent of the annual revenue requirement for the service provider for the relevant regulatory year.²⁷

In making a determination on the amount to be passed through, we must then take into account:²⁸

- the information provided to us by the service provider
- the increase in the costs of providing direct control services that the service provider has incurred and is likely to incur (or the costs in the provision of prescribed transmission services the service provider has saved and is likely to save) until:
 - the end of the regulatory control period in which the event occurred; or
 - if the distribution determination for the regulatory control period following that in which the event occurred does not make any allowance for the recovery of that increase in costs (or the pass through of those cost savings) – the end of the regulatory control period following that in which the event occurred;
- for an increase in costs, the efficiency of the service provider's decisions and actions in relation to the risk of the event, including whether the service provider has failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass through amount in respect of that event and whether the service provider has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of that event;
- the time cost of money based on the allowed rate of return for the service provider for the regulatory control period in which the pass through event occurred;
- the need to ensure that the service provider only recovers any actual or likely increment in costs to the extent that such increment is solely as a consequence of a pass through event;
- in the case of the prescribed tax change event, any change in the way another tax is calculated, or the removal or imposition of another tax, which, in our opinion, is complementary to the tax change event concerned;
- whether the costs of the pass through event have already been factored into the calculation of the service provider's annual revenue requirement for the regulatory

²⁷ NER, Chapter 10: Glossary, definition of 'materially'.

²⁸ NER, cl. 6A.7.3(j) / 6.6.1(j).

control period in which the pass through event occurred or will be factored into the calculation of the provider's annual revenue requirement for a subsequent regulatory control period;

- the extent to which the costs that the service provider has incurred and is likely to incur are the subject of a previous determination we have made on a cost pass through application; and
- any other factors we consider relevant.

What other factors may be relevant to a particular pass through event must—to some extent—be determined on a case by case basis. However, for some events there may be additional factors that can be identified in advance. Where this is the case for nominated pass through events, we include these factors in the approved definitions of those events as part of our determination. This is good regulatory practice for two reasons:

1. It provides transparency and predictability to service providers and users, and allows service providers to address these factors directly in cost pass through applications.
2. It allows us, service providers and users to consider and engage on how a nominated pass through event will operate during the regulatory control period, and therefore to better take into account the nominated pass through event considerations when defining an approved event.

15.3.3 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 building block 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 building block 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.²⁹

For smaller projects, a service provider should generally utilise its existing expenditure allowance.³⁰ This is reflected in the materiality threshold that applies to applications for cost pass through determinations.³¹

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.³²

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.³³

15.4 Reasons for final decision

The following paragraphs set out the reasons for our decisions on AusNet Services' proposed pass through events.

15.4.1 Insurance cap event, natural disaster event and terrorism event

Our preliminary decision accepted AusNet Services' proposed natural disaster and terrorism events and the corresponding definitions. AusNet Services made no changes to these in its revised proposal.³⁴ Our preliminary decision approved AusNet Services' proposed insurance cap event, subject to a typographical correction³⁵ which AusNet Services made in its revised proposal.

We have further considered the definitions of insurance cap event, natural disaster event and terrorism event in concurrent regulatory proposals and have concluded that a number of refinements are desirable.

In relation to the insurance cap event, our preliminary decision and AusNet Services' revised proposal both provide that the relevant policy limit for this event is the greater of:

²⁹ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, pp. 19–20.

³⁰ AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, p. 186.

³¹ NER, Chapter 10: Glossary, definition of 'materially'.

³² 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.

³³ NER, cl. S6A.2.1(f)(1)(ii) / S6.2.1(e)(1)(ii).

³⁴ AER, *Preliminary Decision AusNet Services distribution determination 2016 to 2020, Attachment 15 - Pass through events*, October 2015.

³⁵ The typographical correction was to refer to the correct regulatory control period.

- (a) AusNet Services' 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.

The second limb was included to avoid a perverse incentive for an NSP to reduce its expenditure on insurance below prudent efficient levels, thereby reducing its operating expenditure relative to the approved forecast by transferring insurable risks to its customers instead of through genuine efficiencies. However we have considered recent submissions in other regulatory processes,³⁶ and we accept that a firm's approved operating expenditure allowance may not unambiguously imply a particular level of insurance cover. We have therefore removed this limb from the definition, and added a note that we will take into account, where relevant, any assessments or analysis we have undertaken in relation to insurance when approving AusNet Services' distribution determination.

We have amended the natural disaster event to remove the adjectives 'major' and 'materially' from the definition - this will avoid any confusion with the materiality threshold applying to all pass through events. We have also removed the reference to whether a government authority has declared an occurrence to be a natural disaster - this consideration received criticism in other regulatory processes on the basis it could create uncertainty and introduce irrelevant considerations. While we do not believe these concerns are well founded, we are satisfied it is unnecessary to refer to it explicitly in the definition.

We also amended the definition of terrorism to remove the reference to 'materially', again to avoid any confusion with the materiality threshold applying to all pass through events.

We invited AusNet Services' comments on the modifications set out above. AusNet Services expressed its preference for the draft decision definitions to stand in the absence of an explanation for the changes, but went on to state it had no comments on the terrorism event or the natural disaster event.³⁷

On the insurance cap event, AusNet Services did not comment on the policy limit issue discussed above but noted possible concerns with paragraph (e) of the definition.³⁸ This provides that the service provider will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of the service provider in relation to any aspect of the network or the service provider's business. This clause was included in the definition put forward by the service provider in another regulatory

³⁶ ActewAGL Distribution, *Response to AER's draft determination, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 125; CitiPower, *Revised Regulatory Proposal 2016-2020*, January 2016, pp.420–421; Powercor, *Revised Regulatory Proposal 2016-2020*, January 2016, pp. 412-413.

³⁷ AusNet Services, Response to information request 53 [email to AER], 30 March 2016.

³⁸ AusNet Services, Response to information request 53 [email to AER], 30 March 2016.

process, and we have adopted it in acknowledgement that a service provider may operate its distribution business through more than one company structure. While we consider this a beneficial measure for service providers, and have therefore included it in the definition of insurance cap event for concurrent distribution determinations, we have excluded it from the definition in AusNet Services' determination.

15.4.2 Retailer insolvency event

We accept the retailer insolvency pass through event nominated in AusNet Services' revised proposal, with one modification to the definition.

Retailer insolvency is a category of prescribed pass through event under the NER,³⁹ which defines it as:

The failure of a retailer during a regulatory control period to pay a Distribution Network Service Provider an amount to which the service provider is entitled for the provision of direct control services, if:

- (a) an insolvency official has been appointed in respect of that retailer; and
- (b) the Distribution Network Service Provider is not entitled to payment of that amount in full under the terms of any credit support provided in respect of that retailer.

In our preliminary decision we noted that AusNet Services had incorrectly identified the pass through events prescribed in the NER as including, for AusNet Services, a retailer insolvency event. We directed AusNet Services' attention to the nominated retailer insolvency event approved in our preliminary decisions for other distributors should it wish to pursue this option:⁴⁰

Prior to the commencement of the National Energy Customer Framework in Victoria, retailer insolvency event has the meaning set out in the NER as in force from time to time.

Note: This retailer insolvency event will cease to apply as a nominated pass through event on commencement of the National Energy Customer Framework in Victoria.

In its revised proposal AusNet Services proposed an alternative definition, which it considered:⁴¹

- Maintains the policy objectives of a retailer insolvency pass through event

³⁹ NER, cl. 6.6.1(a1).

⁴⁰ AER, *Preliminary Decision AusNet Services distribution determination 2016 to 2020, Attachment 15 - Pass through events*, October 2015, pp. 15-14 to 15-15.

⁴¹ AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, 6 January 2016, p. 6-7.

- Better reflects the legislative process for adopting the National Energy Customer Framework in Victoria, and by elevating the content of the 'note' removes any uncertainty as to its legal effect
- Ensures that should the materiality threshold that applies to the prescribed retailer insolvency event be removed by the AEMC in its final determination for rule change ERC0172, the nominated pass through event will not be subject to a materiality threshold either.

AusNet Services' proposed definition (with alternative text underlined) is:⁴²

Until such time as the National Energy Retail Law set out in the Schedule to the National Energy Retail Law (South Australia) Act 2011 of South Australia is applied as a law of Victoria, retailer insolvency event has the meaning set out in the NER as in force from time to time, except that:

(a) where used in the definition of 'retailer insolvency event' in the NER, the term 'retailer' means the holder of a licence to sell electricity under the Electricity Industry Act 2000 (Vic) or an exemption from the requirement to hold a licence to sell electricity under that Act; and

(b) other terms used in the definition of retailer insolvency event in the Rules as a consequence of amendments made to that definition from time to time, which would otherwise take their meaning by reference to provisions of the NER or National Energy Retail Law not in force in Victoria, take their ordinary meaning and natural meaning, or their technical meaning (as the case may be).

For the purposes of this definition, the terms 'eligible pass through amount' and 'positive change event' where they appear in the NER are modified in respect of this retailer insolvency event in the same manner as those terms are modified in respect of the retailer insolvency event prescribed in the NER from time to time.

Note: This retailer insolvency event will cease to apply as a nominated pass through event on commencement of the National Energy Customer Framework⁴³ in Victoria.

We accept each of these amendments except for the reference to exempt retailers in paragraph (a). The first and last of the amendments simply clarify our original intent, while paragraph (b) deals with the possibility that future amendments to the NER prescribed event will introduce terms that are not defined in applicable (Victorian or national) energy law.

⁴² AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, 6 January 2016, pp. 6-6 to 6-7.

⁴³ In the Note to the definition, AusNet referred to the National Energy Customer Framework, which was referred to in the Note to the draft decision definition. We have since amended this to 'National Energy Retail Law'.

However, we consider including exempt retailers in paragraph (a) would not achieve the objective of aligning the nominated retailer insolvency event with the corresponding event prescribed in the NER.⁴⁴ A 'retailer', for the purposes of the NER event "means a person who is the holder of a retailer authorisation issued in respect of the sale of electricity". It does not include a person who is exempt from the requirement to hold a retailer authorisation, as contemplated by proposed sub-clause (a). This narrower definition is also consistent with the definition of 'retailer' in Victoria's Electricity Industry Act:⁴⁵

retailer means the holder of a licence to sell electricity otherwise than through the wholesale electricity market;

We have therefore excluded the reference to exempt retailers from the definition of retailer insolvency event. We have consulted with AusNet Services on the final form of this definition. AusNet Services did not comment on the exclusion of exempt retailers but corrected the reference in the note to 'the National Energy Customer Framework', which correctly reads 'the National Energy Retail Law'.

15.4.3 Insurer credit risk event

This event allows a service provider to pass through costs if an insurer becomes insolvent and the service provider is thereby subject to higher or lower premiums, or a higher or lower claims limit or deductible. AusNet Services did not propose an insurer credit risk event in its initial proposal. Noting that we allowed an insurer credit risk event in our preliminary decision for other Victorian distributors, it included that event in its revised proposal.

The definition proposed by AusNet Services is substantially identical to that we approved in our draft decisions for other Victorian distributors. Having regard to the nominated pass through event considerations, we consider it is appropriate to include it in the distribution determination on the basis that:

- Increased costs arising from the failure of a service provider's insurer is not covered by one of the prescribed pass through events
- The type of event can be clearly identified at the time the distribution determination is made
- A prudent service could not necessarily prevent the event occurring or fully mitigate its impacts, although its choice of insurer and its actions in arranging alternative insurance would be relevant to assessing a pass through amount
- Insurance against the event appears likely to be unavailable or inefficient.

⁴⁴ NER, r. 6.6.1(a1).

⁴⁵ *Electricity Industry Act 2000* (Vic), s. 3.

We have made one minor amendment to the definition in AusNet Service's proposal to remove a redundant word.⁴⁶

15.4.4 Power of Choice costs

While AusNet did not include a pass through event for Power of Choice costs in its revised proposal, it provided further discussion with respect to recovery of this category of costs.⁴⁷ We address this in the following paragraphs.

'Power of Choice' refers to the package of reforms to the national electricity market framework to increase the responsiveness of the demand side to evolving market, technological developments and changing consumer interests over the next 15 to 20 years.⁴⁸ AusNet's original proposal included a pass through for costs associated with the Power of Choice reforms in the following terms:

“A Power of Choice event occurs if:

1. The AEMC publishes notice of the making of a rule under sections 96A, 102 or 102A of the National Electricity Law; and

2. The rule is:

(a) The National Electricity Amendment (Improving demand side participation information provided to AEMO by registered participants) Rule 2015 No. 4; or

(b) The National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 No. 9; or

(c) The National Electricity Amendment (Customer access to information about their energy consumption) Rule 2014 No. 7; or

(d) The final rule made in determination of Rule change proposal ERC0169 Expanding competition in metering and related services; or

(e) The final rule made in determination of the rule change request submitted by AEMO on 2 October 2014 which is identified by the AEMC as ERC0179 Embedded Networks; or

(f) The final rule made in determination of the rule change request submitted by AEMO on 17 December 2014 which is identified by the AEMC as ERC0181 Embedded Networks; or

(g) Any other final rule made in determination of a rule change proposal which reflects, in whole or in part, one or more of the recommendations made by the

⁴⁶ Paragraph (a) of our definition now commences 'an insurer of the service provider becomes insolvent' instead of 'a nominated insurer of the service provider becomes insolvent'. The word 'nominated' was redundant.

⁴⁷ AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, 6 January 2016, p. 6-2.

⁴⁸ AEMC, *Information Sheet Power of Choice Review Final Report and Recommendations*, 30 November 2012.

AEMC in Power of choice review – giving consumers options in the way they use electricity, Final Report dated 30 November 2012; and

3. At the date notice under paragraph 1 is given, implementing or complying with that rule and each rule in paragraph 2 made earlier in time, individually or in aggregate and in any combination, materially increases the cost of providing direct control services.

If, at the time the Power of Choice event occurs:

4. The AEMC has not published notice of the making of one or more of the rules in paragraph 2; and

5. AusNet Services cannot provide evidence of the actual or likely increase in costs that it will or is likely to incur in providing direct control services as a result of the making of that rule or rules, AusNet Services may seek the approval of the AER later in the regulatory control period to pass through those amounts on the basis that the materiality threshold is met.”

This definition would have allowed pass through of Power of Choice cost increases where, in aggregate, they materially increase the cost of providing direct control services, even though the rule changes individually may not exceed the materiality threshold.

We rejected the Power of Choice event in our preliminary determination because rule changes are already covered by another category prescribed pass through event, the regulatory change event or the service standard event.⁴⁹ Like the other prescribed pass through events, these allow pass through when the cost impacts are material but not otherwise.

AusNet Services contended the materiality threshold may prevent recovery of Power of Choice costs under the prescribed events because each reform may not be significant on its own. Our preliminary decision considered this did not warrant allowing a nominated pass through for aggregated costs of Power of Choice reforms.⁵⁰

AusNet Services did not include a Power of Choice pass through in its revised proposal, indicating it would instead:

- seek to fund these rule changes where the available information is sufficiently certain to ensure a cost estimate that reasonably reflects the criteria for operating and capital expenditure, and

⁴⁹ NER Chapter 10: Glossary, definitions of nominated pass through event considerations (paragraph (a)) and regulatory change event.

⁵⁰ AER, *Preliminary Decision AusNet Services distribution determination 2016 to 2020, Attachment 15 - Pass through events*, October 2015, p. 15-14.

- rely on the prescribed pass through events to recover costs arising from the remaining rule changes.⁵¹

We are satisfied with this approach. As discussed in attachments 6 (capex) and 7 (opex) of this final decision, we have made allowance in AusNet's expenditure forecasts for Power of Choice reforms to the extent that they meet the capex and opex criteria.

Despite not including a Power of Choice event in its revised regulatory proposal, AusNet Services expressed the view that:⁵²

The manner in which the Power of Choice reforms are given effect should not preclude AusNet Services from recovering the costs it incurs arising from those rule changes. The Preliminary Decision is inconsistent with the principle that AusNet Services should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing direct control network services and complying with a regulatory obligation or requirement. Although the Preliminary Decision acknowledges that the Power of Choice rule changes are interrelated but that some may not result in a material change in costs and thus be unrecoverable, the AER dismisses these matters on the basis that they are not unique to the Power of Choice.

We acknowledge that our approach may result in a DNSP not recovering 100 percent of its Power of Choice expenditure. However, the pass through framework under the NEL and NER demands that we ask whether a suggested pass through event is already covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the NER. This is one of the 'nominated pass through considerations' discussed above. The reforms comprising the Power of Choice package are plainly within the existing categories, 'regulatory change event' or 'service standard event'. This is so even though the cost impact of individual reforms may not exceed the materiality threshold and may therefore be unrecoverable.

We also think allowing a Power of Choice pass through would be inconsistent with the incentive regulation model established under the NEL and the NER. It would weaken the effectiveness of the materiality limb, which is a significant element of the model: the one per cent threshold allows a business to recover only cost increases that are significant in any given year. The same threshold allows the business not to effect a negative cost pass through where its costs decrease immaterially, instead allowing them to keep the benefit of that decrease. Weakening the threshold has the potential to allow pass throughs for normal variations in business costs. This would reduce the incentives on service providers to operate their businesses efficiently and minimise

⁵¹ AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, January 2016, p. 6-2.

⁵² AusNet Services, *Electricity Distribution Price Review 2016-20 - Revised Regulatory Proposal Chapter 6: Cost Pass Through*, January 2016, p. 6-5.

unexpected costs. This resembles a cost of service regulation, which would not be consistent with the incentive regulation regime.